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Architects and Engineers Are Special and the New Tax Law Proves It

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Architects and engineers are special in several ways, including:

1. Unlike most professional service firms, they tend to accumulate earnings over time (often to fund redemptions at retirement) instead of maximizing current salaries; and
2. The new tax law treats them more favorably than just about every other type of professional service firm.

In this piece, we don't attempt to understand or explain the rationale for accumulating earnings by architectural and engineering companies — let's just call it tradition. What we will do, is attempt to factor this tradition into some tax elections that you should assess ASAP.

Before we dive in, we need to cover a few bits about the new tax law. On December 22, 2017 President Trump signed into law what has affectionately been referred to as the "Tax Cuts and Jobs Act" (TCJA).[1]

The TCJA changed the business landscape in at least three major ways of direct consequence to architects and engineers:

1. The corporate tax rate dropped from a high of 35 percent to a high of 21 percent.
2. Individual rates changed, mostly downward, though the removal of several tax deductions means that some individuals will see an increase in federal income taxes.
3. A special deduction, in new Internal Revenue Code (IRC) Section 199A, is provided for certain sole proprietors (i.e., independent contractors), owners of S corporations, partnerships and business trusts.

Only the third item requires illumination. For those who appreciate simplicity or loathe details of tax law, here is the minimum of what you need to know about the new IRC Section 199A deduction[2]:

IRC 199A provides many business owners, other than those in specified personal service industries, a deduction equal to the *lesser* of: (i) 20 percent of their earnings from business operations, i.e., excluding investment gains and interest income, or (ii) 50 percent of W-2 wages paid.[3]

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[1] In order to comply with Senate rules for the bill to qualify as a budget reconciliation bill, the short title "Tax Cut and Jobs Act" was actually deleted from the final bill but the name, or at least the acronym, seems to have lingered in local parlance.

[2] A complete explanation of the operation and computation of the new *Qualified Business Income Deduction* (aka the *Small Business Deduction*, the *20% Flow-Through Deduction* and, our favorite name, the *Universal Employment for Tax Advisors Provision) is beyond the scope of this article*. For those interested in greater detail, see our January 16 article titled "Choice of Entity Calculus Modified by Tax Reform in Light of the Qualified Business Income Deduction: IRC Section 199A."

[3] Section 199A limits the benefit of the QBI deduction for most businesses in any service industry (lawyers, accountants, doctors and other professions in which the principal asset of the business is the reputation or skill of the businesses employees). Taxpayers who have QBI income from any of the specified service industries may still claim the QBI deduction but the deduction is phased out if the taxpayer's taxable income exceeds $157,500 (or $315,000 if the taxpayer is married filing joint returns). The phaseout of the QBI deduction is complete when the taxpayer's taxable income exceeds $207,500 ($415,000).

Significantly, architects and engineers are excluded from the carve-out that denies the benefit of this deduction to most other professional service providers!

We've provided some examples below of how the new tax rules may apply to architectural and engineering firms, but it's important to remember that one size does not fit all.

1. Firms eager to retain earnings should consider C corporations.

Architectural and engineering firms that want to retain earnings (*e.g.*, to invest in growth or cover a rainy day) should consider electing C corporate status. C corporations now pay tax on their net earnings at the extremely favorable federal tax rate of 21 percent, but amounts distributed to shareholders are subject to an additional tax of up to 23.8 percent federal tax. For example, after paying all expenses, including salaries to employee-shareholders, a C corporation would pay tax of $21 on $100 of earnings. If the same C corporation then decides to pay a dividend of the remaining $79, the shareholders will pay a second-level tax of as much as 23.8 percent or $18.80. Thus, the combined corporate and individual federal tax on the $100 of earnings would be $39.8 — almost 40 percent. If the same corporation could justify paying its shareholder employees $100 more in the aggregate, then the same amount of earnings would be taxed in the hands of the shareholders at about the same 40 percent rate (37 percent maximum federal income tax rate plus about 2.4 percent net medicare tax on amounts over the social security wage limit).

2. Firms that pay out most earnings as compensation should consider S corporations or possibly an LLC taxed as a partnership.

Non-C-corporation firms that strip out all of their net earnings at the end of each year, on the other hand, will generally benefit from the new IRC 199A deduction. The choice for firms in this second category is basically between a corporation making a subchapter S election and an LLC taxed as a partnership.[4] Continuing the above example without trying to pay the employee-shareholders an extra $100, and assuming sufficient W-2 wages to support a full 20 percent IRC 199A deduction, the effective federal tax rate on the $100 of net earnings would be less than $30. ($100 * 37 percent maximum individual rate * 80 percent after the 20 percent reduction). In other words, this firm has shaved its tax liability by 10 percent on distributed earnings.

3. What should you do?

These general rules are fine for firms that are starting fresh. But what about firms with some history?

Firms organized as S corporations that want to retain earnings might consider revoking their S election and thereby become C corporations. Such S revocations can be made retroactive to the beginning of the year if they file the S termination paperwork before March 15 (assuming they are a calendar year taxpayer).[5] After five years, the shareholders could again elect S status if they so choose, e.g., because the C corporation has accumulated sufficient earnings.

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[4] An LLC can also elect S corporation status when it meets certain criteria.

[5] In the first post-S termination year, such taxpayers can distribute all previously taxed income to shareholders free of a second level of tax. Such distribution might even be accomplished via a promissory note if there is insufficient cash available or distributing the cash is unattractive. After the one year grace period, distributions of previously taxed earnings basically come out pro-rata with corporate earnings that have never been subject to shareholder-level tax. This will allow the new C corporation to accumulate new earnings with only 21 percent federal taxes.

Firms organized as LLCs and taxed as partnerships could also similarly elect to be taxed as a C corporation within the same time limits.[6] Such conversion would require the LLC members to pay themselves reasonable compensation, which also helps increase the W-2 wage base and could reduce self-employment taxes.

On the other hand, firms organized as C corporations might now want to convert to S corporations to maximize the benefit of the new IRC section 199A deduction. Assuming sufficient W-2 payroll to support the full deduction, distributions of S corporation earnings would be far more tax-efficient means than compensation to "manage" the amount of earnings retained.

In sum, one size will not fit all here. Firms eager to retain earnings will find a C corporation structure more tax-efficient whereas firms desiring to maximize shareholder income will likely benefit from an S election. Firms doing business in multiple states will have a little more complicated math but face similar issues.

Finally, architects and engineers operating as sole proprietors, including those operating through single member LLCs that have not made an election to be taxed as a corporation, should definitely consider the IRC 199A benefits of converting to an S corporation and paying themselves reasonable compensation.

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Should you have any questions regarding the new tax law, we strongly encourage you to consult legal counsel.

[6] Thereafter they can convert to an S corporation but returning to a tax partnership is complicated because the goodwill generally would need to be valued and subjected to tax.