

2017 TAX ACT

TAX PLANNING FOR PROFESSIONALS

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[Criminal Tax Evasion - Part 1](#)

[Criminal Tax Evasion – Part 2](#)

[Criminal Tax Evasion – Part 3](#)

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2017 Tax Act – Tax Planning for Professionals

In response to a doctor's inquiry as to whether to switch to an S-corporation from a sole proprietorship I drafted the enclosed response. Although the 2017 Tax Act became law very recently (12/22/17) it is causing many complex questions, including an analysis of the new 20% tax deduction for pass-through entities.

The big question here is simple - whether or not to switch to an S-corporation from a sole proprietorship for a doctor?

Answer: does not matter. The new law regarding the 20% pass-through tax deduction is the same for both.

Other considerations including IRS tax audit risk, payroll taxes and asset protection may be the determining issues for an inquiring client.

The tax rules, under the 2017 Tax Act are very complex (and over the next year await Treasury Regs).

Since the tax bill was signed on 12/22/17, and it is now 12/27/17, do not be surprised if there is further analysis of these provisions that may impact the information presented herein.

As far as the initial information released to the public it appears to be the following: (I am still researching the new law, but this is a preliminary view that may be revised subject to further information received):

- 1) Under the 2017 Tax Act, sole proprietorships, S-corporation shareholders, and partners in a partnership, LLC members in a Limited Liability Company (which files partnership tax returns) will in 2018 be entitled to a deduction equal to 20% of their allocable share of business income. This deduction is for non-corporate taxpayers (declared on personal tax returns). This tax deduction is not allowed in computing AGI; instead it reduces taxable income. This tax deduction is taken on top of page 2 of Form 1040 (personal tax return) not on page 1 (where it would reduce adjusted gross income (AGI) and potentially cause taxpayer to lose or gain other tax benefits).
- 2) This tax provision is not permanent. It expires 12/31/2025. Additionally, between now and then subsequent tax legislation may impact it further.
- 3) The 20% tax deduction applies to all those filing jointly with income below \$315,000 and all those filing with income below \$157,500.
- 4) If the income is over these thresholds \$157,500 single taxpayer/ \$315,000 married filing jointly are also subject to a two-pronged test based on each pass-thru business W-2 wages.

The two-prong test limits the deduction to the greater of:
50% of Taxpayer W-2 wages paid by the business, or 25% of such W-2 wages plus 2.5% of the unadjusted basis (the original purchase price) of property used by the business for production of income.

This W-2 limitation does not apply if the taxpayer earns less than the income limits (i.e. low-income exception: \$157,500 single/ \$315,000 married).

- 5) There is a phase in of the limitations above the income thresholds for the 20% deduction. For single taxpayers the “low income exception” phases out with \$50,000 more income (\$207,500) for single taxpayer and \$100,000 more income (\$415,000) for married taxpayers filing jointly.

Above these higher income levels the 20% deduction phases out in entirety. At that point it appears that the deduction is limited to the two-pronged test for the wages (this fine point is still being researched at this time).

- 6) For example, an S-Corporation has \$5m income. Shareholder (Taxpayer) owns 20% and receives W-2 wages of \$150,000. Under this scenario, the Taxpayer receives \$1m (their share of S-Corp income) so 20% is \$200,000; and 50% of \$150,000 wages (\$75,000).

The test works as follows, the Taxpayer is entitled to a tax deduction equal to the lesser of:

1. \$200,000 (distribution) or \$75,000 (W-2 wages).
2. So for purposes of the tax return a \$75,000 deduction is allowed on combined \$350,000 (distribution/ W-2 wages) received which reduces the total taxable income to \$275,000 (\$350,000-\$75,000).

7) Engineers and Architects are entitled to the tax deduction regardless of their income level (i.e. the phase-out of the 20% tax deduction at \$207,500 single/ \$415,000 married). However, they are still subject to the W-2 limitations (2- pronged test).

8) Other business sectors including health, law, consulting, athletics, financial services and brokerage services are subject to the income thresholds (and phase-outs) and W-2 limitations.

Based on my preliminary research it appears that all high earners are going to be focused on the W-2 test, which may ultimately determine the tax deduction (not the amount of the pass-thru income).

Well I hope I have not thoroughly confused you (I have tried my best to put this in English, daunting task that it is now).

Your decision on whether to stay in a sole proprietorship should not be solely based on this new tax provision (which may be changed going forward and which expires 12/31/2025). Please additionally consider the following issues:

1. As a sole proprietorship you file a Schedule C for your business attached to your Form 1040. The Schedule C has a much higher risk of IRS audit. IRS audit risk is approx. 1% (1 of 100) and ascends to 35% (1 of 3) for those making over \$10m. In comparison the audit risk for an S-Corp /LLC /Partnership is 4/10th of 1% (i.e. 1 of 250)

2. As a sole proprietorship certain deductions may be disallowed (Schedule A which treats certain expenses as misc. itemized deductions which are allowed only to the extent they exceed 2 % of the individual's AGI (See IRC

Sec. 67 (a). Effectively all deductions under the 2% floor are disallowed. Since the top “blended” federal /CA income tax rates may be as high as 55% the loss of these Schedule A misc. itemized deductions may increase tax due.

3. For sole proprietorships any income received is subject to the FICA tax (2017 6.2% of the taxable wage base of \$127,200 i.e. \$7886) and the Medicare Tax of 1.45% on unlimited amount of wages (which is \$1884 on \$127,200 ie. 1.45 % of \$127,200). So the combined FICA/Medicare Tax of is \$9,730 (on \$127,200). As a sole proprietorship the combined Employer/Employee combined tax is \$19,460 annually. S-Corporations do not have payroll taxes imposed on an S-Distribution. If you receive a base salary (e.g. \$100,000) and there is \$127,200 more income so your combined income is \$227,200 the S-Corporation distribution of \$127,200 may save up to \$19,460 annually in payroll taxes that would otherwise be paid by you as a sole proprietor.

In addition, the sole proprietorship offers no asset protection (keep in mind 1.1m lawsuits are filed yearly in CA and doctors are considered “deep pocket defendants”). An S- Corp does not provide good asset protection (i.e. a creditor may seize the stock under a judgment lien/writ of execution) and only an S-Corporation in tandem with an LLC provides good asset protection.

So what to do? First and foremost determine what are your priorities. It appears to me an S-Corp is a much better choice than a sole proprietorship (lesser risk of IRS tax audit and smaller payroll taxes). Under the 2017 Tax Act both a sole proprietorship and/or S-Corp (LLC or Partnership) are all entitled to the 20% tax deduction for pass-thru income so that issue should not be the tax reason to go with an S-Corp.

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