The Daily Dish

Tax Reform and Pass-thru Entities

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Eakinomics: Tax Reform and Pass-thru Entities

Last week Ways and Means Chairman Kevin Brady released his chairman's mark of the Tax Cuts and Jobs Act (TCJA) and the committee will begin to markup the bill at noon today. A central feature of the reform is the growth-related corporate provisions — a lower rate of 20 percent, taxation of only U.S.-sourced income (a territorial system) and immediate deduction of some capital expenditures (expensing) for the next five years.

Firms taxed under the corporation income tax — so-called C corporations — account for less than 50 percent of business income. The majority is earned by "pass-thru" entities in which business income is divided among the owners and taxed as part of their individual income on their personal return. In order to have a level tax playing field for all businesses, there is the need to modify the individual income tax as well.

The TCJA handles this by creating a 25-percent rate for business income. That provides rough parity with corporate income taxed at 20 percent plus another quarter of it taxed as dividends or capital gains. The complication is that if there is $1 million of business income, some of that reflects the labor efforts of the owner and some the return to invested capital. Since having such a large income would likely put the owner in the 39.6-percent bracket, there is a huge incentive to claim that it is <u>all</u> return to capital and tax all of it at the 25-percent rate.

TJCA solves this by imposing the rule that 30 percent of the $1 million is capital income and 70 percent is wage income. The 30-70 split is roughly the economy-wide average. There has been a lot of commentary surrounding this provision, most of it emphasizing that it would be "gamed." That is just plain wrong. The rate is 25 percent and the base is 30 percent of income. Period. There is no way to game it.

On the other hand, it is almost surely wrong for specific firms and owners. TCJA has a second option in which firms can calculate their capital income by multiplying a rate of return times the capital invested. The TCJA specifies the rate of return as 7 percent plus a short-term federal rate (currently about 1.5 percent). In my example, if invested capital was $500 million, applying the 8.5-percent rate would yield $42,500 in capital income and a correspondingly smaller $57,500 in labor income.

Don't expect the controversy to abate. After all, there are still reasons to disagree about both the rate of return and the measurement of invested capital. On top of that, the remainder of the individual tax reforms (e.g., the elimination of deductibility of state and local income taxes) will also affect the overall tax rate of pass-thru owners.