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House's Complex Pass-Through Tax Plan Expected To Fizzle

By **Vidya Kauri**

Law360, New York (December 5, 2017, 6:50 PM EST) -- As the House and Senate prepare to reconcile their vastly different proposals for taxing pass-through enterprises, practitioners anticipate that the more complex House plan, favoring capital-intensive businesses and passive investors, ultimately will get ditched for the more labor-friendly Senate version.

The tax treatment of pass-through businesses, such as S corporations, limited liability companies and partnerships, which pass their income on to owners to be taxed at individual rates, was a crucial 11th-hour bargaining chip that helped win over Republican hold-outs with the power to sink the $1.4 trillion tax cut bill backed by the Trump administration. It is expected to continue being a focal point during negotiations between the House and Senate, which passed separate versions of the Tax Cuts and Jobs Act, on Nov. 16 and Dec. 2, respectively.

The House bill introduces a top rate of 25 percent for pass-through entities while individual tax rates can go as high as 39.6 percent. The lower rate only would apply to 30 percent of income that can be categorized as qualified business income. The remaining 70 percent would be attributable to wages or labor income and be taxed at individual rates — a mechanism put in place to prevent tax avoidance maneuvers to characterize personal wages as business income.

The Senate’s tax bill introduces a 23 percent deduction for pass-throughs, bringing their top effective rate to 29.6 percent.

While votes in the Senate carry more weight because of the Republicans’ slimmer majority in the chamber, tax practitioners say the Senate’s pass-through proposals, with more specific thresholds and rules, also are more refined and well thought out.

For example, while the House bill makes no mention of whether the lower rate would apply to foreign income, the Senate bill makes it clear that the provision is restricted to domestic income, according to Stephen Ziobrowski, a tax attorney at Day Pitney LLP.

“I think it’s fair to say that the Senate bill reflects a bit more thinking about how to target this benefit for intended recipients and I think that’s because it’s a newer proposal than the House [plan], and they had more time to think about it and reflect on it and come up with ways to be more confident that the legislation that is passed will actually hit the people they’re intending to benefit,” Ziobrowski said.

Both the House and Senate bills come with a degree of complexity that could lead to greater compliance difficulties and tax avoidance opportunities, experts said.

According to Julian Fortuna, a tax attorney at Taylor English Duma LLP, the complexity arises from provisions that require legal analysis and has less to do with calculations that can be plugged into tax preparation software programs. The House bill, he said, allows for a lot more variables and elections based on various formulas and a facts-and-circumstances test.

“For example, you can elect for five years to apply a formula to set the ratio of wage income to qualified business income based upon capital investment. That's the kind of thing that will require a

lot of analysis and the kind of complexity that is not as preferable, in my opinion," Fortuna said.

The Senate plan also would pull in people with more diverse income levels, as opposed to the tax rate reduction plan from the House, since many small- and medium-size-business owners already fall into lower tax brackets where they wouldn't see a benefit from the new top rate of 25 percent.

The Urban-Brookings Tax Policy Center noted in an August 2016 report that although two-thirds of households that report business income on their individual tax returns are sole proprietors, their business income is often a small fraction of their overall income and falls into a lower tax bracket, meaning they are unlikely to benefit from a lower pass-through income rate.

However, it is upper-income taxpayers, such as doctors, lawyers and partners in investment firms, earning $200,000 or more, who receive the bulk of business income from pass-through enterprises, the think tank said.

The Senate bill's less direct approach to reducing taxes for pass-through businesses would benefit more smaller businesses — a key demand from Sens. Ron Johnson, R-Wis., and Steve Daines, R-Mont. — because a deduction would reduce overall taxable income, according to Philip Karter, a tax lawyer at Chamberlain Hrdlicka White Williams & Aughtry.

"Because it's not rate-based, it's not directed towards the wealthiest who benefit the most from a rate reduction," Karter said. "The House bill, as far as I can see — it does absolutely nothing for the vast majority of small-business owners because they're not getting anything that they already don't have, which is a tax rate of 25 percent or lower."

Small-business owners also would be disadvantaged under the House bill because the legislation skews heavily toward capital investments and favors passive investors, such as those in the rental real estate industry.

"You've got passive investors who are generating income, high-income investors who are getting the full benefit of this, whereas what we would consider or what's been painted to be small-business America really derives very little from the House bill," Karter said.

The Senate bill, on the other hand, requires that reasonable compensation be paid in the pass-through enterprise, which again allows more taxpayers to qualify for its benefits, Karter said.

While the House bill would encourage taxpayers to try to classify their income as passive, Wes Sheumaker, a tax lawyer at Eversheds Sutherland, said that the Senate's pass-through provision could lead to more audits by the Internal Revenue Service, based on its similarity to the IRC § 199 manufacturing deduction, which attracted the agency's scrutiny.

"The provisions are structured very similarly, and I would expect that similar issues would arise under the Senate bill," Sheumaker said. "I would expect there to be a lot of oversight over what is considered qualified business income."

The value of the Senate bill's deductions is also relative to the applicable tax rate, and a higher-income taxpayer may benefit more since tax cuts for individuals are set to expire in 2026.

"If the tax rates rise again but the deduction remains in place, then the deduction is worth more than it was when you were subject to a lower rate," Karter said. "That's an ameliorating consideration. ... Your deduction is worth more under a higher rate than it would be otherwise."

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