

The Tax Break That Doctors and Plumbers Both Will Miss

Rules around key deduction for many small firms has high earners, experts puzzled; ‘As clear as mud’

By

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The owner of a successful chain of tanning salons should qualify for a new tax deduction, but someone who makes the same amount from a group of dermatology clinics won't.

A high-earning architect can generally claim that same tax break, but the designer who collects a big fee for working on the building's interior probably can't. A chef who owns her restaurant can also expect to pay less, but that may not be true if she is a celebrity chef.

Tax experts and accountants are scratching their heads over these and other quirks in how the new federal tax law treats high-income owners of so-called pass-through businesses, which are firms that pay tax through individual, not corporate, returns.

The new law contains guardrails, designed to limit the pass-through deduction's cost and prevent people from claiming a business tax break for what is really labor income. Among them, doctors, lawyers and others in service businesses can't claim the break if they earn too much money.

The restrictions also affect high earners in any business or trade where the “principal asset” is “the reputation or skill of one or more of its employees or owners.”

The big questions include: Just what is a service business? And if you are famous for what you do—whether you are a baker, hair stylist, florist or the owner of a fashion brand such as an Ivanka Trump —will you end up paying more in taxes?

“My head is spinning,” said Meredith Tucker, a Fort Lauderdale, Fla., accountant who works with entrepreneurs. “I have been doing this for decades and even I don’t feel comfortable.”

As part of a broader rewrite of U.S. tax rules, Congress created a new 20% deduction for owners of pass-through businesses, which include limited liability companies, partnerships, S corporations and sole proprietorships. The tax break effectively lowers their top rate to 29.6% from 39.6% before the new tax law took effect.

Business owners filed 34.4 million pass-through returns in 2014, according to a recent analysis by the Joint Committee on Taxation, which estimates that pass-throughs account for 40.6% of net income reported by businesses.

The deduction can be claimed by all business owners whose taxable income is \$315,000 or less for joint filers. Above that level, the break would be phased out over the next \$100,000 of income for service business owners. There are separate restrictions tied to the level of wages paid and capital investment.

Congress based its definition of service businesses on language used in an obscure part of the tax code dating back to the 1990s that applied to the sale of stock by select small businesses.

Jim Viviano, an Atlanta-based partner in the architecture firm 5G Studio Collaborative, is among those benefiting, thanks to a last-minute change in the law that exempted architects and engineers from the restrictions.

Architecture and engineering groups argued it wasn’t fair to lump them in with other service businesses and that they were losing other tax breaks or face higher capital costs than other professionals such as lawyers and consultants.

“We are right in the sweet spot,” said Mr. Viviano, who lobbied his senators for favorable tax treatment. “For architects, the big thing is this means more money in our pockets.”

Other business owners weren't so lucky. "I feel that it is a mistake in the drafting of the law," said Steve Nelson, chief executive of Capital Insight Partners LLC, an investment adviser in Scottsdale, Ariz., who won't be able to claim the deduction. "Hopefully, over time they may address it."

Owners of financial services, brokerage services and investment management firms cannot claim the deduction if their income is above the limits. Neither can the owner of a business "involving the performance of services" in health, law, accounting, performing arts, actuarial science, consulting or athletics.

The "reputation or skill" clause could create a tax hurdle for celebrity chefs and people in many industries who built companies on their brands, such as Ms. Trump, whose clothing company is set up as a limited liability company. A spokeswoman for Ms. Trump's company declined to comment.

For celebrity brands, whether or not they get to benefit from the 20% deduction is likely to depend on a variety of factors, including the fine points of licensing agreements, said Howard Wagner, a managing director at the accounting firm Crowe Horwath LLP. "This stuff is as clear as mud," he said.

The restrictions also could hit more mundane businesses, such as a construction company that leases its offices and all of its construction equipment, as well as firms involved in remodeling, plumbing and electrical work, said Don Susswein, a principal with the tax advisory firm RSM US LLP.

Tax experts are looking to the Internal Revenue Service to help clarify many of the gray areas, including who falls under the reputation and skills limits and which businesses are covered by words such as "health" and "consulting." The answers to many of these questions are likely to be decided during audits and litigated in court.

An IRS spokesman said, "the IRS is reviewing the recently-enacted tax reform legislation and has already provided initial guidance on several provisions." He added that the IRS "expects to address other issues in the coming months."

Marshall Goldsmith, a California-based executive coach, is among those struggling to determine whether he will be able to claim the new deduction. “My accountant is not sure how this impacts me,” Mr. Goldsmith said in an email. “I guess my answer is, ‘I don’t know.’ ”