WRMarketplace

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TOPIC: Decoding Tax Reform: Taxation of Pass-Through Entities - How the House & Senate Bills Compare

MARKET TREND: The taxation of pass-through entities is a critical concern for many small businesses and is one of the major differences requiring resolution between the Senate and House tax reform bills.

SYNOPSIS: Reducing the tax rate on business income has been a fundamental Republican goal for tax reform. To that end, both the House and Senate versions of the Tax Cuts and Jobs Act ("House Bill" and "Senate Bill," respectively) permanently reduce the maximum tax rate on regular corporations (i.e., C corporations) from 35% to 20%. This change, however, would not benefit business owners of "pass-through entities" (i.e., S corporations, partnerships, LLCs, and sole proprietorships) because their business income generally is taxed at individual income tax rates (up to 39.6% (House Bill) and 38.5% (Senate Bill)). The House and Senate Bills attempt to resolve this rate disparity but use different approaches - the House Bill applies a rate reduction that would limit the maximum tax rate on pass-through business income to 25%, while the Senate Bill would allow a 23% deduction for pass-through business income, resulting in an effective top tax rate of about 29.6%. Both Bills also have significant limitations and qualifiers that could dramatically increase a pass-through business

owner's marginal tax rate if they don't plan carefully, or if they have the "wrong" kind of business. We explore in this report how these approaches compare and what could be the "wrong" kind of business.

TAKE-AWAYS: The pace of this tax reform process is breathtakingly fast. Never before has so much of the tax code been subject to so much change so fast, with the potential for numerous unintended consequences. As a result, business owners and their tax advisors must stay on top of the fast changing process and be prepared to consider altering their manner of doing business in order to adapt to a rapidly changing tax environment.

As the House and Senate proceed to joint conference to resolve the differences in their respective tax reform bills, one of the key issues for resolution is the taxation of business income from pass-through entities. Below we compare how the House Bill and Senate Bill deal with this issue and the potential impact for owners of pass-through business entities.

HOUSE BILL

General Approach. The House wants to incentivize small businesses to beef up their capital base. It does this by providing a maximum tax rate of 25% on business income from a pass-through entity, but only for income earned by a business owner that is attributable to capital, not services. The House Bill assumes that only 30% of a business owner's income is business income (and therefore eligible to be taxed at a maximum rate of 25%), with the remaining 70% taxed as service income, at regular rates for individuals. This approach creates an odd circumstance, ***as the House Bill would give the greatest benefit to purely passive investors, as opposed to founders and others who make the business a success***.

Eligibility for a Lower Tax Rate on More Than 30% of Income. The House Bill, however, would permit an active owner to demonstrate that more than 30% of the income is earned from investment capital (rather than service). In that event, more than 30% of the business owner's income could be eligible for taxation at the 25% (or lower) tax rate. This is determined under a complex formula, which takes into consideration the prevailing interest rate, the amount of the business's capital assets, and the interest expense of the business. The greater the proportion of the company's capital assets, and the less the company's interest expense, the larger the share of an active owner's income that would be eligible for the 25% tax rate.

Example of House Bill's Approach. Assume a non-professional services business, PA Partners, has two 50/50 owners, Peter, a passive owner, and Alan, an active owner. PA Partners has a total of $2 million in net business income. Peter and Alan are each

allocated $1 million of such income and are otherwise in the 35% tax bracket under the House Bill's individual income tax rates:

- As a passive owner, Peter's entire $1 million in income would be taxed at the 25% maximum pass-through rate (resulting in $250,000 of tax), rather than at the applicable 35% individual income tax rate under the House Bill (resulting in $350,000 of tax), for a ***tax savings of about $100,000***.
- For Alan, as the active owner, at least 30% of his income ($300,000) would be taxed at the 25% pass-through rate (resulting in $75,000 of tax), and the $700,000 balance would be taxed at the 35% individual rate (resulting in $245,000 of tax at this bracket), producing a total tax liability of $320,000. This results in an effective tax rate of about 32% and a ***tax savings of roughly $30,000***.

Limits on Professional Service Firms. The House Bill's favorable 25% tax rate would not be available to owners of professional service businesses (like law firms, medical practices, accounting firms, financial services firms), unless the owner could demonstrate that at least 10% of the firm's profits are due to investment in capital. In that event, an active owner would be eligible to tax the portion of income attributable to capital at the favorable 25% tax rate. If this approach becomes law, professional services firms likely will try to take advantage of this lower rate by contributing capital to the business. For example, a law firm or medical practice that rents space could pay for its office buildout in exchange for a lower lease rate. The buildout dollars would likely be treated as capital, and in some cases could be significant. Or the firm could bypass leasing altogether by buying a condominium office unit.

SENATE BILL

General Approach. The Senate Bill incentivizes small business owners to hire workers by providing business owners (whether active or passive) with a special deduction of 23% of the business income that passes through to them after deducting the amount of their reasonable compensation (subject to a cap of 23% of the owner's entire taxable income); but the amount of the deduction is capped at 50% of the wages paid to employees of the business for any owner whose entire taxable income for the year does not exceed $250,000 ($500,000 for a joint return). To count toward this wage requirement, the payments to workers must be the payments shown on Form W-2s timely filed by the business. Compensation to contractors reported on a Form 1099 ***would not count*** toward this wage requirement. Also, unless the business is conducted through an S corporation, compensation paid to business owners would not count as W-2 wages, as proprietorships and partnerships don't pay W-2 wages to owners. The Senate Bill's special deduction is ***not*** permanent, as it expires after December 31, 2025.

Example of Senate Bill Approach. Using the facts from the House Bill example above:

- Assume PA Partners paid a total of $1 million in wages to its employees. Peter and Alan would be able to deduct a total of $460,000 ($230,000 each), or 23% of the total $2 million of business income, in determining their tax liability. With the deduction, Peter and Alan would each owe $269,500 of tax liability (($1,000,000-$230,000) x 35%) at an effective 26.95% tax rate, rather than $350,000 at a 35% rate without the deduction). The deduction results in a ***tax savings to each owner of $80,500***.
- If, however, PA Partners only paid $500,000 in W-2 wages, then the W-2 deduction limitation would kick in, and Peter and Alan would only be able to deduct a total of $250,000 (1/2 of the $500,000 W-2 wages) from their $2 million of business income. Now Peter and Alan would each owe $306,250 of tax liability (($1,000,000-$125,000) x 35%) at an effective 30.6% rate, ***for a tax savings to each owner of only $43,750*** (at the 35% rate bracket).

Maximizing the 23% Pass-Through Income Deduction. Under the Senate Bill, the key would be to ensure that enough compensation is paid to employees to be able to take advantage of the full 23% deduction. Many businesses use independent contractors instead of employees. In the example above, the business might have been able to increase its $500,000 in W-2 wages to $1 million by hiring employees instead of contractors to maximize the deduction. Note, however, that the additional costs of hiring employees directly, including payroll taxes and administrative costs, might exceed the tax savings from the 23% deduction. Also, since the special deduction expires after 2025, taxpayers should be cautious about undertaking any change to their business operations if it would negatively affect the business once the deduction expires.

Limits on Professional Service Businesses. Like the House Bill, the Senate Bill would not allow this favorable deduction treatment for professional service businesses, unless the owner of the business ***has less than*** $500,000 in taxable income (for a married couple filing jointly), or less than $250,000 (for a single owner).

Limits on Trusts and Estates. The Senate Bill would not allow the 23% deduction for trusts and estates receiving pass-through income. Some business owners have transferred their ownership interests to trusts for estate planning purposes. If the trust is a separate taxable entity (i.e., a "non-grantor trust"), it would not be eligible to take the 23% deduction, even if the trust distributes its income to a beneficiary. This limitation on trusts would not apply to a "grantor trust," which is a disregarded entity for income tax purposes. If a business owner has transferred interests in a pass-through business to a non-grantor trust, the owner might want to consider weighing the estate planning and estate tax benefits against the loss of the 23% deduction and possibly restructure the ownership of the business if the Senate Bill's treatment of pass-through business income becomes law.

WHAT NOW?

It is difficult to know for sure what steps to take now, until we know which pass-through entity treatment will make it into law, in part because the House Bill rewards a business with significant capital, while the Senate Bill rewards a business with large payrolls, which creates conflicting incentives. However, there are a few steps that can be considered until we know the ultimate details:

Calculate Cost of Replacing Contractors with Employees. Business owners can ask their accountants to run various scenarios to determine if hiring employees directly to provide services, instead of hiring contractors, to satisfy the wage requirement under the Senate Bill would result in a net savings. In other words, would savings from a maximum 23% tax deduction outweigh the additional payroll tax and administrative costs of hiring employees directly? By running these numbers now, if the Senate Bill's pass-through tax approach passes, a business would be ready to convert ineligible compensation into W-2 wage compensation in order to maximize the 23% deduction.

Calculate Impact of Paying Down Debt. As discussed above, under the House Bill, an active owner is only eligible to tax 30% of his income at the favorable 25% tax rate, unless he can demonstrate that more than 30% of the income from the business is attributable to capital. This is based on a formula, which takes into consideration the amount of interest expense paid by the business - the less the interest expense, the greater the percent of profits that are attributable to capital. So if debt can be paid down, this would improve the ability for an active owner to increase the portion of his/her income eligible for the favorable 25% tax rate.

TAKE AWAYS

The pace of this tax reform process is breathtakingly fast. Never before has so much of the tax code been subject to so much change so fast, with the potential for numerous unintended consequences. As a result, business owners and their tax advisors must stay on top of the fast changing process and be prepared to consider altering their manner of doing business in order to adapt to a rapidly changing tax environment.

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