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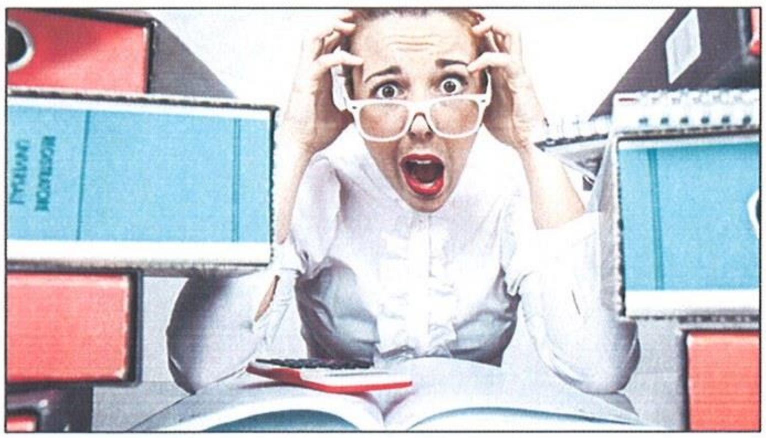
Camp Proposal on Tax Reform Contains Many Changes and Surprises



By STEPHEN R. LOONEY

On February 26, 2014, House Ways and Means Chairman, Dave Camp (R-MI), released a 979-page "Tax Reform Act of 2014" discussion draft (Camp Proposal). The Camp Proposal contains sweeping, sometimes surprising, and controversial changes to both individual and business taxation, that if enacted, will have a dramatic effect on many businesses, including professional service businesses such as medical practices.

This article will briefly summarize select business and individual tax reform proposals contained in the Camp Proposal.

Individual Tax Proposals

Tax Rates

The linchpin of the Camp Proposal is the reduction of both individual and corporate tax rates. Although Representative Camp has stated that there are only two tax brackets for individuals under his proposal, plus an additional 10 percent "surtax," the 10 percent surtax will likely be viewed by most people as a third tax bracket. The tax rate changes, as well as most of the other changes contained in the Camp Proposal would become effective 1/1/2015.

A 10 percent tax bracket would apply on adjusted gross income (AGI) up to $71,199, and the 25 percent tax bracket would apply to AGI from $71,200 up to $450,000 for married taxpayers filing jointly and up to $400,000 for other taxpayers. The new 35 percent tax bracket, or 10 percent "surtax" as Representative Camp prefers to refer to it, applies to a different tax base referred to as "Modified Adjusted Gross Income" (MAGI), which is much broader than AGI, and includes items such as tax-exempt interest, employer-sponsored health insurance payments, self-employed health insurance deductions, pre-tax contributions to defined contribution retirement plans and medical savings account deductions. The 35 percent tax rate, which also works in conjunction with the phase-out of the 10 percent tax bracket, applies to married taxpayers having MAGI of more than $450,000 and to other taxpayers having MAGI of more than $400,000.

Consequently, taxpayers who have MAGI greater than $450,000 (for married taxpayers filing jointly) or greater than $400,000 (for all other taxpayers) will be subject to a tax of 25 percent on their AGI up to those threshold amounts, and then subject to a 35 percent tax rate on MAGI in excess of such amounts. When compared to the current maximum marginal rate of 39.5 percent, the maximum marginal individual tax rate of 35 percent, which applies to a broader base of income than the current 39.5 percent, combined with the effect of the elimination of many deductions and credits, will result in many taxpayers, and in particular, physicians and other professionals, paying higher effective tax rates under the Camp Proposal than they do under current tax law.

Capital Gains and Dividends

Under current law, capital gains and dividends are subject to a maximum marginal tax rate of 20 percent. Under the Camp Proposal, 40 percent of capital gains and dividends generally will be excluded from a taxpayer's income, with the remaining 60 percent subject to taxation at the ordinary income tax rates of 10 percent, 25 percent and 35 percent.

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Changes to Contribution Limit on Pre-Tax Contributions to Section 401(k) Plans

The Camp Proposal reduces by one-half the existing limits on employee pre-tax contributions to Section 401(k) plans, with the remaining one-half eligible to be contributed on an after-tax basis to a Roth account. The combination of including pre-tax contributions to 401(k) plans in MAGI subject to the 35 percent tax bracket and reducing the contribution limits available to employees on a pre-tax basis to Section 401(k) plans would seem to have a very negative impact on the ability of individuals to save for retirement, and will have a particularly harsh impact on physicians and other professionals.

Corporate Tax, Pass-Through Entity and Other Business Tax Reforms Corporate Tax Rates

The Camp Proposal eliminates the current tax brackets ranging from 15 percent to 35 percent for C corporations, in favor of a single 25 percent rate.

Although this reduction to a flat 25 percent rate might at first appear beneficial to personal service corporations such as physician practices, if the "C" corporation medical practice distributes earnings as dividends to its shareholder-physicians, the effective double tax rate on such earnings will be 42.85 percent and such earnings will also be subject to the Florida corporate income tax. Thus, it would still appear to be more tax efficient to operate a professional practice in a pass-through entity, such as an S corporation, rather than in a C corporation.

Under the Camp Proposal, while large publicly-held and multi-national corporations taxed as C corporations, will enjoy a flat tax rate of 25 percent, the majority of America's small businesses which conduct their businesses through S corporations, partnerships, LLCs and sole proprietorships, will be subject to the three bracket system to which individuals are subject, and as such, will be subject to a top marginal tax rate of 35 percent. Combined with the elimination of many business deductions and credits by the Camp Proposal, this could have a crippling effect on America's small businesses, including medical practices, and have a substantial adverse effect on the economy.

Use of Cash Method of Accounting

Under current law, S corporations, partnerships (without C corporation partners), and qualified personal service corporations are allowed to use the cash method of accounting as opposed to the more complicated accrual method of accounting. Under the Camp Proposal, although businesses with average annual gross receipts of $10 million or less could continue to use the cash method of accounting, businesses, including pass-through entities, with more than $10 million of gross receipts would be required to use the accrual method of accounting. This will include many larger personal service corporations, including medical practices.

Social Security Taxes

The Camp Proposal includes a shocking change which imposes the self-employment tax (SECA) on S corporation shareholders (and partners of a partnership) who materially participate in their businesses within the meaning of Section 469. The Camp Proposal generally subjects 70 percent of the combined compensation and the distributive share of an S corporation's (or partnership's) combined and distributive share of the entity's income as net earnings from self-employment subject to FICA or SECA, as applicable. Under present law, S corporations are required to pay "reasonable compensation" to their shareholder-employees, which is subject to FICA, but neither the income that passes through to the shareholders or dividend distributions made by an S corporation to its shareholders is subject to FICA or SECA (or the new 3.8 percent tax imposed on net investment income under Section 1411 provided that the S corporation shareholder materially participates in the trade or business conducted by the S corporation). Consequently, under current law, the profits of an S corporation which are distributed to its shareholders as dividends are not subject to FICA or SECA taxes provided that the S corporation is paying reasonable compensation to its shareholder-employees for the services they are actually rendering to the S corporation.

The author believes that Representative Camp's Social Security tax proposal would have a substantial adverse effect on many small businesses as well as medical and other professional service businesses which utilize pass-through entities.

Conclusion

While the Camp Proposal does contain a number of provisions favorable to taxpayers, and appears to simplify the tax code by eliminating a multitude of individual and business deductions/credits currently available to individuals and businesses, it would appear that the overall impact of the Camp Proposal would favor large publicly-traded C corporations, but would likely have a very detrimental effect on individuals and pass-through entities through which most medical and other professional practices, as well as a majority of America's small businesses, are operated.

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