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How the Tax Cuts and Jobs Act impacts professional service firms

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The Tax Cuts and Jobs Act (Act), passed on Dec. 22, 2017, contains a broad range of changes to the Internal Revenue Code (IRC). This insight focuses on changes that affect law firms and other similar professional service firms. Firms may be organized as limited liability partnerships, limited liability companies, general partnerships or corporations. For income tax purposes, they are generally either taxed as partnerships, C corporations or S corporations. The insight will cover the major changes affecting each of the three different tax structures as well as some planning considerations that impact each of these structures. Notably, this article is not intended to explain the mechanics involved in certain calculations under this Act, but rather to make the reader aware of the certain new provisions and some of the issues and planning opportunities that may exist under this Act.

The first important point to consider is that there are numerous drafting issues with this Act and many more ambiguities or uncertainties with various provisions of the Act. Therefore, it is expected Congress will attempt to pass technical corrections bills to correct or clarify drafting issues in the Act. The IRS will also be expected to issue numerous regulations under the provisions of this act in order to better explain many of its provisions. Because of these challenges, it is not advisable to rush to make significant structural changes to an entity in reaction to the Act until better guidance and certainty about its provisions is available.

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Several provisions of the Act affect all business regardless of form. These provisions are all effective Jan. 1, 2018, unless otherwise indicated and include:

1. **Increased expensing of qualified property under IRC section 179:**
   a. The maximum amount allowed to be expensed under section 179 is increased to $1 million and the phase-out threshold is increased to $2.5 million. These amounts are indexed for inflation after 2018.
   b. The definition of qualified real property under section 179 is expanded to include certain depreciable personal property used in the lodging industry as well as certain improvements to nonresidential real property after the date such property was placed in service, such as roofs; heating, ventilation and air-conditioning property; fire protection and alarm systems; and security systems.
2. **Temporary increase to 100 percent cost recovery qualifying business assets (bonus depreciation):**
   a. For property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023, the first-year deduction is increased to 100 percent.
   b. This deduction is allowed for new and used property.
   c. After 2022, the deduction percentage phases down by 20 percent per year until it sunsets after 2026.
   d. Taxpayers can continue to elect out of bonus depreciation.
   e. While not yet known, we expect most states to decouple from the new bonus depreciation rules.
3. **Limitation on deduction of business interest:**
   a. Businesses are generally subject to a disallowance of net interest expense in excess of 30 percent of the business's adjusted taxable income. The disallowance is determined at the tax filer level but there is a special provision for pass-through entities, which requires the determination be made at the entity level, for example, at the partnership level and not at the partner level.
   b. Most professional service firms taxed as partnerships will not be impacted by this provision as their income at the partnership level is generally relatively high, since the partners' income is not a firm expense. However, this could affect firms taxed as C or S corporations, which tend to have much lower taxable income, as their shareholders are treated as employees whose salary is a firm expense.

4. **Changes regarding entertainment expenses, meals and employee fringe benefits:**
    a. No deduction is allowed for entertainment, amusement or recreation; membership dues for a club organized for business, pleasure, recreation or other social purposes; or a facility used in connection with any of the above.
    b. Costs for entertainment expenses, such as tickets to sporting events, taking clients to play golf and similar activities are no longer deductible.
    c. Meals provided for the convenience of the employer, through an eating facility or other de minimis food and beverage is no longer 100 percent deductible, but now falls into the 50 percent category. It becomes nondeductible after 2025.
    d. Qualified transportation fringe benefits provided to employees continues to be excluded from the employees' income but is no longer deductible by the business.
5. **New credit for employer-paid family and medical leave:**
    a. Between Jan. 1, 2018, and Dec. 31, 2019, the Act allows a credit of 12.5 percent of the amount of wages paid to qualifying employees during any period in which such employees are out on family and medical leave, provided that the rate of payment is 50 percent of the wages normally paid to an employee. The credit increases by .25 percent (but not above 25 percent) for each percentage point by which the wages exceed 50 percent.
    b. Wage expense is reduced when the credit is taken as an alternative.

The following information applies to firms taxed as C corporations:

1. The corporate tax rate was previously a flat 35 percent for personal service corporations and has now been reduced to 21 percent.
2. The corporate alternative minimum tax has been permanently repealed.
3. The NOL carryback of two years has been repealed. Losses arising in tax years beginning after Dec. 31, 2017, may be carried forward indefinitely and the NOL deduction is limited to 80 percent of taxable income (determined without regard to the NOL deduction).

The following information applies to pass-through entities:

In most cases, this insight will make reference to partnerships because that tends to be the more common tax treatment for professional service firms. Significant S corporation differences will be indicated where applicable.

1. Deduction for pass-through income:
    a. A noncorporate taxpayer is generally allowed to deduct on their income tax return an amount based on calculations provided under the Act. The calculated amount is limited by W-2 wages of the qualified trade or business and/or a portion of the unadjusted basis of all qualified property of the trade or business.
    b. This deduction generally is not available to specified service businesses, such as law firms, accounting firms, medical practices and consulting firms. It appears that the exclusion for professional service firms from this deduction does not apply to engineering and architecture firms.
    c. If the taxpayer (partner, S-corporation shareholder or sole proprietor) has taxable income below $157,500 on a single return or $315,000 on a married filing jointly return, the exclusion for specified service businesses does not apply nor does the W-2 wage limitation or unadjusted basis limitation. The benefit of the deduction for service businesses is phased out over the next $50,000 for single filers and $100,000 for joint filers.
    d. For those taxpayers eligible to take the deduction because their income falls under the income limitations stated above, the deduction is the lesser of (a) 20 percent of their share of the qualified business income of the entity; or (b) their taxable income in excess of the sum of their net capital gains and any qualified cooperative dividends.
    e. For partners, amounts shown as guaranteed payments on Schedule K-1 do not count as qualified business income for the deduction.
    f. For S-corporation shareholders, their W-2 wages from the S corporation do not count as qualified business income for the deduction.

g. States have yet to address this new provision, but our expectation is that most states will opt out of this deduction.

h. While the $315,000 joint income limitation may seem to eliminate many taxpayers from taking advantage of the deduction, the following example shows how a partner in a partnership who files jointly, whose spouse does not work outside of the home, can make $435,000 on their Schedule K-1 and still have taxable income below the $315,000 threshold.

Partnership pass-through deduction example

Interest and dividend income	5,000
Income from partnership – line 1	435,000
Total income	440,000
Adjustments to income (page 1 of 1040)	
SE tax deduction	14,500
Retirement plan contributions	48,500
SE health insurance	20,000
Total adjustments	83,000
Adjusted gross income	357,000
Itemized deductions	
Taxes	10,000
Mortgage interest	25,000
Charitable contributions	10,000
Total itemized deductions	45,000
Taxable income	312,000

Planning considerations

As stated earlier, it is not recommended that firms make any significant structural changes without careful consideration and discussion with their advisors. Several questions firms are asking include:

1. Should a partnership or S corporation convert to a C corporation to take advantage of the lower corporate tax rate?

   While it is true that a C corporation will only pay tax at 21 percent, most professional service firm owners want to draw most of the income out of the business each year. They generally do not have significant capital needs that require a large investment in the firm. While any income left in the corporation will only be taxed at 21 percent, any money paid out to the owners in the future will be a dividend, taxable to the owner and not deductible by the corporation, so the combined tax rate will be at least as high as the individual rate on pass-through income. Generally, a pass-through should only consider converting if it has capital needs for a long period of time or wants to use the corporation as an investment vehicle. There are other potential issues with using the corporation as an investment vehicle that are beyond the scope of this article.

2. Should an S corporation lower its shareholders' salaries to take advantage of the pass-through deduction?

   S corporations have always had an incentive to keep shareholders' salaries lower and shareholders' Schedule K-1 income higher. While the Act makes that even more advantageous, the IRS has the ability to reclassify amounts to wages based on reasonableness and charge the entity payroll tax penalties. The best advice is to make sure the shareholders' salaries are reasonable in the market-place. With service businesses, it is frequently more difficult to support lower salaries for the shareholders than in other types of businesses.

3. Some of our partners receive most or all of their compensation as a guaranteed payment. Should we change that?

   In order to allow more of the partners' income to qualify as qualified business income for the pass-through deduction, it needs to be reported as a distributive share of income on line 1 of the Schedule K-1, instead of on line 4 as a guaranteed payment. This may necessitate an amendment to your partnership or operating agreement in order to change the compensation method. This is a strategy worth further investigation.

4. We have different profit centers in our firm; is there anything we can do that would help the partners?

   Since many partners will not qualify for the pass-through deduction because of the exclusion for service businesses and their level of income, it is worth exploring. Some firms may have segments of their business that might not be considered the "practice of law" or other profession that may be conducive to being spun out into a separate entity. If the new entity is not in the professional practice and is not considered a consulting business, then the partners may be able to take advantage of the pass-through deduction for that segment of the business.

Other articles suggest even more extreme changes to the structure of the firm to take advantage of the pass-through deduction. While some of these may have merit, it may be worthwhile waiting until the Joint Committee on Taxation Bluebook is released before proceeding to see what additional guidance regarding the intent of these provisions may be reflected in that document. It is also still too early to know how the IRS will view some of these moves. If the firm wishes to be on the leading edge and isn't afraid of dealing with the IRS, then making moves now is reasonable, but if the firm isn't interested in being the test case, then the advisable approach is to consider these and potentially other options while waiting to see how some of these are viewed by Congress through technical corrections legislation and its bluebook and by the IRS through regulations.

Please visit Baker Tilly's tax reform resource center for additional information.