What Doctors Need To Know About the Tax Cuts and Jobs Act (TCJA)

[Editor’s Note 1/15/2018: The long-awaited White Coat Investor Online Course is live and is available for purchase here. The course is entitled: Fire Your Financial Advisor. No more wading through dozens of books at the library, scrolling through hundreds of blog posts on dozens of blogs, or checking in daily with online forums trying to gain a financial education the way the hobbyists do. This course will take you from feeling anxious and having no plan to having a written financial plan you can follow the rest of your investing career as a professional and a retiree. This course is the material that should have been taught to you in college, medical school, or residency, but never was.]

I’ve been getting hammered with questions about the new tax law and forums are aflame with discussion about it. So although I generally favor “ever-green” content, I guess I’ll have to write about this and do it sooner rather than later. This will be a long post; it won’t cover every single change out there, but it will cover the most important ones to you. There will be at least one follow-up post about it as well.

The Politics Behind the Tax Cuts and Jobs Act
First things first, in order for you to understand what happened, we’ll have to address the politics of the situation. I’m hesitant to do so because political discussions tend to generate more heat than light, but without at least briefly outlining what happened, a lot of the changes don’t make sense. There is no more political topic than tax law changes. It is the ultimate political topic. A political topic is one in which reasonable people can disagree on the best thing to do. In this respect, the Republicans won the overall war, but the Democrats won the PR battle. Apparently they managed to convince Americans that most of their taxes are going up. According to a recent Vox poll, only 14% of Americans believe they’ll see a tax cut. That number is probably closer to 86%, but most Americans, including many financially savvy doctors on this site, don’t actually understand how the tax bill works. Will the tax bill for some people go up? Yes, but it is a very small percentage, and they’re in all of the tax brackets (and mostly in high tax, high COLA states.)

The second aspect of politics that you need to understand to “get” what happened is that the Democrats decided not to work with the Republicans and the Republicans decided not to work with Democrats. So that means the Republicans had to get all of the votes required to pass this things themselves, a bit like when PPACA was passed after the 2008 election. Unlike back then, however, the Republicans didn’t have a filibuster-proof majority in the Senate. That means they had to pass the law in the Senate under special provisions that allowed them to pass it with a simple majority. These “Byrd Rules” (i.e Reconciliation) were key to why some things happened and some
things did not. This caused some desired changes to be left out or compromised on because they simply couldn’t be done under the Reconciliation process. The most important of these was the “sunsetting” of many of the tax cuts in 2027, similar to what happened with the Bush tax cuts. Republicans don’t actually believe that a future Congress will let them sunset. They think they’ll be made permanent. I think it’s hilarious that any politician or American would ever call any tax law “permanent.” This portion of the law combined with a lack of understanding of the tax code is what allowed Democrats to win the PR battle. Democrats could point out that the corporate tax cuts were “permanent” but the individual tax cuts were “temporary.” Well, 10 years is about as permanent as tax law ever is anyway. We’ll see in ten years.

The third aspect to understand is that some Republican senators had to be “bought off” to pass the law. This sort of thing isn’t uncommon, and used to be far more common before all the anti-pork rules were passed and the 24 hours news cycle and social media put Congress under a microscope. Lawmaking is a sausage factory. It’s not something you want to watch. So you end up with a promise to Senator Collins to do some work on health care, you end up with ANWR being opened to oil development to get Murkowski’s vote, you end up with a larger child tax credit to get Rubio and Lee etc. You also ended up with a compromise $10K state income/property tax
deduction to get some of the Blue/High Tax state Republicans on board instead of eliminating that completely.

All of those compromises really watered down the tax reform aspect of the package. A major goal of Republican leadership was to simplify the tax code, i.e. Tax Reform. The main concept behind tax reform is dramatically lowering tax rates across the board, but eliminating a lot of the deductions. Theoretically, that reduces the time and expense we all spend suffering through our tax code. There were a few minor reforms, but not nearly as many as I would have liked to see and as near as I can tell, the Republican leadership and President Trump (who wanted us to be able to do our tax returns on a postcard) would have liked to see. Everyone has a pet deduction and doesn’t want to lose it, but taken together, all of our pet deductions have made a monstrosity. This is all politics. We all want government to do more for us, but we don’t want to pay for it. We’d all rather spend someone else’s money.

Finally, it must be acknowledged that there is a philosophical difference between the parties. One believes firmly that you can better decide what to do with your money than government can and generally advocates for a less progressive tax code. The other party believes that a larger government can make life better for all of us and advocates for a more progressive tax code. It should be no surprise to any of us when that first party is in power and passes laws that the code becomes less progressive and when the second party is in power and passes laws that the code becomes more progressive. That’s just politics. As President Obama famously said, “Elections have consequences.” This election did have the interesting effect of seeing Democrats posturing as deficit hawks, the usual position of the Republicans. But again, that’s just politics. When Democrats want to spend more, the Republicans scream about the deficit. When Republicans want to cut taxes, the Democrats scream about the deficit.
With that lengthy explanation of the politics behind all of this, let’s leave politics behind for the rest of this post (AND THE COMMENTS SECTION—I’ll be deleting all comments related to politics there.) But I think it really is critical to have a basic understanding of the politics of the process to make any sense of the rest of this. Now take a deep breath, realize that your political opponents are your fellow Americans with a simple difference in opinion rather than Nazi stormtroopers or Communist fools, and let’s talk about how this will affect the financial lives of doctors.

**Corporate Tax Reform**

The biggest changes in the tax code are changes to the corporate tax code. I’ll gloss through these because they don’t have as direct of an effect on your life as the changes to the individual tax code. There is a major political argument here between the two parties. Republicans believe lowering the tax burden on corporations will help the American economy. Democrats see it as a giveaway to the wealthy. A bit of perspective on this topic. First, corporations are us. Just like raising tariffs to pay for government is just a different way to tax us (raising the cost of what we buy), taxing corporations is just a different way to tax ourselves. You can charge tariffs, tax corporations, or tax individuals. It’s really all the same. If one method results in a more efficient way to accomplish what needs to be done, wonderful. But neither politicians nor economists can agree on this topic and I’ll be honest, I have no idea what the right combination of tariffs, corporate taxes, and individual taxes is. There is no doubt that taxing corporations less makes our tax system LESS progressive, since wealthier people tend to own a larger percentage of corporations. But those are also the same people paying most of the individual tax burden.

The main changes here are lowering the maximum corporate tax rate from 35% to 21%, eliminating the corporate Alternative
Minimum Tax (AMT) and making it more advantageous for corporations to bring money that has been kept overseas back to the US. These changes should show up in your portfolio as better returns on your stocks. This is likely a major reason for the excellent stock market performance in 2017. I still don’t see a good reason for doctors to form their own C corporations. Even if you’re only paying 21% on your corporate tax returns, you’re likely going to be paying 23.8% on the dividends from that corporation. 44.8% is definitely more than the top individual bracket.

Pass-Thru Entity Deduction

This topic is of sufficient importance to physicians that I will be hitting it in its own blog post coming up, but we’ll hit it briefly today. It isn’t just C corporations that are getting a break. It is also pass-thru entities such as sole proprietorships, partnerships, LLCs (taxed as sole proprietors, partnerships, or S corps), and S Corps. The idea here is that you get a deduction for a portion of your business income. That is NOT the income you pay to yourself as salary. It’s the rest of it. Many docs and other small business owners have been doing this for a long time in order to save payroll taxes by taking an “S Declaration” (turning a C corp or an LLC into an S Corp for tax purposes.) You split your profits into salary and distribution and only pay payroll
(SS and Medicare) taxes on salary. Well, now that pass-thru business income (both salary and distribution) qualifies for lower income taxes too. Basically, you get the lower of 20% of the business income or 50% of what you paid in salaries as a deduction. So, for example, if WCI, LLC makes $1 Million and pays $300K in salaries in 2018, then it’s deduction would be the lower of 20% * $1M = $200K or 50% * $300K = $150K. Given our 37% bracket, that deduction would be worth 37% * $150K = $55,500 off of our tax bill. Actually, it’s even smaller than that. That 20% number isn’t calculated on the business’s gross profit, but on your taxable income. Complicated, I know, but suffice to say there will be some deduction there.

Unfortunately, Congress hates doctors. Don’t feel too badly. It also hates lawyers, accountants, and financial advisors (but not engineers or architects or bloggers.) These “service businesses” have this deduction severely limited. As long as your taxable income is under $157,500 ($315,000 married) you’re fine. You take it just like non-service businesses. Between $157,500 and $207,500 ($315K-415K married) of taxable income, it phases out. Above $207,500 ($415K) you don’t get ANY deduction, even on the first $207,500 ($415K) of pass-thru income. So lower paid doctors, lawyers, accountants, and financial advisors are likely to see a deduction, but higher paid ones will not. It’s going to be a major tax preparation hassle going forward and will make it a little harder to do your own taxes. Which will cause more docs to hire accountants. Which will cause the accountants to make more money. Which will cause them to be phased out of this break too. One vicious circle.

[Update: Note this section has been updated since publication (and may see more updates as we all figure this out.)]

Higher Standard Deduction

Let’s get into the stuff that is a little easier to
understand. The standard deduction is rising from what would have been $6,500 ($13,000 married) to $12,000 ($24,000 married.) That’s a good thing for tax reform and is good tax policy. More people will take the standard deduction and not have to track all the Schedule A (itemized) deductions. In fact, my family will be using the standard deduction in 2018 (probably only for 2018 though) after “bunching” property taxes and charitable contributions into 2017. Overall, estimates are that 70% of taxpayers will take the standard deduction in 2017 and 90% will do so in 2018.

No More Exemptions

Exemptions are now gone. Basically they were rolled into the standard deduction. If you had three family members or fewer, you come out ahead. Four or more, you’re now coming out behind on that point, unless you’re a high earning doctor [AGI of $261,500 ($313,800 married)] and were phased out of those deductions anyway. So low earning doctors with large families are hurt by this. Low earning doctors with small families and high earning doctors were helped by this. It’s probably good reform though as it simplifies things.
Child Tax Credit Increase

This one helps those low earning doctor families with lots of kids. The credit is increased from $1,000 to $2,000 per child under 17. This more than makes up for the loss of exemptions, since the phaseout for this credit was also dramatically increased. The phaseout was at $75,000 ($110,000 married) in 2017. Now it is at $200,000 ($400,000 married.) So lots of doctors that didn’t get child tax credits in the past, now will. Unfortunately, it wasn’t indexed to inflation. That’s bad policy and has caused many issues in the past, particularly with the AMT.

There’s a new “dependent credit” too. It’s only $500, but it’s better than a kick in the teeth. It includes your parents and college students.

Schedule A Changes

A lot fewer people will be itemizing in 2018. Part of that is due to the higher standard deduction. But another part is due to the fact that lots of Schedule A deductions were reduced or eliminated. Let’s go through the major deductions there:

- Medical/Dental Expenses: No change (but few doctors could take this one anyway as it had a 10% of income floor). Actually, there was a slight change. It was decreased to 7.5%, but only for 2018.
- State Income Taxes: Combined with property taxes and limited to $10K. A dramatic decrease for most doctors.
- Property Taxes: Combined with state income taxes and limited to $10K. A decrease for some doctors in high tax states.
Sales Taxes: Gone completely. Some doctors in income tax-free states lose out here.

Mortgage Interest: Slightly limited. Instead of being able to deduct interest on up to $1M in mortgage debt, now you can only deduct up to $750,000. Old mortgages are grandfathered in. This will affect a few docs in high cost of living areas.

Home Equity Loan Interest: Eliminated. No grandfathering.

Charitable Donations: No real change. In fact, it gets slightly better as you can donate up to 60% of your income and deduct it instead of the previous 50%.

Miscellaneous deductions: Severely limited or eliminated completely. This includes tax prep fees, advisory fees, trustee fees, unreimbursed employee expenses, and casualty losses among others. These were always subject to a 2% of income floor, so the truth is that few doctors had enough here to get a deduction. This is honestly good tax policy as it simplifies things quite a bit. Sorry if your pet deduction got euthanized.

AMT Will Hit Fewer Individuals

One of the biggest disappointments of this tax reform effort was that the AMT for individuals wasn’t eliminated completely. Leaving it was a bad policy decision. It makes the tax code far more complicated. The good news is that it will hit fewer of you. The exemption amount was raised from $55,400 to
$70,300 ($86,200 to $109,400 married) and more importantly, the phaseout of that exemption doesn’t start until $500,000 ($1M married.) That number used to be $123,100 ($164,100 married.) Bottom line? If you have always paid AMT in the past, you very well may not in 2018, especially with your state income tax deduction so limited. Unfortunately, you (or more likely your tax software) will still have to run the numbers to know.

**Bracket Changes**

The most significant change that will affect everyone (and will likely lower the overall tax bill for most) is the change to the ordinary income tax brackets. Basically, your entire tax burden gets lowered by around 3% of your taxable income. Ignoring the political decision of whether the tax code should be more or less progressive, I was disappointed to see the five-bracket system originally proposed by the House plan be dropped from the final law. That would have been some serious tax reform and good policy. We still have seven brackets, but at least you’ll pay less in taxes. Here’s what they look like:

### Single Tax Brackets

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<tbody>
<tr>
<td>10%</td>
<td>0 to $9,525</td>
<td>10%</td>
<td>$0 to $9,525</td>
</tr>
<tr>
<td>15%</td>
<td>$9,525 to $38,700</td>
<td>12%</td>
<td>$9,525 to $38,700</td>
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<tr>
<td>25%</td>
<td>$38,700 to $93,700</td>
<td>22%</td>
<td>$38,700 to $82,600</td>
</tr>
<tr>
<td>28%</td>
<td>$93,700 to $195,450</td>
<td>24%</td>
<td>$82,500 to $157,500</td>
</tr>
<tr>
<td>33%</td>
<td>$195,450 to $424,950</td>
<td>32%</td>
<td>$157,500 to $200,000</td>
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<tr>
<td>35%</td>
<td>$424,950 to $426,700</td>
<td>35%</td>
<td>$200,000 to $500,000</td>
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<tr>
<td>39.60%</td>
<td>$426,700 and up</td>
<td>37%</td>
<td>$500,000 and up</td>
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### Married Tax Brackets

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<tbody>
<tr>
<td>10%</td>
<td>0 to $19,050</td>
<td>10%</td>
<td>0 to $19,050</td>
</tr>
<tr>
<td>15%</td>
<td>$19,050 to $77,400</td>
<td>12%</td>
<td>$19,050 to $77,400</td>
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<tr>
<td>25%</td>
<td>$77,400 to $156,150</td>
<td>22%</td>
<td>$77,400 to $165,000</td>
</tr>
<tr>
<td>28%</td>
<td>$156,150 to $237,950</td>
<td>24%</td>
<td>$165,000 to $315,000</td>
</tr>
<tr>
<td>33%</td>
<td>$237,950 to $424,950</td>
<td>32%</td>
<td>$315,000 to $400,000</td>
</tr>
<tr>
<td>35%</td>
<td>$424,950 to $480,050</td>
<td>35%</td>
<td>$400,000 to $600,000</td>
</tr>
<tr>
<td>39.60%</td>
<td>$480,050 and up</td>
<td>37%</td>
<td>$600,000 and up</td>
</tr>
</tbody>
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As you can see, what was 15% is now 12%, what was 25% is now
22% etc. The 35% bracket is now MUCH bigger. The overall effect is that marginal tax rates are lower for everyone except those in the 10% bracket. This is the main change that is going to result in most doctors and (most American taxpayers) paying less in tax. Anyone arguing against that point probably doesn’t actually understand how taxes work.

**Pease Phaseout Gone**

Another benefit for well-paid doctors (and a good reform/simplification) is that Donald Pease will no longer be famous. The Pease phaseouts were basically a stealth 1% bracket that began at a taxable income of $261,500 ($313,800.) I hated this law, and not just because it raised my tax bill. It was poorly written as a phaseout of itemized deductions, when in reality it was just another tax bracket. If you want a more progressive tax code, just increase the tax rates. Don’t make things complicated. Combined with the new top bracket, this basically reduced the federal tax rate on your 500,000th earned dollar for the year by 3.6%, from 41.5% to 37.9% (the 0.9% is the PPACA tax.)

**Less Inflation Adjustment**

Another minor change to the tax brackets is that they won’t quite keep up with inflation. This bill changes the inflation
measurement used to increase the brackets (and other tax policies) from “traditional CPI-U” to “chained CPI-U.” Economists argue about which is more accurate, but the new one is usually lower than the old one. That means a slight tax increase is now baked into the tax code every year.

Marriage Penalty Decreased

There is still a marriage penalty in that 35% bracket, but the overall effect of the marriage penalty is decreased. It maxes out now at $8K in taxes. That’s good news for two physician families.

529 Account Changes

529 plans can now be used for K-12 expenses. That’s good news for those of you with kids in private school. Now you can put the money in a 529 and pull it out the next day to pay high school tuition and maybe get a state income tax break on it. Not sure it will have a huge effect since most of those who can afford to put kids in private school were already getting the maximum 529 state income tax break as they saved for college. Note that there was originally talk of this including home-schooling expenses, but that was taken out in the end. Now there is one less reason to use a Coverdell ESA.

PPACA Taxes

There was no change to the 3.8% tax on investment income for high earners nor any change to the 0.9% tax on earned income for high earners. The penalty for not buying health insurance, however, is gone. You still need health insurance (and are technically still legally required to buy it) so this probably won’t affect you much. There may be some less expensive (and less comprehensive) policies coming back on to the market though. I’m still wrapping my head around how this is going to
change the health insurance and health care landscape in this country, but I think it will have a huge effect over the next few years.

**Long-Term Capital Gains/Qualified Dividends**

No significant changes here that are likely to affect readers of this site. There was some talk of some changes that would make [tax-loss harvesting](#) trickier, but those were not included in the final bill.

**Estate Tax Exemption Amounts Doubled**

The estate tax exemption amounts have been doubled. They are now $11 Million ($22 Million married.) Few doctors had to pay federal estate tax in the past, and it’s even fewer now. It is still indexed to inflation (good policy.) Be aware your state exemption may be MUCH smaller than the federal exemption.

**Alimony Tax Treatment Reversed**

In what may be the worst possible policy change in the bill, those of you who pay alimony can no longer deduct the payment. Basically, now you pay for your ex-spouse’s taxes on that alimony payment. In essence, it is a tax on divorce since that tax arbitrage (between the higher earning spouse and the lower earning spouse) no longer exists. One more reason to follow the [One House, One Spouse](#) rule. The only good news is that if you’re already paying alimony, you’re grandfathered in. Better not renegotiate that agreement though.
Deferred Compensation

There has been a bit of a crackdown on deferred compensation plans like 457(b)s. Expect to see a lot of changes here in the next year or two if you have one of these plans. The distribution options are going to become less attractive such that many doctors will opt to invest in taxable instead of using a 457, and might even regret using a 457 in the past. I’m still wrapping my head around what these changes are going to mean, but you may wish to put any 457 plan contributions off until the end of 2018 when things become more clear.

Loopholes

One person’s pet deduction is another person’s loophole. Here is a list of loopholes that made the cut and a list of those that did not:

Made the cut:

- Tax-credit for electric vehicle
- Schoolteacher deduction
- Elderly and dependent care credit
- Adoption assistance credit
- Increased business auto deduction (makes leasing less attractive)

SoFi
Start saving on your medical school debt.
Graduates who refinance can save thousands.
Didn’t make the cut:

1. Moving expenses deduction
2. Business entertainment expenses

This post is long enough, so I’ll stop here. We’ve hit the high points and discussed how they will affect you. If you love reading about this stuff, you might want to check out what the rest of the WCI Network is saying about the tax plan:

PoF’s Take: [Tax Reform! How Physicians and Self-Employed Are Affected](#)

PIMD’s Take: [How The New Tax Plan Affects the High-Income Physician](#)

What questions do you have about the new tax laws? Comment below, but be aware we’re not going to have a political discussion in the comments section of this post. You can go do that at Fox News or the New York Times if you want. It’ll be deleted here.