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The New Tax Law and How Section 199A Can Save a Dentist Thousands of Dollars

The Tax Cuts and Jobs Act of 2017 (TCJA) made small reductions to income tax rates for most individual tax brackets and significantly reduced the income tax rate for C corporations. It also provided a new 20% tax deduction for owners of pass-through entities. This deduction applies to "qualified business income" from a qualified trade or business operated directly or through a pass-through entity. What does this mean for dentists?

For dentists along with most other professionals, Congress created a special category called "Specified Service Trades or Businesses." What this means is that in order to take full advantage of this deduction, for a married dentist your taxable income must be under $315,000 (the deduction is actually available if your taxable income is between $315,000 and $415,000 but it is prorated and limited). If your taxable income is below $315,000 then the deduction is the lesser of:

- 20% of your Qualified Business Income (for sole proprietors this means your net Schedule C income; for partners in partnerships, it means your allocable share of ordinary income less in general Section 179 deductions; and for S Corporations it means net K-1 income after the salary of the doctor), or

- 20% of your taxable income, not including capital gains

Unfortunately, this limit is reduced in half to $157,500 for single individuals, married individuals who file separately, and unmarried heads of household. This likely eliminates the deduction for most of our practice owner clients who are not married.

So, what does this all mean? Let's use an example of both a sole proprietor dentist and an S corporation dentist.

Sole Proprietor: Dr. Smith operates his dental practice as a sole proprietor. He has gross income of $700,000 per year and net profit of $270,000. He is married and his taxable income after itemized deductions such as home mortgage interest, state income and property taxes (limited to $10,000 under the new law) and charitable donations is $230,000. Assume Dr. Smith has no capital gain income.

Since Dr. and Mrs. Smith have taxable income of less than $315,000 his Section 199A deduction is the lesser of:

- 20% of his net practice income of $270,000 which is $54,000, or
- 20% of his taxable income of $230,000 which is $46,000

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Under the tax rates for 2018, Dr. Smith's Federal income tax with taxable income of $230,000 would be $43,779. With the Section 199A deduction, his taxable income drops to $184,000 ($230,000 taxable income less Section 199A deduction of $46,000) and his tax drops from $43,779 to $32,739 resulting in a tax savings of $11,040.

Partner in a Dental Partnership: The calculation is the same as for the sole proprietor using the net income on Form K-1 for ordinary income from a trade or business.

S Corporation Shareholder: Dr. Jones is the 100% shareholder of an S corporation that owns and operates his dental practice. The practice grosses $1,000,000 per year and has net profit of $370,000.

Under the rules of Section 199A, Dr. Jones does not get to utilize the deduction by using his net income of $370,000 as when he was a sole proprietor. He has to reduce this by taking a reasonable W-2 salary. What is reasonable in the eyes of the IRS? There are no published guidelines, but I believe taking a salary that is equivalent to the salary an employee, non-owner dentist averages (in the range of $140,000 to $180,000) would more than likely pass muster in an audit.

Let's say we give Dr. Jones a salary from his corporation of $160,000. If his net income is $370,000 then his net K-1 income and the income we use to calculate the deduction is $210,000. Therefore, again assuming that Dr. Jones has no capital gains income, his Section 199A deduction (assuming he has taxable income of $310,000) is the lesser of:

- 20% of his Qualified Business Income which is $210,000 x 20% = $42,000, or
- 20% of his taxable income of $310,000 so $310,000 x 20% = $62,000

In this case, Dr. Jones' deduction is $42,000 and since he is in the 24% marginal tax rate, his tax savings is $42,000 x 24% or $10,080.

Who is Eligible for the Deduction?: W-2 income does not qualify, nor do guaranteed payments from a partnership or LLC, and C Corporation shareholders do not qualify for the deduction at all.

So How Do We Plan to Take Taxable Income Under $315,000?: There are several action you can take if your taxable income is above the $315,000 threshold to reduce it. These include:

- Put Children on Payroll: The new tax law substantially increases the standard deduction to $12,000. For example, if you have three children ages 13, 15 and 16, you could put each of them on the payroll assuming they perform services for the dental practice. If you paid them $10,000 each this would reduce your taxable income by $30,000, which would save $7,200 in tax if you were in the 24% marginal tax rate, and it would not cost you a dime for the three children, since their standard deduction is higher than their wages.

- Purchase Equipment and Furnishings for Your Practice: If you purchase dental equipment by the end of the year, you can expense 100% of that equipment in almost all cases through the new bonus depreciation rules. For example, assume Dr. Jones has taxable income of $360,000 and is looking for ways to qualify for the deduction. He has been looking at a digital x-ray unit which costs $60,000, so if he buys it his taxable income will be $300,000 and he qualifies for the full deduction.

A few caveats about purchasing equipment:

  - First, the equipment has to be placed in service on or before the last day of the tax year. The equipment is delivered and installed by December 31st, although payments can start in the succeeding year.

  - Second, and this is a question for your CPA, if you are practicing as an S corporation, you must have S corporation tax basis in order to take the deduction. Since most dentists take out most all of the profit from their businesses, it is likely that by the end of the year there is little or no S corporation tax basis. The work-around is to either put the money into your entity to buy the equipment, or have the bank loan you the money personally, in which case you show it as a capital contribution to the corporation (which gives you S corporation basis and allows you to take the deduction). Again, check with your CPA.

- Establish or Beef Up Your Retirement Plan Contributions: There are three types of retirement plans a dentist can have in general; a SIMPLE-IRA plan which allows the dentist's spouse (if on the payroll) a deduction of about $30,000-35,000; a profit sharing plan with a 401(k) component which allows for a deduction of up to about $85,000 with a non-dentist spouse on the payroll, plus around $10,000-15,000 to the dental team (you can do less than this amount - if you are going to do $35,000 or less in total, use the SIMPLE-IRA plan); and a defined benefit plan which allows for contributions in the hundreds of thousands of dollars and should be used if you are planning on contribution of over $85,000 to your retirement plan.

For doctors with higher incomes, we have found that adding what is called a cash balance defined benefit plan on top of a profit-sharing plan with a 3% safe harbor contribution for the dental team can allow you to put in $100,000-250,000 to the plan with a less than 10% contribution for the dental team. In this case, it is recommended that you speak to your CPA, as well as your pension plan administrator and actuary. This is a way for someone with taxable

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income in the $500,000-600,000 range to reduce it the $315,000 range, year after year (if funds are available for the contribution).

There are many other aspects of this deduction. Please give us a call at 714-259-0505 and ask to speak to one of our dental CPA specialists if you would like to explore ways you can qualify for this great income tax deduction.

2018 Art Wiederman, CPA

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