ISSUE BRIEF
National Taxpayers Union Foundation

What's the Deal with Pass-Through Taxation?

NTUF Issue Brief #173

November 29, 2017

By Andrew Moylan

With the advancement of both the House and Senate versions of the Tax Cuts and Jobs Act (TCJA) in the last few weeks, Congress has signaled that it will finally embark on a fundamental reform of our tax code after months of discussions and negotiations. As with any tax reform plan, however, the devil is in the details and one detail that has generated a lot of focus - and confusion - is the bill's treatment of so-called "pass-through" income.

Many small businesses are referred to as "pass-throughs" because their profits are "passed through" the business and claimed by the owners of the business on their personal tax returns. While corporations tend to dominate news coverage, pass-throughs represent over 90 percent of all businesses and over 57 percent of employment while producing nearly 50 percent more revenue in total than traditional corporations.[1] This makes treatment of pass-through income one of the most important aspects of any pro-growth tax reform package.

Structuring a business as a pass-through helps reduce the double taxation effects inherent in the corporate income tax, but under our current tax code pass-through businesses can face high tax burdens as well. A marginal dollar in corporate income earned under current law will face a tax rate of 50.47 percent, when combining both the corporate income and individual income tax layers. A marginal dollar in pass-through income, meanwhile, faces a top rate of 39.6 percent. When adding self-employment taxes and state income tax levies, however, tax bills can rise above 50 percent of income.[2]

The bottom line…

- Pass-throughs comprise more than 90 percent of all businesses and over 57 percent of employment, so it's crucial that tax reform provide them relief.
- The House tax reform bill provides nearly $600 billion in pass-through tax relief by establishing a special 9 percent rate at the bottom and capping the top rate at 25 percent.
- The Senate tax reform bill provides more than $360 billion in pass-through tax relief by creating a widely-available 17.4 percent deduction for pass-through income.
- Under either plan, top marginal rates on pass-through income would remain substantially lower than top marginal rates on corporate income: nearly 4 percentage points lower under the House bill, and more than 7 percentage points lower under the Senate bill.
- Under either plan, lower and simpler individual income tax rates, increased cash accounting, and improved cost recovery will benefit pass-throughs regardless of income.

House and Senate negotiators have each sought to reduce these high tax burdens, but in substantially different ways.

The House Approach

The House-passed version of TCJA proposes a new cap on the top rate for pass-through income of 25 percent.[3] This change would reduce tax burdens for the most successful small businesses that face steep levels of taxation under the current code.

The obvious challenge that arises from capping taxation of pass-through income at a rate lower than the top income tax rate is that individuals could attempt to game the system. Absent safeguards, some high-income individuals could reorganize their income to pose as pass-throughs. Doing so would enable them to benefit from lower rates, which threatens to turn the system into a giant loophole.

When constructing safeguards to prevent that outcome, there are three general policy options: selectively apply or deny the benefits of a lower pass-through rate depending on the type of business or service, apply a blanket standard whereby a fixed ratio of income is treated as business versus wage income, or create a so-called "facts and circumstances" test that allows each pass-through to prove how much of its income is in fact business versus wage income.

Rather than choosing one of these options, the House version of the Tax Cuts and Jobs Act blends all three together. It dictates that certain professional services, like attorneys, would be unable to benefit from the lower pass-through rate. Absent guardrails, these types of services would benefit disproportionately from a lower pass-through rate and thus would be expected to reorganize in large numbers to take advantage of it, creating a "leakage" problem. While not the cleanest solution, denying the benefits of the pass-through rate to such service entities can prove effective in preventing that leak.

For businesses that are not selectively denied the benefits of the pass-through rate, the general approach is a so-called "70-30" rule, which establishes a bright-line standard that they count 70 percent of income as ordinary wage income (and thus subject to ordinary income tax rates) and 30 percent as business income (and thus subject to the lower pass-through rate).

This rule is derived from historical data which shows that roughly 70 percent of returns accrue to labor (i.e. workers earning income) while 30 percent of returns accrue to capital (i.e. ownership).[4] Using that historical precedent to establish a bright-line standard will provide taxpayers clarity on attributing income for tax purposes. For those that argue that a 70-30 rule is based off a broad view of the economy and unfairly penalizes some business models, the facts-and-circumstances option allows for a more tailored approach.

Wage income refers to the income that is paid to employees, and thus subject to ordinary income tax rates. Under the tax reform plan, that would mean a consolidated rate structure with a lowest marginal rate of 12 percent and highest of 39.6 percent. Business income refers to a company's profits (or losses). Small businesses bear the burden of figuring out what part of their business profits they want to pay to their owners and workers and what part should be invested back in the business.

Alternatively, for businesses that feel a 70-30 rule would unfairly characterize too much income as wage income not eligible for the 25 percent top rate, the bill provides for a "facts-and-circumstances" option which calculates taxability based on a formula relating to capital investments and rate of return. This theoretically allows a "safety valve" for businesses that don't fit the traditional 70-30 model well by letting them "prove out" of the default treatment and use the facts-and-circumstances test. This would allow them to calculate taxability based on the aforementioned formula for a five-year period.

In essence, the plan is centered on the 70-30 rule with fixes aimed at complaints on either side. For pass-throughs that feel the 70-30 rule is too restrictive in allowing small businesses to enjoy the benefits of a lower rate, there's the facts-and-circumstances test that allows them to "prove out" of default treatment based on their particular situation. This adds significant complexity, but does allow for some flexibility in addressing the concerns of pass-throughs that would be treated unfairly by the rigidity of a 70-30 rule. For those that fear rampant gaming of the pass-through rate by accounting firms or lawyers, the default denial to those industries prevents that. This approach isn't particularly precise in its application, but does, on an economy-wide basis, take steps to close potential loopholes.

Many small businesses, of course, don't earn enough income to face taxation at the highest rates. Some have alleged that this means that pass-throughs with more modest incomes will receive no benefit from the TCJA as currently constructed, since their top income tax rate is already at or below the 25 percent pass-through rate. This overlooks significant changes that benefit pass-throughs of all sizes, like the increase in the standard deduction and the consolidation and lowering of tax rates.

Other reforms will help pass-throughs less directly. Small businesses stand to benefit from increased cash accounting and an expansion of "Section 179," which will allow them to more quickly recover the costs of new investments. Additionally, filing taxes is time consuming and expensive for all filers, but for small businesses even more than most. Approximately 85 percent of small businesses have to pay an outside accountant to file their taxes, and a report from a few years ago found that businesses with less than 50 workers spend approximately 50 percent more on tax compliance than other businesses.[5] The significant simplifications in the House TCJA mean more businesses can opt for the standard deduction and avoid the process of navigating through confusing credits and deductions. Those that opt to itemize will also find a simpler tax code with a lighter compliance burden.

To enhance benefits for lower-income pass-throughs, House negotiators also added a new 9 percent bracket covering smaller amounts of pass-through income. This provision extends some additional benefits to lower-income pass-throughs, but in doing so adds significant complexity. The first $75,000 of pass-through earnings for a taxpayer with less than $150,000 in such income is subject to the 9 percent rate, but the discount phases out approaching $225,000 in income. Once fully phased-out, there's a small window of income between $225,000 and $260,000 where no special pass-through rate applies. Income above $260,000, however, benefits from the aforementioned 25 percent special rate. On top of this, the 9 percent rate itself is phased in over the course of several years, starting out at 11 percent over the next two years and dropping to 10 percent for two additional years, before finally reaching 9 percent.

The Senate Approach

The Senate approach is quite different. On its face, it takes a simpler approach by establishing a deduction worth 17.4 percent of qualified business income from a pass-through. The "guardrails," such as they are, with this deduction are relatively limited.[6]

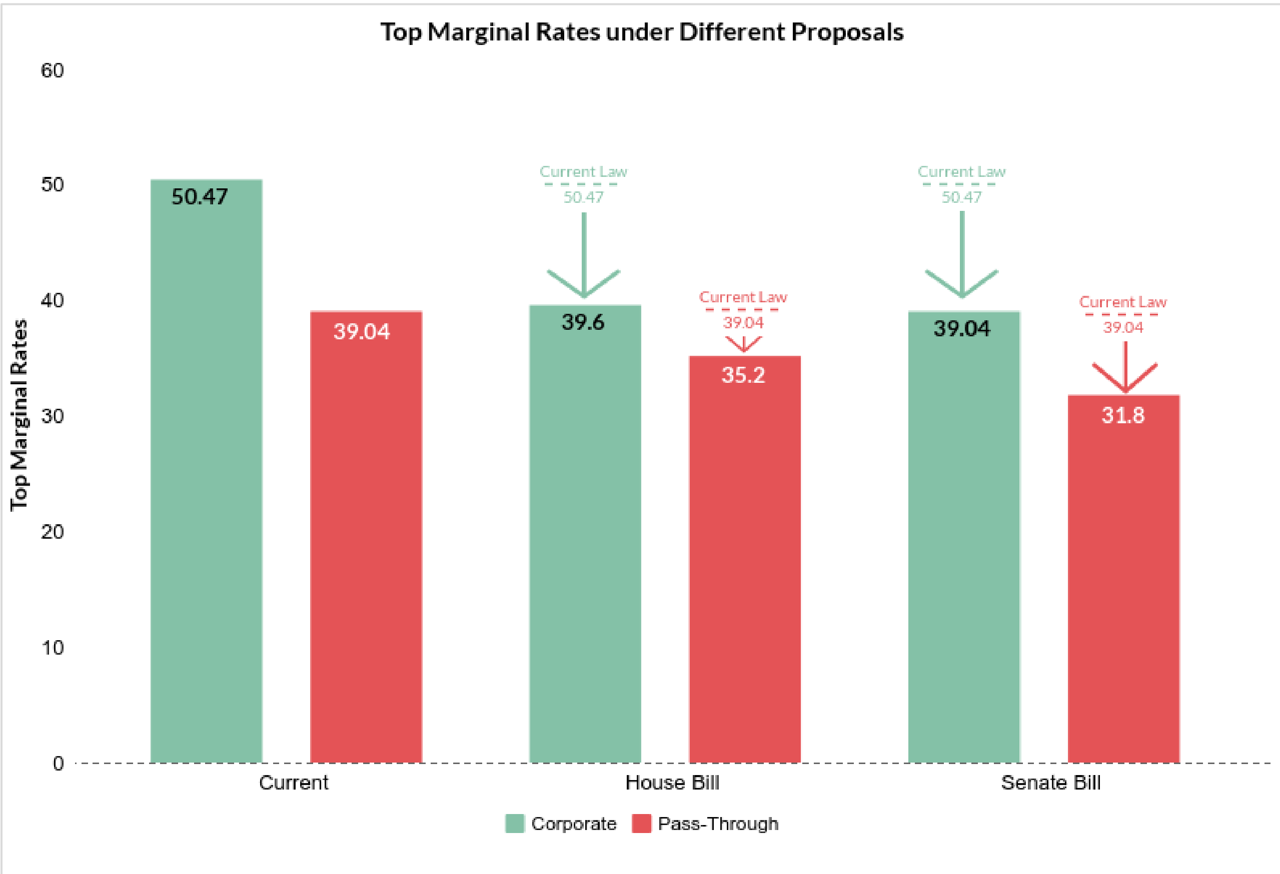
First, in a manner similar to the House plan, the Senate bill does not allow certain professional service pass-throughs to claim the deduction, but only if their income exceeds $500,000 for a couple or $250,000 for an individual. Professional service providers with income below that very high threshold can still claim the deduction. Additionally, it restricts the total amount of the deduction to no more than half of the taxpayer's W2 wages, but again only if income exceeds $500,000/$250,000. Practically speaking, this serves as very modest limitation.

Structured as a flat deduction rather than as a preferential rate, the Senate provision is significantly less complicated than the House's. It also has the effect of distributing its benefits somewhat more consistently, since all qualifying taxpayers would apply the same 17.4 percent deduction. By contrast, the value of the House bill's preferential top rate accelerates as incomes climb since it protects pass-throughs from high ordinary income tax rates.

Though simpler and somewhat more progressive, the Senate pass-through provision also provides less overall tax relief than the House's, in part because it is scheduled to sunset (along with several other features) at the end of 2025. The Joint Committee on Taxation estimated that the House pass-through provisions would provide $596.6 billion in tax relief for small businesses over the course of the next decade.[7] By contrast, the Senate plan provides $362.2 billion in relief.[8]

On the other hand, the Senate plan would yield a significantly larger advantage for pass-throughs in terms of top marginal rate faced. Under both the House and Senate bills, corporate income faces a top marginal rate of 39.04 percent when accounting for both layers of taxation. Under the House plan, pass-throughs would face a top marginal rate of 35.2 percent, nearly 4 percentage points lower than the combined corporate burden. Under the Senate plan, the top marginal rate for pass-through income would be 31.8 percent, over 7.2 percentage points lower.[9] The top marginal rate, of course, is not a measure of overall tax burdens but a measure of the tax burden on an additional dollar of income that faces the highest rates of taxation.

As Senate negotiators continue their work, there is speculation that the 17.4 percent deduction in the original draft of the bill might increase to 20 percent.[10] If such an amendment were added to the plan, it would increase the tax advantage enjoyed by pass-throughs, once accounting for total tax burdens, to over 8.2 percentage points as pass-throughs would face top rates of 30.8 percent, compared to 39.04 percent for corporations.



Conclusion

Small business owners, who employ the majority of American workers, pay their taxes on their personal tax returns. It is imperative that any tax reform plan take significant steps to lower their burdens in order to unlock additional growth that is squandered by our current tax code. Though they take different approaches, both the House and Senate tax reform bills would make significant progress toward that goal.

By setting up preferential rates on both the low and high ends of the income spectrum, the House bill provides substantial tax relief to pass-throughs. By establishing a deduction widely available to pass-through owners, the Senate has a similar effect through different means. The simple fact is that regardless of the approach Congress pursues should the legislation reach a conference, pass-through business owners will see their tax rates reduced and will continue to face lighter tax burdens than traditional corporations.

About this Issue Brief

This is the fourth release in NTUF's "What's the Deal with Tax Reform?" series, designed to provide non-technical explanations of highly technical tax policy issues. Previous editions covered base erosion, expensing, and the state and local tax deduction.

About the Author

Andrew Moylan is Executive Vice President of the National Taxpayers Union Foundation, the research and educational affiliate of the National Taxpayers Union.

---

[1] Greenberg, Scott, *Pass-Through Businesses: Data and Policy*, Tax Foundation, January 17, 2017, https://taxfoundation.org/pass-through-businesses-data-and-policy/.
[2] Pomerleau, Kyle, *An Overview of Pass-through Businesses in the United States*, Tax Foundation, January 21, 2015, https://taxfoundation.org/overview-pass-through-businesses-united-states/.
[3] H.R. 1, Tax Cuts and Jobs Act, introduced November 2, 2017, https://www.congress.gov/bill/115th-congress/house-bill/1.
[4] The S. Corporation Association, *Pass Through Tax Rates and the 70/30 Rule*, September 25, 2017, http://s-corp.org/2017/09/25/pass-through-tax-rates-and-the-7030-rule/ .
[5] Cohn, Michael, *Small Businesses Overwhelmed by Tax Compliance Work*, April 9, 2015, https://www.accountingtoday.com/news/small-businesses-overwhelmed-by-tax-compliance-work; Crain, W. Mark and Crain, Nicole V., *The Cost of Federal Regulation*, National Association of Manufacturers, September 10, 2014, http://www.nam.org/Data-and-Reports/Reports/Cost-of-Federal-Regulations/The-Cost-of-Federal-Regulation/.
[6] Joint Committee on Taxation, *Description of the Chairman's Modification to the Chairman's Mark of the "Tax Cuts and Jobs Act,"* November 14, 2017, https://www.finance.senate.gov/download/tax-reform-chairmans-modified-mark.
[7] The Joint Committee on Taxation, *Estimated Revenue Effects Of H.R. 1, The "Tax Cuts and Jobs Act,"* November 9, 2017, https://www.jct.gov/publications.html?func=startdown&id=5034.
[8] The Joint Committee on Taxation, *Estimated Revenue Effects Of The Chairman's Mark Of The "Tax Cuts And Jobs Act,"* November 9, 2017, https://www.jct.gov/publications.html?func=startdown&id=5033.
[9] Walczak, Jared, *Are Pass-Through Businesses Treated Fairly Under the Senate Version of the Tax Cuts and Jobs Act?* November 17, 2017, https://taxfoundation.org/pass-businesses-treated-fairly-senate-version-tax-cuts-jobs-act/.
[10] Rubin, Richard and Hughes, Siobhan, "Senators Seek Changes to Tax Bill as Busy Week Kicks Off," November 27, 2017, https://www.wsj.com/articles/senators-seek-changes-to-tax-bill-as-busy-week-kicks-off-1511805833.