
The Tax Cuts and Jobs Act Takeaways for Healthcare Finance Leaders

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The Tax Cuts and Jobs Act of 2017 (TCJA) has many taxpayers wondering what its exact effects will be. For healthcare organizations and professionals, there are several important changes.

Individual Tax Rate and Deduction Changes

Prior law provided for graduated personal tax rates ranging from 10 percent to 39.6 percent. The TCJA lowers bracket thresholds and rates to range from 10 percent to 37 percent until 2025, when the lower rates are set to expire unless they are extended by Congress. Although personal exemptions for individuals are eliminated, standard deductions are doubled. The standard deduction is now \$12,000 for individual taxpayers and \$24,000 for married couples filing joint returns.

The TCJA also limits the amount of property taxes and state and local income taxes that may be deducted to \$10,000 for all state and local taxes combined. The TCJA slashes other deductions, such as portfolio expenses (e.g., investment manager fees), interest deductions for mortgage debt incurred in 2018 or later, tax return preparation fees, and unreimbursed employee expenses. Due to the significant reductions in these itemized deductions, some healthcare professionals may see their overall tax burden actually increase despite the lower income tax rates.

Provider-Owned Businesses

For individual providers who own their practices, the TCJA creates certain advantages and disadvantages resulting from the form of business entity in which the practice operates. One of the most publicized pieces of the TCJA is the overall reduction in the corporate tax rate to a flat 21 percent—a significant cut from the prior top rate of 35 percent.

As with the individual tax rate changes, the TCJA's lower corporate rates are paired with limitations on business deductions. Prior law permitted a 50 percent deduction for business meals and entertainment. The TCJA disallows business entertainment expenses completely but does not change the meals deduction.

Another significant change is the new limitation on interest expense deductions. Prior law allowed for a full deduction of interest payments. However, for businesses with average

annual gross receipts of more than \$25 million for the three prior years, the TCJA caps interest deductions to 30 percent of earnings before interest, taxes, depreciation, and amortization. Some analysts have projected that this change may raise tax collections after 2017 and increase the cost of borrowing by highly leveraged businesses. Notably, preferred equity returns do not appear to be treated as interest for purposes of this limitation; thus, deductibility of preferred return payments may not be restricted.

The TCJA also places new limits on the ability of businesses to carry forward net operating losses to 80 percent of taxable income in a year (down from 90 percent).

On the bright side, the TCJA significantly expands immediate expensing under Code Section 179 (which allows businesses to deduct the full price of equipment in the year the equipment was purchased) and bonus depreciation for depreciable personal property (such as medical equipment). Qualified depreciable personal property placed in service after Sept. 2, 2017, and prior to Jan. 1, 2023, may be fully expensed. After 2022, the expense amount is reduced 20 percent per year. An important point for healthcare providers is that bonus depreciation also is expanded to apply to purchases of used equipment. These changes will likely encourage the purchase of equipment qualifying for the Code Section 179 deduction or bonus depreciation.

The TCJA provides for a new “pass-through” deduction of up to 20 percent of qualifying business income for S Corporations, limited liability companies, partnerships, and sole proprietorships. The pass-through deduction has more limitations for those businesses that are considered “specified service businesses,” which include the provision of services as a physician, lawyer, accountant, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. An example of this in the medical field would be income from a physician group’s medical practice.

The pass-through deduction for specified service businesses is subject to phase out and is eliminated for taxpayers with taxable income in excess of \$207,500 (\$415,000 if married). The deduction for all other businesses, such as ownership in a laboratory, is subject to limitations based upon the amount of W-2 wages the entity pays and the amount of capital invested by the entity. Tax planning to maximize the pass-through deduction is a must.

The lower corporate tax rate might encourage a practice to restructure as a C corporation from a pass-through entity. However, C corporation status would still subject the practice entity to double taxation, meaning income would be first taxed at the entity level rate of 21 percent, with any dividends being taxed to the individual at up to 23.8 percent, but only in the year in which the dividends are actually paid. Once both taxes are paid, the effective tax rate of a C corporation is higher than that for a pass-through entity, especially if the

owner of the pass-through entity is able to take the 20 percent pass-through deduction described above.

In general, C corporation status makes the sale of a practice more problematic unless the practice is merged rather than purchased outright. A buyer typically will want a step up in the basis of purchased assets (i.e., goodwill) so that it may amortize or depreciate that basis over time. Sellers, however, generally want to sell equity rather than assets, especially if the practice is a corporation and the seller can obtain capital gain treatment from a stock sale. An asset sale by a corporation generally results in a less tax-efficient transaction for the seller due to the two levels of taxation. If it is likely that a practice will be sold very soon, retaining the practice in pass-through form may be better than converting the practice to a C corporation.

Caveats abound: Switching entity types could be a taxable event and may cost more money than necessary in the long run, and elective entity classification changes are permitted only once every five years.

Taxable Hospitals

Taxable hospitals will encounter many of the same issues as physician-owned practices. A hospital's sheer size relative to a medical practice, however, means that it will feel a greater impact of the interest expense limitations while it also will benefit more from immediate expensing of many purchased assets. For similar reasons, a taxable hospital may have more flexibility declaring or deferring dividends.

Tax-Exempt Hospitals

One of the most significant changes for tax-exempt entities under the TCJA is a new 21 percent excise tax on compensation in excess of \$1 million that is paid by the tax-exempt entity to "covered employees." In assessing the impact of this excise tax, the following points are noteworthy.

The excise tax does not apply to payments made to licensed practitioners for their professional medical services. This point may prompt amendments to employment agreements or revisions to compensation practices aimed at specifically delineating what amount of compensation is attributable to medical services versus nonmedical services.

A "covered employee" includes the five highest-paid current (or former) employees for a particular tax year. Also included are any former employees from 2016 onward who are still receiving post-termination payments, meaning that the number of "covered employees" may not actually be limited to five per year.

Compensation subject to the excise tax includes cash compensation, deferred compensation, and parachute payments to any top five employees in excess of three times the five-year average of their total compensation.

For hospitals with a layered system, the excise tax applies at each entity level. So if two tax-exempt entities within a hospital system each have five or more employees compensated \$1 million or more, compensation payments to all these employees would be subject to the excise tax.

Although the excise tax is not imposed on individual employees, it may force a tax-exempt entity to review its corporate structures and compensation schemes, potentially thwarting talent acquisitions and increasing attrition rates. The TCJA thus puts tax-exempt entities at a distinct disadvantage in obtaining high-level healthcare services when compared with taxable entities, which do not have to pay a similar excise tax on their highly compensated employees.

The TCJA makes several significant changes to the reporting of unrelated business taxable income (UBTI) of interest to tax-exempt hospitals that pay tax on a portion of their income.

First, the lower corporate tax rate, which is now at 21 percent, applies to the UBTI of a tax-exempt entity as well as regular income of a taxable corporation. This change may make certain tax-exempt hospitals more likely to engage in activities that generate UBTI.

Second, certain employee fringe benefits such as qualified transportation, parking benefits, and on-site gyms are now considered to be UBTI to the tax-exempt entity. The effect of this provision could be to require a tax-exempt entity that did not have UBTI in the past to now report it and pay tax on such amounts.

Third, the net operating loss restriction described previously applies equally to tax-exempt entities in calculating UBTI.

Fourth, the TCJA requires UBTI to be calculated separately for each trade or business activity and now prevents a tax-exempt entity from cumulatively offsetting aggregate income and loss from all such activities. It is not clear yet whether “blocker” entities such as subsidiary corporations may be used to bunch activities or minimize the increased likelihood that tax-exempt entities will be required to pay tax on UBTI.

Elimination of Health Insurance Penalty

The TCJA eliminates the penalties on individuals without health insurance mandated by the Affordable Care Act (ACA). The ACA imposed a penalty, which increased each year, on individuals without health insurance. It was most recently set at the higher of \$695 or 2.5 percent of household adjusted gross income.

This change may affect all healthcare providers, but it may particularly affect primary care practitioners because data generally have shown an increase in patients seeing primary care practitioners and using health services due to the ACA's expanded coverage access.

Similarly, because the overall number of insured individuals was rising, hospital systems experienced a reduced amount of uncompensated care or charity care that would otherwise have been written off. It will take at least a year or two to note any difference in uninsured patient levels attributable to the elimination of this penalty.

Note that the TCJA increases available medical deductions to individuals. Medical deductions are itemized deductions and are deductible only over a threshold based on a taxpayer's adjusted gross income. The TCJA lowers the threshold from 10 percent of adjusted gross income to 7.5 percent of adjusted gross income for the 2017 and 2018 tax years. The threshold will increase back to 10 percent in 2019.

Effect on Medicare

The TCJA is projected to increase the federal deficit by almost \$1 trillion over the next decade. An increasing deficit paired with the "pay-as-you-go" rule (PAYGO) may mean looming automatic cuts to Medicare. PAYGO, established in 1990, triggers automatic cuts to current entitlement programs to offset costs from new legislation so as to avoid increasing the deficit. Congress historically has waived cuts to Medicare, but PAYGO may reach a tipping point where this waiver is no longer possible.

The TCJA and the resulting changes to tax law affecting medical care are still being absorbed by experts and the public alike. To lower overall tax rates across the board, Congress made significant changes to tax deductions that might disproportionately affect healthcare providers. It is clear, however, that many tax-exempt hospitals may be facing UBTI (albeit at a reduced corporate tax rate) for the first time. Due to the breadth of these changes, it will be important to monitor any guidance provided by the IRS over the coming year—particularly guidance regarding separating activities in pass-through entities and updates on UBTI calculation and reporting.

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