Implications of Tax Reform on For-Profit Health Care Providers

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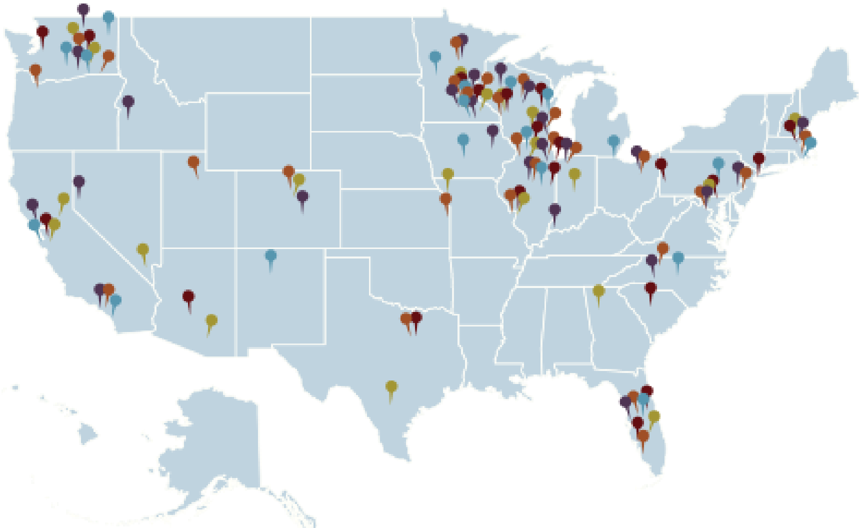

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Speaker Introductions

Greg Blake, Principal

Greg joined CLA as a principal in November 2015. Greg is licensed to practice in Arizona and California, and has continuously practiced in public accounting since 1972. He provides professional services with an emphasis in tax, accounting, and business and personal wealth management and strategic planning. Greg primarily works with high income/high net worth individuals and their closely-held businesses, frequently coordinating his services with clients' other professional advisors.

Claire Pearson, Principal

Claire is the national tax leader for CLA's health care practice. She offers 16 years of dedicated experience providing tax consulting, strategic planning, and compliance services to for-profit health care providers and real estate companies. Claire assists physician practices through various types of transactions, including admitting new partners, structuring partner buy-outs, and transactions involving private equity groups.

Cameron Weldon, Principal

Cameron is a principal in the San Antonio office of CLA. His primary focus is working as a tax professional with closely held businesses and their owners in a variety of industries including real estate, health care, professional services, and technology. Cameron enjoys assisting clients with tax planning, research, and compliance services, as well as general business and accounting consulting. He also assists clients with the tax considerations of business sales, mergers, and acquisitions.

Learning Objectives

- At the end of this session, you will be able to:
  - Understand the benefits and impacts of tax reform
  - Describe the steps you or your organization may need to take to comply with the new tax law
  - Recognize the importance of developing a flexible long-term planning strategy

Perspective

How does this tax reform act compare with the last major tax reform (1986)?

- Major legislation generally required bipartisan support and considerable investment of time and effort.
- 1986 tax reform act (under Reagan) took several years to accomplish.
- Affordable Care Act (ACA) did not have bipartisan support and still has major issues to resolve.
- Tax Cuts and Jobs Act (TCJA) did not have bipartisan support and may have major issues to resolve.
- Makes long-term planning challenging. Laws may change as control of Congress changes

Polling Question #1

What Kind of Entity Structure Is Most Tax Efficient Now?

- The 15% and graduated rate structure of regular "C" corporations was replaced by the flat 21% tax rate after 2017.
- The 35% flat rate imposed on personal service corporations was replaced by the flat 21% tax rate after 2017.

What Kind of Entity Structure Is Most Tax Efficient Now? (cont'd)

- New section 199A provides a 20% qualified business income (QBI) deduction for pass-through entities which are not a specified service business. This effectively lowers the maximum individual tax rate from 37% to an effective top marginal rate of 29.6%.
  - Amounts attributable to reasonable compensation paid to the taxpayer and guaranteed payments to partners are not eligible for the reduced tax rate.
  - Most health care entities will be considered a specified service business.
  - There is a limited exception for "small" taxpayers with pass-through income from a specified service business, and who have taxable income below $415,000 (married filing jointly) or $207,500 (all others).
  - Section 199A deduction does not affect calculation of self-employment taxes.
  - Accuracy-related penalty for substantial understatement of income applies if income tax is understated by 5% (instead of 10%) to discourage taxpayers from taking aggressive positions with respect to the 199A deduction.

What Kind of Entity Structure Is Most Tax Efficient Now? (cont'd)

- Variables and calculations are complex.
  - Specified service business activities are not well-defined.
  - QBI amount applied to each trade or business activity (*Sec. 162 definition*).
  - Have to look at facts of each situation. (*When can we expect IRS Reg's?)*

What Is the Tax Effect of Changing my Entity Structure?

- Changing from a “C” corporation to a pass-through entity (partnership) is a taxable event.
  - Corporate liquidation
  - Business valuation?
  - Who owns the goodwill (such as the personal relationships of the business owner)?
- Changing from a “C” corporation to an “S” corporation (pass-through entity) requires determining any built-in gain and careful planning to avoid triggering taxes.
- Changing from a pass-through entity to a corporation may or may not result in a currently taxable event.

What Is the Tax Effect of Changing my Entity Structure? (cont'd)

- Changing requires careful planning and consideration:
  - Current and future tax consequences
  - Current and future tax benefits
  - The 21% rate for C corporations is the first layer of tax. (*The shareholders of the C corporation are taxed when they receive dividends or have a gain on the sale of their shares. Until then, however, the corporation can grow its after-tax earnings faster, and the deduction for state income taxes is not limited*.)
  - As an "S" corporation or partnership, the 20% deduction may be limited or not available, and the deduction for state income taxes paid by the "S" shareholders or partners may be limited. (*The highest individual tax rate is 37%*.)
  - Qualified small business stock gain exclusion is generally not available for corporations which provide health care services.
  - How much of the profits are paid out to owners and what is reasonable compensation?
  - Does it make economic sense even without tax benefits?
  - Will it still make sense if the tax laws change again?

What Is the Tax Effect of Changing my Entity Structure? (cont'd)

- What are the legal implications (*Consult with your attorneys*):
  - What is required to change the legal entity or activities within an entity?
  - What contracts and agreements are affected?
    - ◊ Vendors, insurance contracts, leases?
    - ◊ Bank loan agreements and covenants?
    - ◊ Any CMS (Stark) issues?
    - ◊ Partnership agreement?
- New employer identification and accounts?
- Effects on ownership succession planning?

Polling Question #2

Tax Provisions Favorable to Business Taxpayers

- **Bonus depreciation**
  - Increased to **100%** for property acquired and placed into service after September 27, 2017. Includes new and used property.
  - Election to apply 50% (instead of 100%) for first tax year ending after September 27, 2017.
- **Section 179 limits**
  - Increased thresholds to:
    - ◊ $1 million for expensing
    - ◊ $2.5 million for phase-out
- **Luxury Vehicles**
  - Increased luxury vehicle depreciation limits

Tax Provisions Favorable to Business Taxpayers (cont'd)

- **Qualified improvement property**
  - Expanded definition of qualifying property
  - Opportunities for expensing over shorter period
  - Cost segregation and fixed asset studies to identify eligible property
  - *Caution: pending technical correction for drafting error in Act*
- **Small business accounting method simplification**
  - Small: $25 million gross receipts test. (Average 3 preceding tax years)
  - Cash method of accounting allowed.
  - Expanded exemptions for requirement to keep certain inventories and supplies. (Essentially accelerates expensing)
  - File Form 3115. IRS automatic consent. (Current year deduction allowed, or 4-year spread if income)

Tax Provisions Favorable to Business Taxpayers (cont'd)

- **Business tax credits (*considered "favorable", but subject to limitations*):**
  - Paid family and medical leave (2018 and 2019)
    - ◊ Paid to qualifying employees (employed for at least one year) who receive at least 50% of normal wages, pursuant to a written policy;
    - ◊ Other limiting conditions.
  - Rehabilitation credit for qualified rehabilitation expenditures for qualifying buildings.
  - Orphan drug credit for clinical testing expenses.
- **Real property taxes and state income taxes**
  - Real property taxes for business property not limited (*not a Schedule A deduction*).
  - State income taxes paid by business entities not limited (*not a Schedule A deduction*).

Tax Provisions Favorable to Business Taxpayers (cont'd)

- **Interest expense limitation (*considered "favorable" to "Small" taxpayers*)**
  - Generally not applicable to businesses with average annual gross receipts less than $25 million for 3 preceding tax years. (*Consider affiliated and controlled group rules*.)
  - Every business (regardless of form) not exempt, generally subject to disallowance of deduction for net interest expense in excess of 30% of its adjusted taxable income (*computed without regard to interest, depreciation, amortization, net operating loss, or Section 199A deduction*).
    - ◊ Disallowed amount carried forward indefinitely (subject to restrictions).
    - ◊ Special rules apply to partnerships and "S" corporations.
    - ◊ Certain elections available for real property trades or businesses.

Tax Provisions Unfavorable to Business Taxpayers

- **Like kind exchanges**
  - Recognize gain or loss on exchange (trade-in) of personal property.
  - Replacement property likely to qualify for Bonus depreciation or Section 179.

Tax Provisions Unfavorable to Business Taxpayers (cont'd)

- **Meals and entertainment expenses**
  - Eliminates deduction for entertainment expenses.
    - ◊ When does a business meal become entertainment? (*Emphasis on contemporaneous documentation.*)
    - ◊ Need to segregate in books and records.
  - Includes employee working meals in definition of business meals (*now subject to 50% disallowance, and employee working meals deduction will be eliminated after 2025*).
  - Full deduction still allowed for employee traditional, recreational activities, and holiday parties.
  - Full deduction still allowed for items made available to general public.
  - Membership dues for professional, civic, and public service organizations are still deductible if not for entertainment purposes.

Tax Provisions Unfavorable to Business Taxpayers (cont'd)

- **Employee moving expenses**
  - Deduction for moving expenses will be disallowed. (*Employee reimbursements will be reported to employee and deducted by employer as taxable compensation*.)
- **Net operating losses**
  - Repeals 2-year carryback (*for most taxpayers*).
  - Net operating loss deduction limited to 80% of taxable income for losses arising in tax years beginning after 12/31/2017.

Other Planning Considerations

- **Reasonable compensation issues**
  - These issues are still relevant. (*Caution: compare any changes with positions in prior tax years*.)
- **Self-employment income**
  - Recent court cases have generally been unfavorable to partners who attempted to exclude some partnership income from self-employment tax.
- **Partnership audit rules**
  - Unrelated to the new tax reform act are the new rules for IRS audits of partnerships and the ability to assess additional taxes at the partnership level. (*Consult with legal counsel and consider need for amendments to partnership agreements.*)

Concluding Remarks

- **What should we do now?**
  - Determine if you qualify for the 20% QBI Deduction, and if so, how to maximize it.
  - Tax reform act encourages investment in business tangible property.
  - If it makes economic sense for your business, purchase qualifying assets and expand your business in 2018 and 2019.
  - Consider automatic accounting method changes.
  - Strategize with your team of professional advisors:
    - ◊ Consider facts and circumstances of your entity.
    - ◊ How does TCJA impact your entity?
    - ◊ Have a tentative action plan subject to regulations and further guidance.

Concluding Remarks

- **Planning challenges**
  - Estimated taxes for 2018
  - Try to build some flexibility into long-term planning. (*A number of favorable provisions expire in 2025.*)
  - Expect Congress to continue to tinker with the tax code.
  - We need regulations, but remember Executive Order 13771 (*generally requires removing two regulations for every new regulation*).
  - Don’t hold your breath for tax simplification.

How hard can it be?

Questions?

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