New Rules for Taxing Pass-Through Income

It may be time to reconsider how to structure your practice.

BY JAMES D. KRICKETT

Pass-through entities such as partnerships, limited liability companies (LLCs), and S corporations, have long been extremely popular entities for solo practitioners and podiatry practices. In fact, one form of pass-through entity, the S corporation, is currently the most-used business entity. Limited liability companies (LLCs), are coming on strong as the pass-through most frequently being chosen today.

In addition to the increased liability protections, a key benefit of operating as a pass-through entity has been the fact that the podiatry practice's income is passed on to the principal's tax return where it is taxed at his or her personal tax rate. Generally, a pass-through entity will pay no tax on its profits. Under last December's Tax Cuts and Jobs Act (TCJA), however, individual tax rates were reduced with a top rate of 37%—far above the new 21% flat tax rate for incorporated practices and businesses.

To balance things out, lawmakers created a deduction of up to 20% for pass-through entities on so-called "qualified business income" or QBI. QBI is defined as net income from a practice or business without counting compensation and excluding investment income.

Although the deduction from pass-through income may be good news for some podiatric professionals, it will not help all podiatrists or podiatry practices.

Passing Through Practice Profits

In addition to profits being taxed only once, only when passed onto their personal tax returns, many podiatrists choose to operate as so-called "pass-through" entities because of the protection from personal liability. By electing to operate as a pass-through entity, a podiatric professional can benefit from the legal advantages available to practices with a corporate structure as well as the tax advantages available to a sole practitioner.

Of course, the main attraction of pass-through entities has been the tax savings for both the podiatry practice and its principals. But, a pass-through designation also allows a practice to have an independent life, separate from its principals. If a principal leaves the podiatry practice, or sells his or her shares, the pass-through entity can continue doing business relatively undisturbed. Maintaining the practice as a distinct, separate entity also creates a clear line between the principals and the practice, greatly improving the principal's liability protection.

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TCJA Pass-Through Practices and Businesses

Those podiatric professionals operating as pass-through entities are effectively taxed on earnings at their individual tax rates, much in the manner corporate owners are taxed on wages. Now, thanks to the TCJA, pass-through income can benefit from a unique 20% deduction.

The TCJA's 20% deduction applies to the first $315,000 of income (half that for single taxpayers) earned by podiatry practices operating as pass-through entities. For pass-through income above the threshold, the new law also provides a deduction for up to 20%—but only for "business profits."

Business profits are generally defined as income that has been reduced by the amount of "reasonable compensation" paid the practice's principal. That yet-to-be defined "reasonable" compensation, often referred to as "wage income" does not qualify as pass-through income for the purposes of that 20% deduction.

Continued on page 88

New Tax Rules (from page 87)

There are, however, still more, equally strong, safeguards lawmakers incorporated in the TCJA to ensure that not all practice profits will qualify as pass-through income.

Service Businesses May Not Count

Despite being limited to "business profits," the deduction from pass-through income may be good news for some, but not all podiatric professionals. This benefit will not help a number of so-called "service providers" because of restrictions placed on "specified service trades and businesses."

That's right, under the TCJA, so-called "service businesses" are not eligible for the 20% deduction. Businesses defined as service business include those in the fields of health as well as "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees."

All practices and businesses under the pass-through income thresholds, regardless of whether they're "service" professionals or not, can take advantage of the 20% deduction. The TCJA does, however, place limits on who can qualify for the pass-through deduction, with strong safeguards to ensure that so-called "wage income" does not receive the lower marginal tax rates for business income.

Service Business Maybe Will Count

Fortunately, the service business limitation doesn't always apply. Instead the limitation is phased in once taxable income exceeds $315,000 (for married couples) or $157,000 (for individuals). The phase-in range is $100,000 (for married couples), or $50,000 (for individuals) which means once taxable income exceeds $415,000 or $207,500, respectively, the QBI (Qualified Business Income) deduction is phased all the way down to zero for a podiatry practice or business.

Podiatric professionals practicing as, or participating in, pass-through entities lose things like fringe benefits, plus being required to pay themselves "reasonable" compensation and deal with the other restrictions.

It is, of course, important to recognize that the income phase-out for a specified service business or practice is based on the individual's personal tax return, not just on the amount of income from the practice or business. In fact, any income which contributes to the podiatric professional's taxable income can result in service income being phased out. Not only does it not need to be merely business income over the threshold, it doesn't even need to be wages or other active income.

A sizeable long-term capital gain can also contribute to a phase-out of the QBI deduction for specified service businesses. This means that even though long-term capital gain is eligible for the 15% capital gain tax rate (plus, the 3.8% Medicare surtax), it will impact the "true" marginal capital gain tax rate.

On the plus side, the Specified Service business limitation applies only to "specified" service business income, not all service businesses. And, the QBI deduction itself is calculated separately for each business, which means someone who owns/operates multiple businesses and practices—where some provide "specified" services and others do not—may see some QBI deductions phased out while others are not.

Further complicating things, the deduction of all pass-through practices and businesses, whether they are personal service firms or not, may be limited based on a two-part formula. The deduction is partially limited by the greater of either 50% of the wages the practice pays its employees or 25% of wages plus 2.5% of the basis of the business' qualified property. Practice and business owners compare these calculations to 20% of their QBI. They may deduct only the smaller amount. This limit, too, phases in over the same taxable income range: between $315,000 and $415,000 for joint filers.

Continued on page 89

New Tax Rules (from page 88)

Lost with Pass-Throughs

Podiatric professionals practicing as, or participating in, pass-through entities lose things like fringe benefits, plus being required to pay thenmselves "reasonable" compensation and deal with the other restrictions. And, then, there is the elimination of a number of itemized, personal deductions to consider.

The vast majority of podiatrists receiving pass-through income are no longer able to deduct state and local income taxes and are permitted to write off only $10,000 of their property taxes—all thanks to the TCJA.

As a general rule, the losses from a pass-through entity cannot be claimed by S corporation shareholders, LLC "members" or partners in excess of the amount they have invested, their "basis" in the pass-through entity. And, not too surprisingly, there are several other tax issues pass-through practices and businesses must consider.

Partners, for example, are considered to be self-employed, not employees, and required to file a Schedule SE with their Form 1040 and pay self-employment taxes.

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Because of this self-employed status, each partner is also responsible for paying his or her share of Social Security taxes and Medicare.

Partners are responsible for paying double what an employee would pay (because employers match employees' contributions). Of course, the partners' tax burden is reduced by an allowance for one-half of the self-employment tax that can be deducted from taxable income.

Taxing Pass-Throughs

While pass-through entities are generally not subject to federal income tax, they may be liable for and required to make estimated tax payments based on entity-level tax bill for previously unrecognized profits, the tax on so-called "Built-In Gains" (BIG) that resulted from an entity change. Other entity level taxes include a tax on passive income, voluntary and involuntary terminations, as well as a tax on profits accumulated rather than paid out.

With the 20% deduction phased out by the amounts of "reasonable" compensation paid to the practices' principals, restrictions for practices labeled as "service businesses," and with some podiatric professionals facing personal tax rates as high as 29.6%, it is little wonder that many have begun considering switching to the basic 'C' corporation for their practices.

Switching to Corporate Form

In the eyes of many experts, there is no longer a reason to operate any practice as an S corporation or other pass-through entity. However, converting from a pass-through entity to a regular 'C' corporation can be a complicated process requiring quite a few adjustments.

In order to determine how best to structure a practice for tax purposes, it will be necessary to take into account other factors. A sale of assets by an S corporation that was formerly a 'C' corporation during a "recognition period" is, for example, subject to the already mentioned BIG tax.

The BIG tax is imposed on the incorporated podiatric practice at the highest corporate tax rate, 21%, based on the appreciation in asset value from the date the incorporated practice switched to an S corporation. Shareholders may, of course, be subject to a second tax when sale proceeds are distributed.

This "double tax" created by imposing the BIG rules can be eliminated if the corporation holds and sells assets only AFTER the former 10-year recognition period has expired. Naturally, the longer the recognition period, the more difficult it is to avoid the double tax.

Under the former rules, distributions made by a S corporation converting to a regular 'C' corporation during the post-termination transition period (PTTP) can be tax-

Continued on page 90

New Tax Rules (from page 89)

free to the shareholders. Distributed funds from those accumulated adjustment accounts can also reduce the adjusted basis of the stock.

According to the new TCJA rules, adjustment of a terminated S corporation (even if only changing accounting methods) is taken into account ratably during a six-year period beginning with the year of change.

Decisions, Decisions

The annual tax return has long provided an opportunity to re-consider the options available to some podiatric practices. Entities with more than one shareholder, partner, or member can elect corporate status right on the federal tax returns. Thus, a partnership under state laws may elect to be taxed as a 'C' corporation, or S corporation, for federal taxes by using Form 8832 (Entity Classification Election). Unfortunately, those so-called "check-the-box" regulations say entities formed under a state's corporate laws are automatically classified as corporations and may not elect to be treated as any other type of entity.

Changing Business Entities

Changing circumstances, revised tax laws, and even the success of the podiatric practice might prompt a re-assessment of the type of entity used. Although many of the tax law's provisions apply to all business entities, confusion need not be the name of the game when choosing among the various entities—or choosing to be treated as a regular 'C' corporation.

Since some areas of the law specifically target each entity, choosing among the various entities can result in significant differences in federal income tax treatment. Remember, however, there is more to choosing the right structure for a podiatric practice than taxes.

Not only will the decision to change the practice entity have an impact on how much is paid in taxes, it will also affect the amount of paperwork required for the practice, the personal liability faced by the principals and, especially important in today's economy, the practice's ability to raise money.

To switch or not to switch? Knowing how much income will qualify for the new pass-through deduction is critical when determining whether it's advantageous to be a pass-through practice. Since every situation is different, the best approach when choosing a practice entity might be to ignore the possibility of further tax "reform."

If earlier tax law changes are any indication, the IRS can be expected to issue guidelines to help the podiatrist and his or her practice switch entities without incurring a penalty. In the meantime, ensuring that the practice qualifies for any or all of the new provisions should be a priority. To help in this decision-making process, professional advice is strongly recommended. **PM**

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