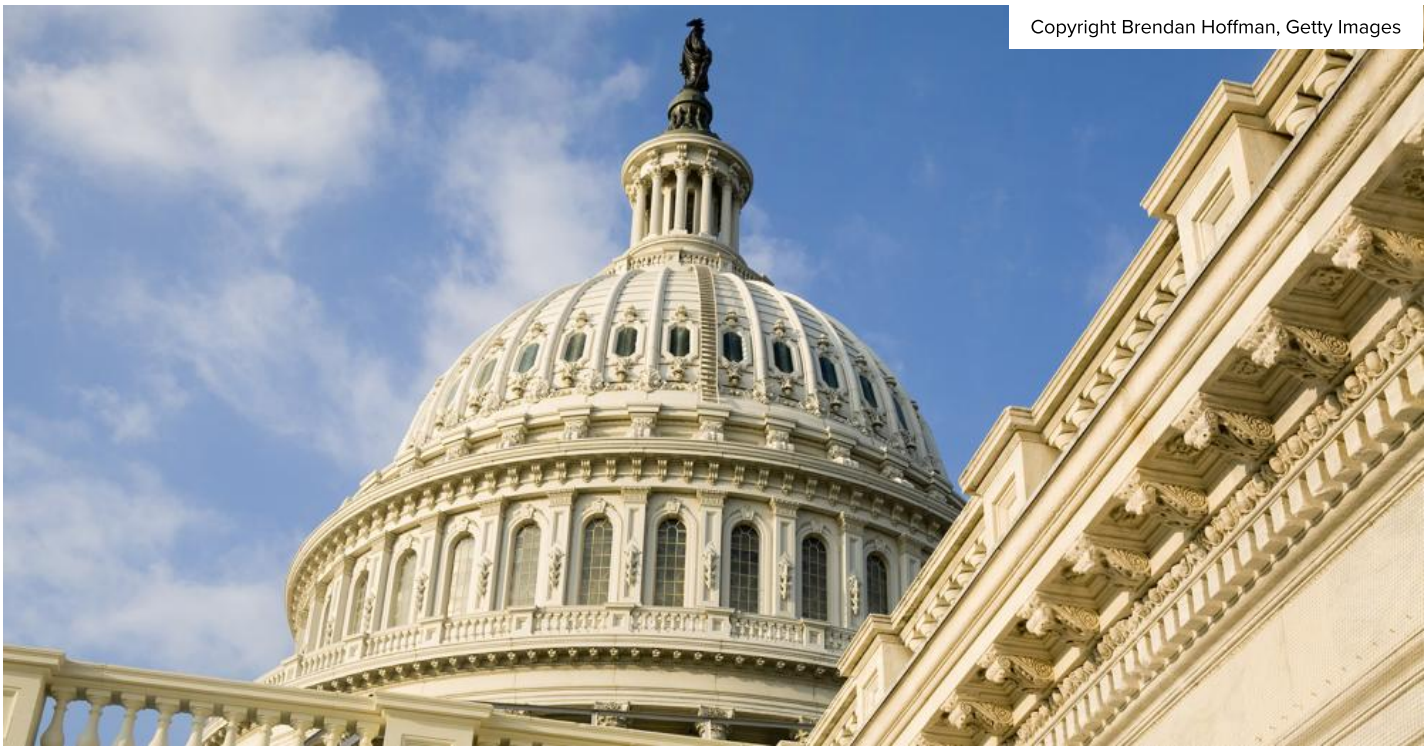
WealthManagement.com


Copyright Brendan Hoffman, Getty Images

WEALTH PLANNING > HIGH NET WORTH

Tax Reform Proposals for Pass-Through Entities

The House and Senate's proposals have ripple effects through many aspects of wealth planning.

Martin M. Shenkman , Joy Matak | Dec 12, 2017

The House and Senate have proposed very different approaches to reduce taxes on pass-through entities. Each approach is complex, and introduces an array of new planning constructs that will change how taxpayers who are affected will do business. The interplay of either approach will have ripple effects through many

other aspects of planning, including retirement planning, asset protection planning, estate planning, budgeting for business expenses and more.

House Version

Section 1004 of the Tax Cuts and Jobs Act lowers the maximum income tax rate on business income derived from small and family-owned pass-through entities: sole proprietorships, partnerships, limited liability companies, taxed as partnerships and S corporations to 25 percent.

Net income earned from passive business activity, as determined under Internal Revenue Code Section 469, would be fully eligible for the 25 percent business income tax rate. Income from an activity that isn't considered passive under IRC Section 469, a so-called "active business activity," is viewed differently under the Act.

Under the Act, income is taxed based on the applicable capital percentage, and the default is that 30 percent of the income from active business activities should be taxed at the reduced 25 percent tax rate. The balance of the income (70 percent of the income) would be taxed as ordinary flow-through income at the individual's income tax rate, the top rate of which is 38.5 percent.

The Act provides for an alternate to the default applicable capital percentage based on the facts and circumstances of each individual case, but ultimately, this plan appears to create issues for clients who had taken steps to support and document that they were material participants in a business to avoid the passive loss rules. Those businesses may now have to be evaluated differently under the new tax paradigm if the Act becomes law. Net income earned by equity holders actively participating in the business will be determined based on their capital percentage of income derived from active activities. Thus, active income will be taxed at the general tax rates, not the favorable lower 25 percent rate. This construct, which is a

new approach to taxation, will introduce incredible complexity, thereby negating the advertised simplicity, certainly for taxpayers affected.

Personal service entities. Given the Act's focus on capital assets invested in the business, owners of personal service entities would generally have an applicable capital percentage of 0, so that all their income would be subject to ordinary income tax rates, the top rate of which is 38.5 percent. Affected endeavors would include: businesses involving the performance of services in the fields of law, accounting, consulting, engineering, financial services or performing arts. So generally, an ultra-high-net-worth client earning millions of dollars per year from passive business endeavors will be taxed at a lower income tax rate than her advisors working 2,000 plus-hour years.

The provision does permit the owners of certain personal services businesses to use an alternative capital percentage based on the business's capital investments by making an election to calculate an applicable percentage based generally on the income that can be attributed to assets held by the business. This election would be effective for the taxable year for which such election was made and each of the four subsequent taxable years, subject to certain limitations. Is this possibly simplification?

Bifurcation of entity income. A portion of net income distributed by a pass-through entity to an equity holder may be characterized as "business income" subject to a maximum tax rate of 25 percent. The portion of income not characterized as business income would be deemed compensation and subjected instead to the higher ordinary individual income tax rates. This new tax paradigm will introduce new complexity to bifurcate income of a pass-through entity and to deal with new terms and calculations created by the Act.

Facts and circumstances capital calculation. Despite the Act's default provision creating a 30 to 70 split for active business activity income, actively engaged equity owners can apply a formula based on the facts and circumstances of their businesses. This facts and circumstances test requires that an imputed return

on capital should be calculated by multiplying the federal short-term interest rate plus 7 percent by the capital used in the business to calculate a return on capital. That figure is presumed to be the passive return on capital, which will be taxed at 25 percent maximum rate, with the remainder of the economic return subject to tax at the regular individual rates. If the taxpayer opts for the facts and circumstances approach, rather than the 70/30 approach, that election would be binding for a 5-year period.

How will these calculations be made? For the purposes of the calculations, capital appears to be based on the adjusted basis of the property used in connection with the activities of the business. How will capital investment in business be determined if most or all equipment is deducted under the expanded IRC Section 179 expensing provisions? How can we use the same calculations for a 5-year period if some of the property might have an adjusted basis of 0? If an operating agreement provides for the payment of a guaranteed payment, might there be an incentive to renegotiate that agreement? If a senior family member continues to draw a salary post-retirement but provides modest services, might that arrangement be reviewed and perhaps reconsidered so that if she's fully retired, the 25 percent maximum tax would apply to all earnings? How will the quantum of services that can be provided without tainting the return on the pass-through entity as partially taxed at higher rates be determined? Would the entity have to revisit its analysis under Section 469 and related regulations annually to confirm which owners are materially participating and which owners receive only passive income? What will the impact of this be on buyout agreements, post-sale or post-retirement consulting agreements? How might the result of these calculations impact wages for retirement plan contributions or for Social Security tax or benefits? A special rule would apply to prevent the recharacterization of actual wages paid as business income. An owner's or shareholder's capital percentage would be limited if actual wages or income treated as received in exchange for services from the pass-through entity (for example, a guaranteed payment) exceeds the taxpayer's otherwise applicable capital percentage.

Senate Version

For business owners engaged in the performance of services such as those in the fields of law, accounting, consulting, engineering, financial services or performing arts, the Senate version provides a favorable tax deduction of 23 percent for those with income under $500,000. However, for any taxpayer who files as "married filing jointly," this deduction would be reduced for every dollar earned over $500,000, and once the income from the activity reached $600,000, the Senate version would provide no benefit. In fact, the Senate version contemplates a tax calculation "cliff" for any pass-through entity earning income of $600,000 or more, requiring instead that the pass-through business pay tax at the regular rate on its entire taxable income. The net effect is that, on the last $100,000 of income, taxes will be assessed at a rate in excess of 100 percent!

If the pass-through entity engaged in a service business has income exceeding $500,000, then a wage test will apply, and the deduction will be limited to the lesser of 23 percent or 50 percent of the company's W-2 wages.

For entities not engaged in the performance of personal services, the Senate version provides for a deduction equal to 23 percent of qualified business income, or QBI, from a pass-through entity, resulting in an effective income tax rate of about 30 percent. However, this rate would only be effective for QBI up to $500,000 for taxpayers who are "married filing jointly." For every dollar earned in excess of $500,000, the 23 percent deduction is phased out precipitously, with no part of the deduction available for taxpayers receiving pass-through income in excess of $600,000.

Trusts and Estates

The Act doesn't exclude trusts and estates. As a result, business income flowing through a trust or estate will be eligible for the lower 25 percent income tax rate, to

the extent of the applicable capital percentage. In other words, to the extent that income earned by the trust or estate is treated as passive, all of it will be taxed at the favorable 25 percent rate. For any income deemed to be earned from an active business activity, the default would be that 30 percent of the income would be taxed at 25 percent, and the balance would be taxed at ordinary income tax rates. This raises a myriad of questions. If the trustee is active in the business, might that have a different result under the Act than a trust for which the trustee is inactive? How will directed trusts be treated for these purposes? Might changing trustees to someone who isn't active in the business provide a different result?

The Senate version specifically states that the favorable 23 percent deduction wouldn't apply to business income earned by trusts and estates. It's unclear whether the business income would retain its character as business income eligible for the 23 percent deduction when distributed to a beneficiary. If prior regulations on similar deductions, such as IRC Section 179, are any indicator, it appears likely that business income passed through a trust to a beneficiary might not be eligible for the 23 percent deduction, but would instead be subject to tax at ordinary income tax rates. However, if a trust is a qualified subchapter S trust and income flows through to the beneficiary from the trust, might that affect the result? In contrast, will income of a business held in an electing small business trust be trapped at the costlier trust level without benefit of this rule whereas S corporation stock owned outside of a trust would benefit from the lower more favorable tax rate? What this all might mean is uncertain at present. If the Senate version is enacted, it would create a significant tax disadvantage for trust-owned businesses. How planners will have to react is uncertain. While hopefully the unwarranted and disparate harsh treatment of trusts will be eliminated before enactment, it may not be. If not, then, perhaps some trusts might be dissolved if feasible, but for most the loss of estate tax (assuming repeal doesn't in fact occur) and asset protection benefits would make dissolution unpalatable. Might pass-through entities owned by trusts structure consulting or other agreements with non trust-owned entities to qualify some portion of the income earned for the more favorable tax rate?

Interest

Under the Act, the deduction for interest expenses is limited to the business interest plus 30 percent of the business's adjusted taxable income, determined before depreciation. Whereas the Act carves out real estate developers from application of this limitation and permits an unlimited deduction for interest expenses, it appears that the Senate version doesn't include such a carve-out, and the deduction is limited by 30 percent of the business's earnings after depreciation. For real estate developers, this limitation in the Senate version could be very costly.

The Senate version provides that interest that's disallowed would be carried forward for 5 years and may qualify to be deducted in those later years. Under the Act, the interest carryover would expire after the 5-year carryforward.

While both the Act and the Senate versions provide an exception from these rules for businesses with average gross receipts under $25 million, but aggregation rules determined at the tax filer level (e.g., partnership, not the partners) could result in wider applicability.

Reconciling Approaches

While it's uncertain how these differing approaches will be reconciled, the conventional wisdom is that perhaps a variation of the Senate version will be selected. Either way, it's clear that the result will be anything but simple. Also, taxpayers will no doubt be forced to take new tax-motivated actions to respond to whatever new paradigm is ultimately enacted.