IRS Issues Proposed Regulations On Deduction for Owners of Pass-Through Businesses: The Good, Bad and Ugly for Health Care Providers

In early August, the Internal Revenue Service issued proposed regulations that provide guidance to owners of pass-through businesses as to eligibility for a federal tax deduction of 20 percent of the income generated by the businesses. This deduction was part of the Tax Cuts and Jobs Act (TCJA). Although the stated purpose of the proposed regulations is to provide clarity on eligibility for and the means to compute the deduction, this guidance is lengthy and complex. However, for healthcare providers, there are two important takeaways.

Takeaway No. 1: Guidance on whether a healthcare business is a "specified service trade or business."

One of the important limitations to the pass-through deduction in the TCJA is that owners of pass-through businesses that conduct a specified service trade or business (SSTB) and whose income exceed the so-called income limitation ($207,500 for single taxpayers and $415,000 for married taxpayers who file jointly) are not entitled to claim the 20 percent deduction. The TCJA provides that a SSTB includes a trade or business that involves the performance of services in the health field.

The proposed regulations provide guidance as to what types of businesses involve the performance of health services:

> The performance of services in the field of health means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient (emphasis supplied).
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> Prop Reg. 1.199A – 5(b)(2)(ii).

Providers of certain types of healthcare services might be able to avoid the SSTB limitation if their services are not provided directly to patients. For example, radiologists who are partners in a professional limited liability company and who merely read test results may be eligible for the deduction but the treating physician will not be entitled to the deduction since the treating physician provides services "directly to patients."

Similarly, if an orthopedic group also owns a physical therapy clinic, because that clinic's services are directly related to the medical field, it is likely that the clinic will be deemed to be engaged in a SSTB. However if the same physician group also operates a health clinic "that provide[s] physical service or conditioning to their customers (i.e., not medical related)", the clinic will not be engaged in a SSTB.

Takeaway No. 2: The use of a "captive MSO" will not work.

Prior to issuance of the proposed regulations, one of the planning suggestions that many advisors had recommended for consideration by owners of healthcare businesses whose income exceeded the income limitation was segregation of the billing, collection, accounting and other "back office" activities of the practice into a separate legal entity under common ownership with the practice group. This new legal entity would in reality be a management service organization (MSO) that provides services only to the affiliated practice group. Such a new entity was referred to by some as a "captive MSO".

Under the proposed regulations, if the captive MSO provides services only to the practice group under common control, the MSO would be deemed to conduct a SSTB. This of course eliminates the tax advantage of establishment for the MSO.

By contrast, if more than 20 percent of the income of the MSO is generated from providing management services to other payors such as unrelated medical practice groups, the MSO would not be found to engage in a SSTB.

Similarly, if a dentist is the sole member of a limited liability company that owns a two story office building and rents the first floor to the dentist's dental practice but leases the second floor to an unrelated business, half of the income generated by the LLC from the building will be deemed to be generated from a SSTB.

Although the proposed regulations limit the ability of health care providers to use affiliated entities to maximize the 20 percent deduction, planning opportunities still exist if the ancillary business is owned by a trust or other entities not under "common control" or if the business provides services to unrelated service providers.

In summary, even though they are complex and cut-off some available planning opportunities, the newly issued proposed regulations do not eliminate all planning opportunities to maximize the 20 percent deduction for owners of pass-through businesses that provide health care services.

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