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NEWSLETTER

Trump Tax Windfall for Pass-Through Entities? Stay Tuned.

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Even before the Trump Administration in April 2017 publicly outlined its tax-reform proposals, tax advisors had begun strategizing about using pass-through entities to reduce the federal income tax rate on income from performing services. Tax policy wonks and budget hawks have warned that this "windfall" would abuse and jeopardize projected revenues from a reformed tax system. While we await the details of the Trump Administration's proposals and proposed legislation, let's consider the possibilities and how the rules might address them.

Pass-Through Entities

For tax purposes, the term "pass-through entity" refers to a legal entity that itself is not subject to income tax. Instead, the entity's income passes or "flows" through to the entity's owners who report the income on their own income tax returns. Pass-through entities generally include partnerships, limited liability companies (LLCs) except single member LLCs, and Subchapter S corporations ("S" corporations). Regular corporations ("C" corporations), by contrast, are themselves subject to income tax, and their shareholders are taxable on corporate income distributed to them as dividends.

Current and Proposed Rates

Currently, compensation including salaries and wages and income earned from serving as an independent contractor (sometimes referred to as "1099 income") is taxable at a maximum federal income tax rate of 39.6%. Income other than capital gains that flows through from pass-through entities is also subject to a maximum rate of 39.6%.

Practice Areas

Corporate

Under the Trump Administration's outlined tax-reform proposals, "business" income from both corporations and pass-through entities would be taxable at a maximum rate of 15%. "Personal" income such as salaries and wages would be taxable at a maximum rate of 35%, down from 39.6% currently. See "2017 Tax Reform for Economic Growth and American Jobs" (April 27, 2017). Consequently, pass-through income could be taxed at a rate up to 20% lower than the tax rate on personal income.

The Issue

By arranging to earn services income through a pass-through entity instead of directly, could an individual including a doctor, lawyer, or other professional convert income traditionally taxable at personal rates (up to 35% under the proposals) into business income taxable at a maximum rate of 15%?

The Answer

The answer appears to be yes, but only if the arrangement is structured around existing rules and any new rules that do not successfully thwart the technique.

Existing Rules

Existing rules address the character of income and require reporting of services income to the IRS. Under long-standing rules, income flowing through a pass-through entity to its owners retains its underlying character determined at its source. See Internal Revenue Code Sections 702(b) (partnerships) and 1366(b) (S corporations).

Payors of compensation report it to recipients and the IRS on Form W-2 (Employees) or Form 1099 (Independent Contractors). The IRS has become adept at matching the reported information to individual tax returns. For example, if the IRS has received a Form 1099 but does not see the reported amount on the payee's income tax return, then the IRS's computers typically generate a notice to the taxpayer requiring an explanation.

The IRS could use these reporting rules and procedures to prevent some inappropriate results. For example, even if an employee were to instruct an employer to issue a Form W-2 to the employee's pass-through entity (and even if the IRS unlikely accepted the Form), the reported income would retain its compensatory character. Similarly, even if an independent contractor were to instruct the payor to issue a Form 1099 to a pass-through entity, the income would retain its character as nonemployee compensation. By matching, as it already can, Form W-2 or Form 1099 to an individual's tax return, the IRS could satisfy itself that the income was properly taxed at personal rates.

More Creative Approaches

But what if an individual structured or restructured an arrangement around these reporting rules? For example, an individual forms a partnership, LLC, or S corporation and holds the entity out as conducting a business. The individual instructs clients and customers to pay the pass-through entity directly for services rendered. No Form W-2 or Form 1099 is issued because technically it's not required. The individual characterizes the

payments as flow-through income taxable at 15%.

Commentators on tax policy have warned that the "Kansas experience" portends abusive results at the federal level. In 2013, Kansas abolished its state income tax on pass-through entities. Thousands of residents have reacted to the change by converting themselves to pass-through entities and claiming that all the income they receive from the entity, including income from performing services, is exempt from Kansas income tax. The state's collections of income tax have significantly declined.

Possible Responsive Rules

Publicly acknowledging the potential for abuse, prominent members of the Trump Administration have stated confidently that responsive rules can and would be issued. At the press conference unveiling the Administration's tax-reform outline, U.S. Treasury Secretary Steven Mnuchin stated, "We will make sure that there are rules in place so that wealthy people can't create pass-throughs and use that as a mechanism to avoid paying the tax rate they should be paying on the personal side." Earlier, at a tax policy forum held in October 2016, Wilbur Ross – since appointed U.S. Secretary of Commerce – dismissed concerns about the difficulty of thwarting abuses, stating, "If all the people in Washington, if all the lawyers, if all the tax experts can't figure out how to draft a simple thing like that successfully, they ought to quit."

Technical Challenges

Notwithstanding these expressions of confidence, responsive rules would prove technically challenging to write. They also would further complicate the Internal Revenue Code or Regulations, contradicting the Trump Administration's stated goal of tax simplification.

Anti-abuse rules could take various forms. For example, they could prescribe that no more than a stated percentage of income from a pass-through entity qualifies for the 15% rate, the remaining flow-through income having to be taxed at the personal rates. Upon proposing his own tax reform ideas in 2014, Dave Camp, then Chairman of the House Ways and Means Committee, suggested such an approach. Another possibility would consist of prescribing that all pass-through income from particular categories of personal services (for example, medicine, law, accounting, and consulting) must be taxed at the rates on personal income rather than the 15% maximum rate on business income.

Predicted Responses and the Future

Endeavoring to exploit a planning opportunity, or at least front-run the effective date of any future rules attacking it, aggressive taxpayers might not wait to convert themselves to pass-through entities. More cautious taxpayers will await the details. Only in the fullness of time will we know the answers to three questions: First, will a reformed Internal Revenue Code in fact tax business income from pass-through entities at lower rates than wages, salaries, and other compensation? Second, if so, will the amended rules seek to prevent abusive results? Third, will any anti-abuse rules succeed? Stay tuned.