Section 199A (Pass-Thru Business Deduction) Tips for Physicians

[Editor's Note: This guest post comes from CPA Stephen L. Nelson who previously guest blogged here about real estate investing in the two posts Real Estate Tax Loopholes for Unintentional Investors and Ten Tax Loopholes for Active Real Estate Investors. He is a managing member of a Seattle area CPA firm and has written dozens of books including Quicken for Dummies and QuickBooks for Dummies. Stephen knows more about the 199A deduction than anyone I know and has written the best book out there on the subject, Maximizing Section 199a Deductions. It's not cheap ($150) but it's a lot cheaper than missing out on this deduction that could be worth tens of thousands to some docs and other business owners. We have no financial relationship other than the usual affiliate fees I make any time you buy a book through a link on this website.]

Eleven Sec. 199A Tips for Physicians (and Other White Coat Professionals)

In the eight months since White Coat Investor provided an overview of how the Sec. 199A "pass-thru deduction" works (see What You Need To Know About the Pass-Through Income Deduction), how the law works has become clearer. Congress passed a technical corrections act shortly after that original post. Tax accountants and attorneys have now pretty thoroughly digested the new law. And the IRS has begun to issue instructions about how the new deduction works.

Note: Typically, the new deduction equals the lesser of 20% of your sole proprietorship profits or of your share of a partnership or S corporation's profits—or 20% of your taxable income after any capital gains or losses.

With all the information now available, self-employed physicians, as well as other "White Coat" professionals, want to make sure they're maximizing the size of the Sec. 199A deduction they can take.

Sec. 199A Tip #1: Assume You Get the Deduction

A first tip: Assume you get the deduction or can get the deduction if you own your practice or you are a partner or shareholder in a group practice.

Yes, physicians, dentists, and basically every other "white coat" healthcare professional are *potentially* disqualified from using the new Sec. 199A deduction. But most won't lose or *completely* lose the deduction.

To *completely* lose the Sec. 199A deduction on the business income earned in a professional practice, a single taxpayer's taxable income must exceed $207,500. A married taxpayer's taxable income must exceed $415,000.

Sec. 199A Tip #2: Don't Count on a Full 20% Deduction

While most self-employed "white coat" professionals get to use the Sec. 199A deduction, many of these folks won't get a full 20% deduction.

If a single taxpayer's taxable income falls between $157,500 and $207,500 or a married taxpayer's taxable income falls between $315,000 and $415,000, Sec. 199A phase-out rules apply.

In essence, the phase-out rules apply a sliding scale to move the deduction percentage from 20% to 0% as taxpayer's taxable income goes from $157,500 to $207,500 or from $315,000 to $415,000.

Note: If you want detailed information about how the phase-out calculations work, you can refer to a blog post I did for tax accountants here: Sec. 199A Phase-out Calculations.

Sec. 199A Tip #3: Understand Threshold Amount Equals Taxable

Income

An important point that many taxpayers miss. The threshold amounts that cause a "white coat" professional to lose, potentially, the Sec. 199A deduction are *taxable income* amounts.

Keep this wrinkle in mind as you consider your own eligibility.

To determine your taxable income, you start with your total income.

But then you need to deduct the Form 1040 page 1 deductions for self-employment taxes, alimony (potentially), pensions, health insurance and health savings accounts.

These deductions, for a high-income self-employed taxpayer, should approach and may exceed $100,000.

And then you need to also deduct either the standard deduction or the total of your Schedule A itemized deductions, including state and local taxes (up to $10,000), charitable contributions, and mortgage interest.

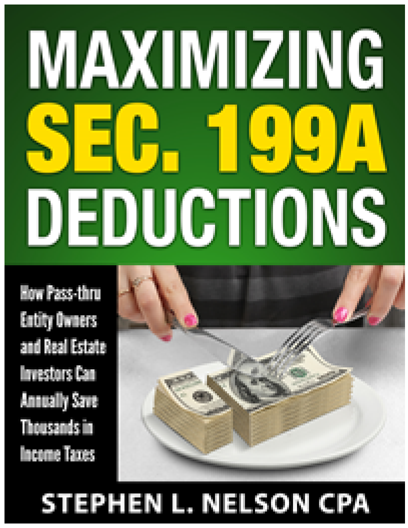
These deductions for a high-income self-employed taxpayer could easily run another $25,000 to $50,000. Maybe even more.

Sec. 199A Tip #4: Ignore the W-2 Wages and Depreciable Assets Limitations

As you may have heard, the Sec. 199A deduction rules potentially limit the deduction a taxpayer receives based on the W-2 wages and depreciable assets of the business.

Specifically, if single taxpayer's taxable income exceeds $207,500 or a married taxpayer's income exceeds $415,000, her or his Sec. 199A deduction can't exceed 50% of the W-2 wages paid by the business or the sum of 25% of the W-2 wages paid by the business plus 2.5% of the depreciable assets used in the business (whichever is more).

Gosh, confusing right? So some good news here. You can probably ignore this complexity—at least in regards to income you earn in your professional practice.



Here's why: Any white coat taxpayer with taxable income above these thresholds will already be losing the Sec. 199A deduction on their professional practice income due to her or his status as a white coat taxpayer. The W-2 wages-based limitations for white coat taxpayers become, for the most part, redundant.

Sec. 199A Tip #5: Confirm Partnership Agreement Updated

Hopefully, if you're a partner in a group practice, the partnership has already updated its partnership agreement for Sec. 199A.

If that hasn't yet happened, gosh, you want to talk with your partners and get on this.

The big issue here? The qualified business income amount you use to calculate the 20% deduction only includes the business income amount shown in box 1 of your K-1. You do not get a Sec. 199A deduction for any guaranteed payments you receive from the partnership.

For example, suppose your group practice produces per partner profits of $200,000. Further suppose that the partnership makes a $15,000-per-month guaranteed payment to each partner, or $180,000, over the course of the year.

In this case, the Sec. 199A deduction equals 20% of the $20,000 that's leftover from the $200,000 in profits after the $180,000 of guaranteed payments. This means a $4,000 Sec. 199A deduction and maybe $1000 to $1600 in federal tax savings.

Consider the case where a partnership just skips the guaranteed payments and instead just distributes $15,000 each month to partners. In this case, the Sec. 199A deduction equals 20% of the full $200,000. This means a $40,000 Sec. 199A deduction and maybe $10,000 to $16,000 in federal tax savings.

Sec. 199A Tip #6: Reconsider any Subchapter S Election

If you operate your practice as an S corporation, talk with your tax advisor about whether or not you should revoke your Subchapter S election or terminate your entity classification.

Most smart Subchapter S elections should still make sense. Especially if shareholder-employees save Social Security taxes due to the Subchapter S status.

Shareholder-employees saving only Medicare or net investment income taxes (NIIT), however, face a more complicated riddle. The Subchapter S election in these cases saves less payroll tax or NIIT.

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Further, because Subchapter A shareholder-employee wages don't count as qualified business income, the S election reduces the size of the Sec. 199 deduction.

Note: If you think you may need to look at unwinding an S election, I've got a long discussion at my blog: [Sec. 199A and S Corporation Dissolutions](#).

Sec. 199A Tip #7: Understand Sec. 199A Deduction Partner and Shareholder Specific

An obvious point once you think about it—but an important one to consider as you personally try to maximize your Sec. 199A deduction. The business income that flows out of a partnership or S corporation drives the size of the taxpayer's Sec. 199A deduction.

But all the other stuff going inside the individual 1040 tax return matters too. Remember that.

You may have partners making $500,000 a year or more whom you assume can't use the deduction but who in fact will be able to add a $60,000 Sec. 199A deduction to the return. (This person just needs big deductions on their 1040.)

You may have partners making $100,000 a year or less whom you assume easily qualify for the deduction but who don't because they earn lots of investment income or married a high-wage spouse.

Sec. 199A Tip #8: Update Any Self-Rental Agreements

If you own or own a part of a professional practice (something like an S corporation or partnership) that rents a building you own and you get disqualified from the Sec. 199A deduction on your professional practice earnings, look at updating the rental agreement for your building.

The Sec. 199A deduction applies to rental property income—even if it doesn't apply to income earned in a "white coat" professional practice due to the professional's high taxable income.

In this situation, paying a higher rent on the office building used in the professional practice may create or increase a Sec. 199A deduction.

For example, making a $100,000 less in a "white coat" professional practice may not lose the partners or shareholders any of their Sec. 199A deduction on the professional practice earnings because taxpayer earns too much. But earning $100,000 more in rental income? That should create a $20,000 Sec. 199A deduction.

Sec. 199A Tip #9: Account for Non-professional Services and Products

Some “white coat” business owners don’t only operate professional practices. They also sell non-professional services or ancillary products that while connected to their profession aren’t actually “part” of the professional service.

An optometrist might sell eyeglasses. A plastic surgeon may provide a health spa. I had a dentist a while back who sold expensive electric toothbrushes.

If you own a professional practice that delivers non-professional services or sells products, make sure your accounting system tracks revenues and costs with enough granularity.

You should break apart your total income into income from your professional services (potentially disqualified from Sec. 199A treatment) and income from your other “non-professional” services and products (probably qualified for Sec. 199A treatment).

Note: The conference report on the new tax law, in talking about the Sec. 199A deduction, discussed this. In one paragraph, for example, the report noted that something like a spa treatment that purports to be healthy doesn’t cause that service to rise to the level of a healthcare service.

Sec. 199A Tip #10: Look Over Your Investment Portfolio

Mostly, Sec. 199A affects your active business income. But the new deduction changes the rules for some types of investments.

You want to keep these changes in mind going forward.

For example, you can use the 20% Sec. 199A deduction to partially shelter REIT dividends and qualifying partnership income from income taxes. (This may change where you locate these investments.)

The deduction math dials down the benefits of using like-kind exchanges (since a “like kind” exchange pushes down the original basis value of the real estate and that can push down the Sec. 199A deduction on real estate income.)

The deduction only applies to domestic income and not to equivalent foreign income. So, a Florida condo in a rental pool possibly generates the deduction but a Bahama condo doesn’t. Similarly, a domestic REIT gives you the deduction, but a foreign REIT doesn’t.

Finally, the way the math of the deduction works, you possibly want to deleverage investments producing qualified “Sec. 199A” business income to increase their income and the Sec. 199A deduction you get. For example, if you sell bonds or CDs and then pay down a rental property’s mortgage, your net investment income may not change. But because you generate more qualified “Sec. 199A” business income, you would enjoy a larger Sec. 199A deduction.

One quickly falls down the rabbit hole on this kind of stuff. You don't want to go overboard.

But do consider the Sec. 199A deduction as you move game pieces around the investment game board.

Sec. 199A Tip #11: Watch Out for Additional Guidance

One last, quick maybe obvious point: The IRS will surely end up providing lots of additional guidance on this new deduction. So watch for that. Or confirm your tax advisor watches.

Buy Maximizing Section 199a Deductions Today!

What do you think? Will you be getting the 199A deduction? Why or why not? What questions do you have about it? Comment below!