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After Changes to Pass-Through Taxation, Will You Get a Tax Break?

In case you have been in a coma, major tax changes to the Internal Revenue Code were passed in December 2017. *See* Pub. L. 115-97 (115th Cong., 1st Sess.). Those changes make it much more attractive (from a tax perspective) to arrange one's affairs like a business owner.

Broadly speaking, the new tax law changed the landscape so that many business owners will now benefit from dramatically lower tax rates (*e.g.*, the corporate rate has not been this low since 1939). Nevertheless, to take full advantage of the massive tax cuts, careful attention must be paid to match the appropriate entity type with the underlying business. In the professional services context, H.R. 1 may lead to some business reorganizations. When the stars align, one attractive entity type is the cooperative. Cooperative owners face fewer hurdles to obtaining a tax cut than every other business entity type but governance challenges may outweigh the tax benefit.

What's All This About a Pass-Through?

First, let us understand the changes. C corporations pay entity-level tax, whereas S corporations, partnerships, and other "pass-through" entities do not pay entity-level tax (at the federal level). In addition, for the last 30 years, individual income tax rates have generally been lower than corporate income tax rates. Therefore, there has been a strong incentive to use pass-through forms of business ownership to avoid two layers of tax and to pay a lower overall rate of tax. About 15 years ago, the introduction of a lower rate of tax on "qualified dividends" (which include many domestic corporate dividends) made corporate ownership less expensive, but did not eliminate the two layers of tax.

H.R. 1 dropped the corporate tax rate from 35% to 21%. Meanwhile the highest rate for individuals is now 37%, down from 39.6%, with the qualified dividend rate at 15% for many taxpayers. Hence the dual rates applied to corporate income combined (21% at the corporation level and 15% on the dividend to shareholders, for 36% total) are lower than the highest individual income tax rate. Does this mean that all those businesses that organized as pass-through entities (and settled for one layer of tax over two) are possibly worse off than they would be if they had organized as corporations?

H.R. 1 section 11011 creates new section 199A of the Internal Revenue Code, aimed at lowering the individual rate on pass-through income. Section 199A is 10 pages long and it is complex. Nevertheless, section 199A is designed around an idea that is easy to understand. Namely, to avoid incentivizing incorporation over other business forms, section 199A is meant to bring the pass-through rate down so that the total tax paid by a business owner is roughly the same whether the business is organized as a corporation or a pass-through.

A Few Details, Please

Next let us look at the mechanics of the pass-through change. Section 199A is a “below the line” itemized deduction. That means section 199A will not reduce an individual’s adjusted gross income but will reduce the amount of taxable income in a particular year. In addition, section 199A applies to taxpayers *other* than a C corporation. This means that an individual sole proprietor may take advantage of the “pass-through” deduction without forming a new entity.

Section 199A is designed to exempt 20% of ordinary income from a pass-through trade or business from income tax. Yet because it is a tax provision, it has to be more complex. So there are phase-ins and phase-outs; defined terms; calculations; reference to other sections in the Internal Revenue Code; basically a turkey with all the trimmings for a tax nerd (and an absolute nightmare for any normal person).

The absolute basics are as follows:

1. For all single taxpayers with less than $157,000 in taxable income (or married taxpayers with less than $315,000 in taxable income): if the taxpayer quit his job, started Consulting LLC, and he charged his old employer a consulting fee, the taxpayer would be able to exempt 20% of his income from federal income tax.
2. For all single taxpayers with more than $207,000 in taxable income (or married taxpayers with more than $415,000 in taxable income): this trick continues to work only if the taxpayer’s trade is not on a list of “specified service trade or business” as defined in section 199A(d)(2). The list includes businesses generally characterized as professional service firms, such as: doctors, law firms, accounting firms, financial services, and consulting firms. (Engineering and architecture firms are expressly excluded from the definition of a “specified service trade or business”, presumably because their lobbyists are betters than ours.)
3. Where a taxpayer’s profession is a “specified service trade or business” and she makes more than $207,000 or $415,000 (if she is married): section 199A does not apply. That is, if you are a lawyer making over $415,000, you have the pleasure of paying a higher rate of tax than your architect or engineer clients.
4. Unlike payments from other pass-through entities, “patronage dividends” from cooperative corporations are not subject to the restrictions and limitations discussed above. Hence, if our taxpayer forms a cooperative with his fellow colleagues instead of a single member LLC, the taxpayer may be able to obtain exempt 20% of his income, **regardless of profession or income amount**.

Those basics are subject to some strong caveats, namely:

1. The taxpayer cannot take a deduction for “the trade or business of performing services as an employee” under section 199A(d)(1)(B). Hence, the relationship between the taxpayer and her former employer will need to meaningfully change.
2. The reduction in income tax will be partially offset by an increase in self-employment tax of 7.65% on the first $128,400 (in 2018). Other pre-tax employee benefits (such as health care) would now be paid

post-tax by the self-employed taxpayer and subject to itemized deduction limitations.

3. Existing state law and/or professional ethics rules may restrict professional services taxpayers abilities to practice to certain entity types (*e.g.*, California does not allow an LLC to render legal services; and laws governing cooperatives vary drastically from state-to-state).
4. Judicial doctrines and factors employed by the IRS to look to the substance rather than the form of a situation may catch out even careful taxpayers.
5. Section 199A is complex and the summary above is a very simplified version; consult a tax colleague in conjunction with any planning.

Give Me an Example or Four

Finally, with an understanding of the basic concepts, let us consider four examples: a sole-proprietor barber, an associate attorney; a real estate executive; and an artist.

First, the barber. Suppose singleton Calvin the barber is a sole proprietor and has no employees. He leases a building and offsets his risk with insurance. He reports his income and expenses on Schedule C. After expenses, Calvin makes $50,000 per year. Good news for Calvin. Although his business has no employees and few assets, he is below the $157,500 threshold and his services are not being an employee but being a barber. Assuming the barbershop is Calvin’s only source of income, he will get to exclude $10,000 from his taxable income (20% of the $50,000 business income).

Second, the associate attorney. Suppose engaged attorney Rachel intends to start work at law firm Pearson Specter in New York with an annual salary of $180,000 on January 2, 2018. If Rachel works as an employee, her marginal income tax rate will top out at 32%. But if Rachel instead convinces Pearson Spector to hire Rachel LLC (her legal services entity) and Rachel otherwise avoids “employee” status, she will be able to take advantage of section 199A, though it will be somewhat limited due to the phase out for “specified service trade or business” over $157,500 (the calculation is complicated but in this example, Rachel would a 45% section 199A deduction, which means she would exclude 9% of her income (45% x 20%), or $16,200). If Rachel happens to marry a well-mannered prince with no income, she will be able to file a joint return and the phase-out for “specified service trade or business” will not apply until the couple reach $315,000 in taxable income. In that case, Rachel will to exclude $36,000 from her taxable income (20% of the $180,000 LLC income).

Third, the real estate professional. Suppose real estate salesman Fred has been selling units of a building in SoHo for his employer. Fred, an employee, expects to make $450,000 from his employer this year. As an employee, his marginal income tax rate on $450,000 will top out at 35%. So Fred gets an idea. He offers to continue to sell units in the SoHo as Fred LLC, rather than as an employee. Because real estate is not a “specified service trade or business”, Fred is entitled to the section 199A deduction. However, due to restrictions on the section 199A deduction, Fred's section 199A deduction will be limited to acquisition value of the LLC's qualified property and to W-2 wages paid to employees.

Finally, consider the struggling artist. Artist Georgia is upset because artists are included in the definition of “specified service trade or business”. Hence, despite the fact that she has worked hard to build a successful business model around her art, she is unable to take advantage of section 199A because of the “specified service trade or business” provisions. But if Georgia were to form a cooperative corporation with her fellow artists, and structure the payments so that she only received “patronage dividends”, Georgia would be able to fully take advantage of section 199A. This appears to be the case even if her income is above the threshold amounts and even though her trade or business is a “specified service trade or business”. In exchange for a 20% tax break, Georgia must put up with one-member, one-vote governance;

and “patronage dividend” rules. Nevertheless, it might be worth the tax savings.

Conclusion

H.R. 1 brings with it many changes to the Internal Revenue Code. In general, this is legislation that benefits business owners. As many employees will find themselves paying lower taxes than their bosses, questions of equity cannot be far behind. If and when employees have an opportunity to negotiate with their employers, restructuring employment may be the next frontier. Forget fringe benefits, turning employees in to an independent contractor relationship with an employee-owned pass-through is the biggest gift an employer can give. The employee gets to exempt 20% of income from federal tax; other than transaction costs, the employer is not seriously inconvenienced. Seems like a win-win-lose, where only Treasury loses out.

For more information, please contact:

Michael J. Gorback, Partner
(415) 995-5100
mgorback@hansonbridgett.com