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## PHYSICIAN COMPENSATION: Getting Your Legal Structure Right With Tax Reform

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By the time this article is published, President Trump will have been sworn in and he and House Speaker Paul Ryan will be hard at work in finalizing their tax reform proposal. It is now mid-January and the most up-to-date information on the basics of the Republican overhaul of the tax code are found in the Blueprint published by the GOP's House Ways and Means Tax Reform Task Force. Before exploring what tax reform will mean, let's look at where tax planning starts under current law.

### The Current Rates

Income from professional services is taxed as regular income and according to IRS statistics, most medical professionals pay tax at one of the top four brackets: 28% (\$151,900 to \$231,450), 33% (\$231,450 to \$413,350), 35% (\$413,350 to \$466,950) or 39.6% (over \$466,950).

However, that is not the end of the tax calculation. Alabama takes its "fair share" at 5% and additional Medicare taxes of 0.9% and 1.45% are imposed on wages received over the Social Security limit (for self-employed individuals, this total is 3.8%). So, for physicians and many other professionals, this combination often results in an effective tax rate of just under 50%.

The distinction between portfolio and investment income versus earned income was more important for planning until the enactment of the net investment income tax ("NIIT") in 2012. In truth, very little of a taxpayer's income now escapes the extra 3.8% Medicare tax; it applies as either the Medicare surtax or as the NIIT.

The only types of income which receive a true preferred rate under current law are capital gains and qualified dividends, both of which are taxed for most high income professionals at 15% (20% when the taxpayer is in the 39.6% bracket). And except for the exemption allowing up to \$25,000 of losses from rental real estate, only passive loss can offset passive income or active loss offset active income. So, as a general proposition, much of the tax planning available for high income professionals focuses on matching the taxpayer's deductions and losses with the type(s) of income he or she regularly generates.

### Current Planning Issues

The legal form of a medical practice (P.C., LLC, sole proprietor), partially determines how the income from the practice is taxed. If the practice is a regular corporation (not an S corporation for tax purposes), the practice income is paid out as wages and bonuses which are effectively taxed at a

total maximum rate in Alabama of 47% (rounded); however, any income retained by the practice is taxed at a flat 35% (often resulting in a total 55% tax rate).

S corporations and LLC's are "flow through" entities; the income earned by the practice flows through to the owners' returns. In an LLC, practice income is treated as self-employment income and taxed at an effective rate of 48.4% for those in the highest bracket. If the practice is an S corporation, only the portion of the practice income paid out as salary is taxed at the highest rate of 47%, with any excess treated as non-employment income and taxed to the owner at a maximum combined federal and state rate of 44.6% (amounts in excess of wages and bonuses avoid the 3.8% NIIT tax).

When the practice is a traditional corporation for tax purposes, e.g., not an S corporation, the owners must be aware of the "unreasonable compensation" doctrine. If the IRS applies that doctrine during an audit, some portion of an owner's salary may be reclassified as a dividend. If that happens, no deduction is allowed and such income becomes subject to double taxation. Further, both the taxpayers (the practice *and* the owners) are subject to tax penalties. In professional practices, "unreasonable compensation" arises most often when more than an insignificant portion of the practice's income is attributable to services performed by non-owners and/or intellectual property or other capital assets.

In addition to unreasonable compensation, another tax planning challenge for physicians and other high income taxpayers is how to properly group business activities under the passive activity loss rules. Late in 2016, the IRS issued technical advice memorandum ("TAM") 201634022, in which it provided a roadmap for taxpayers who wish to avoid automatically treating certain income related to their profession as earned income. In the TAM, the IRS held that the IRS could not require a physician to treat income from his investment in a surgery center the same as income from his practice because, under the surgery center's legal documents, the physician had no say in the day-to-day operations of the center. This ruling is important to physicians because of the distinction between the TAM and Treas. Reg. Section 1.469-4(f)(2), in which physicians unsuccessfully attempted to separate radiological service income from their regular medical practices.

### **The GOP's "Better Way" Blueprint for Tax Reform**

The first part of tax reform that will impact tax planning are the proposed cuts to tax rates for corporations, flow-through entities and individuals. While the Blueprint calls for the corporate tax rate to be cut to 20%, even more important is that business income flowing through to a personal tax return (e.g., from an S Corporation, LLC and/or partnership) is to be capped at 25%. Proposed individual tax rates go down to 12%, 25% and 33%.

So what will these rate changes actually mean for professional practices? The most important change is the one which caps the tax rate on income from flow-through entities at 25%. Professional practice income flowing through to the owners of LLC's and S corporations is to be taxed at a rate less than wages from a regular corporation. Accordingly, professional corporations which have not yet elected S status because of the built-in gain tax cost (usually the tax on accounts receivable) should begin to consider whether to make an S election for 2017, especially since the corporate rate for built-in gains will also have been significantly reduced.

Another important portion of the Blueprint for tax planning is the provision allowing investors to deduct one-half of their capital gains, dividends and interest (a completely new wrinkle), before subjecting the remainder to tax. Under this format, the tax rate on such income will effectively be reduced to 6%, 12.5% or 16.5% (depending on the taxpayer's regular tax bracket). Unfortunately, as of the week before his inauguration, Mr. Trump's plan has not endorsed this proposal.

It seems clear that tax reform is going to significantly broaden and flatten corporate and individual tax rates. Exactly what happens with respect to investment types of income and gain is still up in the air, but I tend to believe that there will be reductions in those rates too. Therefore, I believe that many, if not all professional service providers are going to be looking to take advantage of both sets of lower rates by converting PC's treated as corporations to S corporations and/or LLCs, even if that means taking a one-time hit on certain built-in gain. I also expect that these lower rates will generate more investments in other types of business and income producing activities which should likewise be organized as pass-through entities.



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