H.R. 1 and Your Taxes: Primer for Health Professionals

As health professionals, in addition to a general overview, there are several key items to highlight in the recently enacted tax bill, including the new pass-through provisions, changes to the state and local tax (SALT) deduction, section 179 changes, and changes related to college endowments. Of course, these are preliminary observations and calculations based on the newly enacted legislation. The Internal Revenue Service (IRS) will need to fully interpret and implement the new tax code to provide further clarity. Therefore, for your own personal situation, please consult your accountant or tax professional. In general, the tax changes outlined below begin in calendar year 2018.

Overview. The new tax laws have a dramatic effect for individual households. While seven tax brackets remain, most are decreased by a few percentage points (to a top rate of 37%), along with the repeal of the Pease limitation which had reduced the value of itemized deductions for high income taxpayers. The alternative minimum tax (AMT) remains, but its exemption is widened. Most common deductions remain, though they are more limited, and an expanded standard deduction means fewer will likely claim itemized deductions in the future. And, a doubling of the estate tax exemption amount – to $11.2M for individuals and $22.4M for couples with portability -- will make estate tax planning irrelevant in 2018 and beyond for all but the wealthiest.

Of particular interest for financial advisors (and health care providers with financial advisors) are a number of key provisions. The controversial rule that would have eliminated individual lot identification and required all investors to use first-in, first out (FIFO) accounting is not included in the final legislation. Unfortunately, the legislation also eliminated the ability to deduct any miscellaneous itemized deductions subject to the 2% of average gross income (AGI) floor, which means all investment advisory fees will no longer be deductible starting in 2018. In addition, several popular Roth IRA strategies will be curtailed by the repeal of recharacterizations of Roth IRA conversions.

Pass-through payments. Many small businesses (including physicians and health professionals receiving 1099s) are considered pass-through entities (which can include sole proprietorships, partnerships, limited liability companies, and S corporations). Pass-through businesses' profits "pass through" their books directly to owners, unlike corporations. Under existing law, pass-through owners pay the individual income tax rate on those profits, not the corporate rate. Under the new law, the corporate rate would be reduced to 21 percent, while the top individual income tax rate, which some pass-through business owners pay, would be 37 percent. To address the disparity, the new law includes tax relief for pass-through owners beginning in taxable year 2018, allowing them to deduct 20 percent of their pass-through business income, with some exceptions. For instance, the taxable income eligible for the full 20-percent deduction is capped at $315,000 for married couples and $157,500 for individuals, with a phase-out to $415,000 for married couples and $207,500 for individuals, if the pass-through entity participates in professional services businesses, including those in health, law, and accounting.

Example of pass-through payments. A locum tenens doctor, who is married with two children, is an independent contractor (i.e., receives a 1099 rather than a W-2) and earns $400,000 reported on a 1099. To keep things simple, the family has no other income and the family's deductions are $60,000 into an individual 401(k) (e.g., a SEP IRA), $18,000 for health insurance, and the $24,000 standard deduction. The family's taxable income is $298,000, well under $315,000 threshold for married filing jointly, so the family can deduct 20% of its taxable income (i.e., $59,600 in 24% marginal tax bracket, worth $14,304).

State and Local Tax (SALT) deduction. Taxpayers who itemize deductions on their federal income tax are permitted to deduct certain taxes paid to state and local governments from their gross income for federal income tax liability purposes. The deduction favors high-income, high-tax states like California and New York, which together receive nearly one-third of the deduction's total value nationwide. Six states—California, New York, New Jersey, Illinois, Texas, and Pennsylvania—claim more than half of the value of the deduction. The state and local tax deduction in New York and California represents 9.1 and 7.9 percent of adjusted gross income respectively, compared to a median of 4.5 percent.

The latest tax bill creates a new cap – which covers both income tax and property tax -- of $10,000 for both individuals and for married individuals filing jointly. The new SALT limit will be gentler on individual filers than married couples. Given that the SALT deduction is an itemized deduction, it can only be utilized if the tax filers have taxes in excess of the standard deduction ($12,000 for individuals and $24,000 for married individuals filing jointly).

Section 179 changes. The tax bill would expand "Section 179" expensing, which allows businesses to immediately expense some of the costs of qualifying property such as off-the-shelf computer software and some real property. Current law specifies that as much as $500,000 can be expensed unless more than $2 million in property is bought, in which case there's a dollar-for-dollar reduction in the deductible amount. The thresholds are indexed for inflation. Under the new measure, as much as $1 million could be expensed under Section 179, while the phaseout threshold would be increased to $2.5 million. Both amounts would be indexed to inflation. Eligibility for Section 179 expensing would also be expanded to include furniture, as well as nonresidential roofs, heating and air conditioning systems, and fire and alarm systems.

College endowments and other changes. Any private university with endowments worth $500,000 per student or more would have to pay a tax of 1.4 percent on the endowment's earnings. Depending on how the numbers are run, higher education groups estimate that about 30 colleges would be subject to the tax. The Joint Committee on Taxation has said it expects the tax to raise $1.8 billion over the next decade.

Beyond the endowment tax, many more schools would have to revamp their accounting for different business units on campuses. All nonprofit colleges would have to adjust to changes in the GOP tax plan that they say would reduce the incentive for philanthropic giving. The doubling of the standard deduction under the plan would lead to far fewer taxpayers choosing to itemize their taxes, meaning they wouldn't be able to take advantage of the deduction for charitable giving. In other words, fewer people would get a tax break for making a gift to a university or other nonprofit organization.

While there were previous proposals that would repeal the tax deduction for student loan interest (which allows people repaying student loans to cut their tax burden by as much as $2,500 annually) as well as taxing tuition waivers (which allow many graduate students to attend school tuition-free) as income, those provisions were not included in the final tax bill.