



180 Montgomery Street · Suite 1950
San Francisco, CA 94104
phone : 415.394.7200
fax : 415.398.6501
web : moskowitzllp.com

The background of the page is a blurred photograph of an office interior. In the foreground, there is a wooden desk with several papers, a pen, and a calculator. The background shows office chairs and a wall with some papers. A large, semi-transparent blue rectangle is overlaid on the bottom half of the image, containing the main title text.

| Maximizing The
**20% TAX DEDUCTION
MEDICAL PRACTICE**

THE NEW 20% Deduction

The New Tax Law creates a new deduction that lowers the tax rates on income of Partnerships, Limited Liability Companies and S Corporations, which presents many tax planning opportunities. This lowers the effective tax rate on qualifying pass-through income from 37% to 29.6%.

The deduction has major limitations

- Qualified Trade or business
- Wage limitation
- Property limitation
- Netting Limitation

What is Qualified Business Income?

Qualified Business Income (QBI) is, essentially, the profit a pass-through business makes during a year.

QBI includes

- Rental income from a rental business
- Income from publicly traded partnerships
- Real estate investments trusts
- Qualified cooperatives

QBI does not include

- Dividend income
- Interest income
- S corporation shareholder wages
- Business income earned outside the United States
- Guaranteed payments to LLC members or partnership partners
- Capital gain or loss

Qualified Trade or Business

A qualified trade or business is a business other than a “specified service trade”. The definition of “specified service trade or business” has two parts.

01 *Specified occupations (including physicians)*

02 *A general definition (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 or owners)*



Specified Businesses

A “specified business” is performance of services in the fields of:

-
- Health
 - Law
 - Accounting
 - Actuarial Science
 - Performing Arts
 - Consulting
 - Athletics
 - Financial Services
 - Brokerage Services
 - Investing and investment management

Calculating the Deduction

Generally, the deduction is the lesser of:

- 20% of the taxpayer’s QBI
- The alternative base amount

The alternative base amount is the greater of:

- 50% of the W-2 wages with respect to a business, or
- The sum of 25% of the W-2 wages and 2.5% of the tax basis of the qualified property of the business

These limitations are meant to restrict the deduction to “real” businesses rather than investment partnerships or structured arrangements.

The Wage Limitation

The amount of W-2 wages for this limitation is subject to several caveats: (1) The term “W-2 wages” means, with respect to any partnership for any taxable year of such partnership; (2) the wages at issue must be properly allocable to the QBI at issue and cannot be unrelated wage expense; and (3) the term only include wages properly included in a return properly and timely filed with the Social Security Administration.

The Partnership Limitation

In the case of a partnership, the pass-through deduction is determined at the partner level. Each partner is treated as having W-2 wages equal to such person’s “allocable share” of the partnership’s W-2 wages. For these purposes, a partner’s allocable share of W-2 wages is determined in the same manner as the partner’s allocable share of wage expense.

Qualified Property

In order to help capital intensive businesses, the wage limit was expanded to include a qualified property calculation. “Qualified property” is tangible depreciable property that is utilized in the production of QBI. Deductions will be taken on your individual return.

Calculations apply to each separate business – businesses are not grouped into a single calculation.

What is “Qualified Property”?

The definition of “qualified property” for purposes of the wages/property limitation means:

- Tangible property of a character subject to the allowance for depreciation under Section 167
- Which is held by, and available for use in, the QTB at the close of the taxable year
- Which is used at any point during the taxable year in the production of QBI, AND
- For which the depreciation period has not ended before the close of the taxable year

The term “depreciable period” means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of:

- The date that is 10 years after such date, or
- The last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to section 168(g)).
- Thus, even if you elect to expense an asset, you get the benefit of the acquisition date tax basis.

Qualified Property: Partner Limitation.

The unadjusted basis of a partnership's qualified property allocated to the partner must be determined. Each partner is treated as having an "allocable share" of the partnership's qualified property. A partner's allocable share of the unadjusted basis of qualified property shall be determined in the same manner as the partner's or shareholder's allocable share of depreciation expense.

Medicine is a "Specified Service".

In the case of a partnership, the pass-through deduction is determined at the partner level. Each partner is treated as having W-2 wages equal to such person's "allocable share" of the partnership's W-2 wages. For these purposes, a partner's allocable share of W-2 wages is determined in the same manner as the partner's allocable share of wage expense.

Calculating Qualified Business Income

Step 1

Net income of your business without the salary or payments made to the owner for services. For a Sole proprietor this is simply Schedule C income, as the owner would not have wages reported on a W-2 within the business.

Step 2

Calculate the ratio, if any, of the income over the threshold limitation of \$157,500 for single taxpayers and \$315,000 for Married Filing Jointly taxpayers. The deduction is pro-rated for the amount you may be over the threshold limitation.



EXAMPLE

Doctor is a single taxpayer with taxable income of \$175,000. Part of that income is \$100,000 of Schedule C income from your practice. You paid employees \$120,000 in wages.

Step 1. A Calculate the “applicable percentage” - Taxable income, subtracting the threshold limitation amount and then divide that by \$50,000. This result is subtracted from 100% to give you the applicable percentage. In this case, the applicable percentage is 65%, calculated as 100% minus that amount. $[(\$175,000 - \$157,500)/\$50,000 = 35\%]$.

Step 2. Calculate the “applicable percentage” - Taxable income, subtracting the threshold limitation amount and then divide that by \$50,000. This result is subtracted from 100% to give you the applicable percentage. In this case, the applicable percentage is 65%, calculated as 100% minus that amount. $[(\$175,000 - \$157,500)/\$50,000 = 35\%]$.

Step 3. Determine includible W-2 wages, multiply \$120,000 (wages) by 65%, or \$78,000 and then apply the 50% limitation, resulting in a wage limitation of \$39,000.

Your deduction is the lesser of Step Two or Step Three. In this case, the 20% of QBI deduction is the lower of the two, \$13,000.

Non-medical practice income: No phase out

If your taxable income exceeds the threshold amounts of \$157,500 (S) or \$315,000 (MJF), wage and capital limits are phased in.

The rule basically says that once your taxable income reaches \$207,500 (S) or \$415,000 (MFJ), the QBI deduction is limited to 50% of your W-2 wages from that business OR the sum of 25% of W-2 wages from the business, plus 2.5% of qualified property acquisition. From the threshold of \$157,700/\$315,000 to the phaseout of \$207,500/\$415,000, the limitation is on a pro rata basis.

Calculate the Phase-in Amount

Step 1

Calculate 20% of your QBI.

Step 2

Calculate which is the greater of (1) 50% of your W-2 wages from this business or (2) the sum of 25% of W-2 wages + 2.5% of the unadjusted basis of all qualified property.



EXAMPLE: MARRIED COUPLE WITH NON-MEDICAL INCOME

Assume that you and your spouse file a joint return with taxable income of \$400,000. Your business (not an SSTB) income was \$175,000 and your share of W-2 wages paid by your business was \$60,000. There is no qualified property.

Step 1. (a) is 20% of your qualified business income, or \$35,000.

Step 2. (b) is 50% of W-2 wages, or \$30,000 (there's no qualified property).

Step 3. Calculate the applicable percentage of the phase in. Because (b) is less than (a), the wage limit applies. Your 20% deduction will be reduced by the phase-in. The applicable percentage is (taxable income of \$400,000 - cap of \$315,000)/\$100,000, or 85%.

Step 4. Reduce the tentative deduction (Step 1) of \$35,000 (a) by the difference between (a) and (b) (\$5,000) multiplied by the 85% phase-in (\$4,250). In this case, your deduction should be \$30,750. (\$35,000 (a) less the phase in amount, \$4,250).



199A TAX PLANNING

Set Wages at Optimum Level

A business owner's deduction under Section 199A is limited to the greater of 50 percent of W-2 wages or 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of all qualified property used or held by the business.

- Business owners may set their wages at an appropriate level.
- Taxable Income Threshold: \$157,000 for individuals, \$315,000 for married filing jointly
- Phase-Out Limit: \$207,500 for individuals, \$415,000 for married taxpayers
- The tax code defines W-2 wages as the sum of wages subject to withholding, elective deferrals and deferred compensation paid by the partnership, S corporation or sole proprietorship during a given tax year.

Here are some planning opportunities to optimize the taxable income and wage requirements of Section 199A:

- Hire independent contractors as employees.
- Make self-employed retirement plan contributions.
- Consider bunching itemized deductions.

Your tax advisor can evaluate these and other methods to maximize Section 199A eligibility within the context of your unique circumstances

Deduction Planning for Medical Practices

How to avoid having a business categorized as a specified service trade or business:

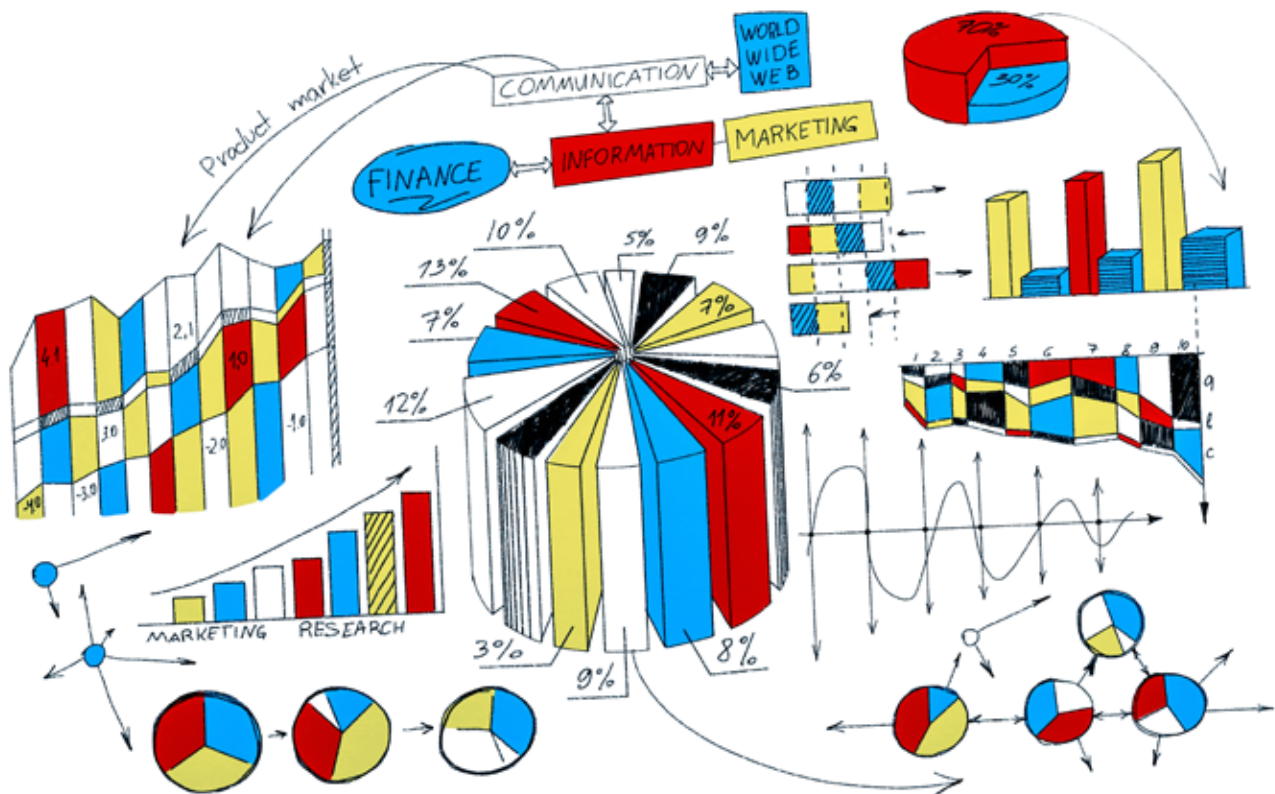
- Segregate professional services in separate entity from other business income.
- Characterize activities as the sale of a product rather than the providing of services.
- Distinguish between activities involving the providing of professional services by licensed physicians and nurses and activities such as operating medical office buildings.

EXAMPLE: RESTRUCTURING AS AN S CORPORATION

An individual makes \$1,000,000 annually selling medical equipment through a sole proprietorship that has no employees would not be entitled to a deduction. Why?

- Taxable income would exceed the Cutoff Threshold and,
- No W-2 wages or depreciable property associated with the business to support the deduction.
- Plus, 100% of the owner's income would be subject to employment taxes.

Restructuring as an S corporation creates an opportunity to undertake both IRC § 199A and self-employment tax planning, provided that "reasonable compensation" is paid to the owner/employee.



Deduction planning with partnership guaranteed payments

If a taxpayer makes a loan to an LLC, the interest on the indebtedness is excluded from the scope of qualified business income. But a guaranteed payment made to a holder of preferred LLC units for the use of the member's capital should be eligible for treatment as qualified business income.

The 199A Deduction Marriage Penalty

There may be a "marriage penalty" associated with the calculation of the deduction. For example, if a highly compensated doctor marries a lawyer whose income falls below the single person's Phase-Out Amount, the lawyer will lose the ability to take the Deduction.

EXAMPLE – W-2 INCOME ONLY

Debbie is a medical doctor with \$150,000 in W-2 wages, \$150,000 of net capital gains and \$100,000 of interest income. None of Debbie's income is qualified business income. Debbie does not qualify for the deduction.

EXAMPLE – SOLE PROPRIETOR

Jim earns \$100,000 of medical income as an independent contractor, and has \$100,000 of net capital gains and \$100,000 of interest income.

His Form 1040 shows taxable income of \$240,000 after netting out contributions to retirement plans, payment of health insurance premiums and the taking of itemized deductions. Jim's deduction will be \$20,000.

In spite of the fact that IRC § 199A reduces Jim's net income by \$20,000, ALL of his business income will be subject to self-employment taxes and her state's income tax.

EXAMPLE – MEDICAL PRACTICE & NON-MEDICAL PRACTICE INCOME

Ken is married, practices medicine and invests in a medical device development and sale business.

He earns \$600,000 from his medical practice and is allocated \$500,000 of qualified business income from the medical device partnership. Ken and his wife also have \$200,000 of dividends and \$50,000 of net capital gains. Ken's Form 1040 joint return shows \$970,000 in taxable income. Ken's share of W-2 wages from the medical device partnership is \$100,000.

The medical device company leases all of its equipment. Ken determines that 20% of the excess of his taxable income over net capital gains (\$250,000) exceeds 20% of aggregate business income (\$220,000), but because Ken's taxable income exceeds the \$415,000 Cutoff Threshold, he would not be entitled to any Deduction with respect to his medical practice income.

With respect his allocation of medical device company business income, Ken's deduction would be limited to \$20,000 – the lesser of \$20,000 (20% of \$100,000) or \$50,000 (50% of Ken's share of W-2 wages paid by the medical device company).



RESTRUCTURING AS AN S CORPORATION

Mary is medical doctor, who has recently formed an S Corporation.

Mary's S corporation produces \$300,000 of net business income, after paying her (and deducting from business income), \$300,000 of W-2 compensation. Mary also has \$250,000 of net capital gains, \$100,000 of dividends and \$200,000 of interest income.

Assuming that Mary is paid reasonable compensation, she would be entitled to a \$60,000 deduction – the lesser of (20% of \$300,000) or \$150,000 (50% of \$300,000). By restructuring as an S corporation, only the \$300,000 of Mary's W-2 wages would be subject to employment taxes – the \$300,000 passed through to her as an S corporation shareholder would not be subject to employment taxes.

Why choose an S Corporation?

Operate a business as an S corporation rather than as a sole proprietorship or through a partnership:

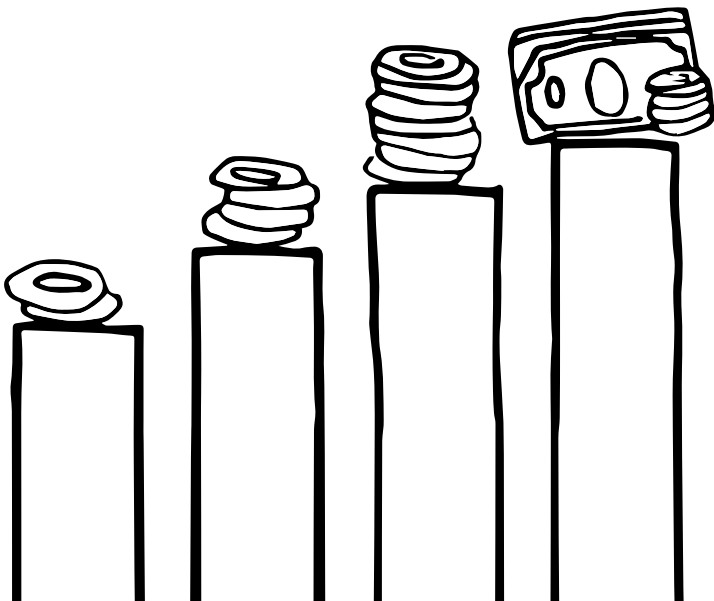
- Sole proprietorship or partner cannot be paid W-2 wages
- S corporation owner can also be an employee of the business.

Restructuring of an S Corporation

An individual makes \$1,000,000 annually selling medical equipment through a sole proprietorship that has no employees would not be entitled to a deduction. Why?

- Taxable income would exceed the Cutoff Threshold, and
- No W-2 wages or depreciable property associated with the business to support the deduction.
- Plus, 100% of the owner's income would be subject to employment taxes.

Restructuring as an S Corporation creates an opportunity to undertake both IRC § 199A and self-employment tax planning, provided that "reasonable compensation" is paid to the owner/employee.



Corporate practice of medicine and tax planning

The policy against the corporate practice of medicine is intended to prevent unlicensed persons from interfering with or influencing the physician's professional judgment. The following health care decisions should be made by a physician licensed in the State of California and would otherwise constitute the unlicensed practice of medicine:

- Determining diagnostic tests
- Referrals to another physician or specialist.
- Treatment options available to the patient.
- Selection of medical equipment and medical supplies for the medical practice.

Prohibited Structures

The following types of medical practice ownership and operating structures also are prohibited:

- Non-physicians owning or operating a business that offers patient evaluation, diagnosis, care and/or treatment.
- Physician(s) operating a medical practice as a limited liability company, a limited liability partnership, or a general corporation.
- Management service organizations arranging for, advertising, or providing medical services

Corporate practice of medicine: What is allowed?

An unlicensed person can:

- Lease office space and certain equipment to the medical practice
- Provide back-office administrative services including accounts payable and billing services
- Provide staffing of unlicensed personnel

Unlicensed persons and the administrative OR management service company **MUST** receive compensation that is directly related to the goods and services provided:

- Flat lease rentals
- Hourly billing amounts
- The compensation must be at fair market value
- The medical practice should not pay any percentage or portion of its gross or net profits to an unlicensed person

CAUTIONS: CA Business & Professions Code 650(b) on its face might permit the payment of a percentage of gross revenues to an unlicensed person, but the payment must be fair market value. Given this, it's best to simply pay FMV.

Have an attorney run all forms of compensation through a CA and federal Stark and Kickback analysis. It is very easy to violate these laws when paying outsiders for services related to the practice.

Recommended corporate structures

The management service company is a common structure that unlicensed persons use to participate in a medical practice. Unlicensed persons perform the administrative and back-office functions permitted by law, freeing the physicians to spend more time on patient care.

Each physician provides patient care through a professional medical corporation (S Corporation) that he or she wholly owns. The unlicensed persons provide their services through an ordinary corporation or an LLC that anyone can own. Contracts link the management service company or other entities with the medical corporation, providing the terms of service and compensation, rent, etc.

Tax Advantages

Corporations or partners which are not medical practices are NOT "Specified Businesses" and are therefore NOT subject to the phase out limitations. Up to 100% of their net income is eligible for the 20% pass-through deduction.

