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M E M O R A N D U M

TO: The Council

FROM: Scott Sinder
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RE: Tax Reform: Comparison of Pass-Through Proposals of House and Senate with respect to Service Businesses

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The House and Senate have now each passed tax reform legislation that would dramatically reshape fundamental elements of the US tax code particularly with respect to the taxation of businesses. This memorandum provides a brief overview and analysis of how the different approaches to the taxation of pass-through businesses like LLCs and S-Corps would impact professional services businesses.

ANALYSIS

I. Introduction

The House proposal involves special individual income tax rates applied to business income of individuals earned through sole proprietorships, tax partnerships (general partnerships, LPs, LLPs, LLCs, etc.), and S corporations. As opposed to special tax rates, the Senate proposal involves a special tax deduction for individuals earning business income through sole proprietorships, tax partnerships, and S corporations.

Both provisions are conceptually aimed at offering tax benefits primarily for business income that constitutes a return on capital (rather than a return on labor). One manifestation of this concept is the fact that both proposals partially exclude from the offered tax relief income from specified service businesses. This term is given a broad definition in both proposals, which includes business activity involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, trading, or dealing in securities, partnership interests, or commodities, or any business activity where the principal asset of such business is the reputation or skill of one or more of its employees. The proposals, however, carve-out of such exclusion certain specified service business income, although in varying ways, as described below.

Unlike the permanent House proposal, the Senate proposal is scheduled to be sunset by 2026. Coupling that with the fact that the level of the deduction does not seem to be as generous as the offered lower income tax rates of the House proposal, the Senate proposal may not be as generous overall. However, the carve-out from the exception for specified service businesses seems more generous in the Senate proposal. In other words, while it seems that the Senate proposal does not generally offer as large a tax benefit, the Senate proposal seems to offer such lower tax benefit to a wider population of individual taxpayers, particularly ones engaged in specified service businesses.

The Senate deduction proposal has been touted as administratively easier to implement for taxpayers than the special tax rates of the House proposal. It seems that both proposals would require a great deal of regulatory explanation and increased annual tax reporting by individual taxpayers and pass-throughs.

II. House Pass-Through Proposal with respect to Service Businesses

The House proposal provides for a maximum 25 percent individual income tax rate on "qualified business income" of individuals from sole proprietorships, tax partnerships, and S corporations. Qualified business income is generally the aggregate of net income attributable to business activities reduced by net loss attributable to any other business activities. All investment-like income and loss would be excluded (such as capital gains and losses, dividends, nonbusiness interest income, and other similar items). Unlike the Senate proposal, the issue of whether an individual is passive or active with respect to a business activity is relevant. If the individual is passive (generally, if hours devoted to the activity do not exceed 500 hours a year), then 100% of allocable net business income is qualified. If the individual is active, then generally only 30% of allocable business income is qualified, with an ability to elect to establish a higher percentage (the deemed rate of return formula), based on the portion of net business income equal to a deemed rate of return of approximately 7% (plus the short-term AFR) on the asset basis of depreciable personal property or real property used in the business (less interest expense deductions attributable to such business). Such property would exclude, among other items, cash, receivables, other items of working capital, and some intangibles. Such 30% or otherwise-established percentage is further reduced (the excess compensation limitation) to the extent that the portion of active net business income consisting of wages or the equivalent paid to such active individual exceeds 1 minus such 30% or otherwise-established percentage (e.g., if 80% of active net business income of an individual consists of wages paid to such individual, then only 20% (rather than the default 30%) of such net business income would be qualified).

There are three wrinkles with respect to such general rules regarding specified service businesses (as described above). First, if the individual is passive with respect to such business, then there is no specified service business limitation on allocable business income being qualified. Second, if the individual is active with respect to such business, the above-described 30% limit on allocable business income is reduced to 0%, unless the individual elects (on an annual basis) to establish that the deemed rate of return formula described above produces a percentage greater than or equal to 10% (essentially capturing service businesses that also have at least modest amounts of business assets deployed). Taking advantage of such annual election would require significant information coordination between the pass-through and the relevant individual. Such annual election percentage, however, would still remain subject to the excess compensation limitation. Third, a special 11 percent (for 2018 and 2019), 10 percent (for 2020 and 2021), or 9 percent (for 2022 and beyond) individual income tax rate will apply to the first $75K of active net business income of an individual that has taxable income less than $150K, where such lower rate is phased out gradually between $150K and $225K of taxable income (all of these amounts are for MFJ filers, with proportionally lower amounts for other filers). This provision is aimed at providing some tax benefit to individual taxpayers whose net business income would not otherwise push them into otherwise applicable individual income tax rates of 25% or above (i.e., capturing individual taxpayers whose taxable income would be subject only to the lower proposed 12% individual income tax rate under the House bill, where a special "25% pass-through rate" would be of no help).

III. Senate Pass-Through Proposal with respect to Service Businesses

Rather than permanent special tax rates, the Senate proposal provides for a special 23% deduction for individual taxpayers and only on a temporary basis (sunsetting at the end of 2025). The deduction is the aggregation of the lower of the following two variables with respect to each business with respect to the taxpayer: (i) 23% of net qualified business income of each such business and (ii) 50% of wages paid to (or withheld/deferred for retirement for) employees with respect to each such business (the W-2 limit). Qualified business income has the same definition as in the House proposal, except that it (i) is limited to business income only from US businesses (applying the same tax standards that apply to determine whether business income of foreign individuals should be subject to US taxation – the effectively-connected income rules) and (ii) excludes compensation or similar payments to such individual from any such business. In the case of tax partnerships and S corporations, the deduction is determined at the partner or shareholder level (which necessarily will require annual information-reporting by the relevant partnerships and S corporations to their owners). Since the overall Senate plan also proposes to retain the individual AMT, it is relevant to note that it seems that such deduction is also permitted for the AMT.

There are two wrinkles with respect to such general rules regarding a specified service business, which has virtually the same meaning as in the House proposal (as described above). First, business income of a specified service business is excluded from the determination of the deduction. Second, however, to the extent that an individual's taxable income is less than \$500K, business income of a specified service business is included in the determination of the deduction (and the W-2 limit does not apply). As taxable income increases from \$500K to \$600K, such exclusion (and W-2 limit) gradually phases in (all of these amounts are for MFJ filers, with proportionally lower amounts for other filers). This \$500K/\$600K taxable income carve-out for specified service business income captures a much broader swath of taxpayers than the special 11%/10%/9% tax rate carve-out in the House proposal, and it would seem to be easier to determine than the special "prove-out election" carve-out in the House proposal for capital-intensive service businesses. This \$500K/\$600K carve-out also helps partially alleviate a timing issue with the Senate deduction provision in that many businesses may experience income growth before increasing employee wages, which would cause the W-2 limit to drag down the applicable deduction until employee wages presumably increase in the future. Overall, however, a 23% deduction may still be less beneficial than a special 25% rate with respect to qualified business income, depending on where any relevant individual taxpayer falls in whatever graduated individual tax rate structure is enacted.