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Tax Cuts for Small-Business Owners? It's Complicated

By Paul Sullivan
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The House Republicans' tax overhaul bill calls for reducing the tax burden on people who own small businesses like Steve's Bike Shop — not give breaks to professional athletes like Stephen Curry, the N.B.A. All-Star.

The rewrite of the tax code, which the House passed on Thursday, proposed a 25 percent tax rate for small businesses for owners who report their profits as income on their tax returns. It was slightly higher than the 20 percent rate for corporations but a break from the top individual rate of 39.6 percent.

In the end, though, the bill might not help the fictional Steve or the real Steph, who were named in the bill. But Mr. Curry's wife, Ayesha, a TV personality who receives royalties and licensing fees from businesses she represents, could get a tax break. The reason is that the proposals for taxing small-business owners — whose companies are called pass-through entities, because the income passes through to their personal tax returns — hinge on the ownership of those entities.

Those who make money passively — by owning part of a pass-through entity they do not run or receiving endorsements and licensing agreements through a passive vehicle — could structure their payments to achieve a lower tax rate. Those who are actively running a business that is structured as a pass-through — for instance, a limited liability company, an S corporation or a partnership — will not see as great a reduction in taxes and may even see an increase in certain states.

"It's not how much you make," said Edward Reitmeyer, partner at Marcum, a national accounting firm. "It's how you make it."

In other words, the House bill may seem like a tax cut for small businesses, but it is not likely to bring much relief to many of those owners, and it is certainly not comparable to what was proposed for large corporations. And some professions, like consultants, lawyers, doctors and other professional services companies, are not even eligible for the lower pass-through rate.

"What's really going to happen is, people are going to change their behavior based on this tax act," Mr. Reitmeyer said, like rethinking their business tax structure.

The House bill says that up to 30 percent of business income can be taxed at the lower 25 percent rate, with the rest at the personal income tax rate. At the highest level, this is a blended tax rate of 35.22 percent, at least for businesses that qualify. That is a far cry from the 20 percent proposed for corporations.

The Senate proposal, which is wending its way through the committee process, offers the possibility of a deduction of business income of up to 17.4 percent. But it still has hurdles: This week, it lost one Republican vote, when Senator Ron Johnson of Wisconsin opposed the different treatment for corporations and pass-through entities.

What becomes of the two bills when they get reconciled is going to determine whether small-business owners will pay less in taxes. But it will also determine what resources they will have to invest in their businesses and still maintain their lifestyles.

The savviest business owners will begin by calling a sophisticated accountant or tax lawyer. These advisers already have plans to take advantage of lower tax brackets and shift income away from areas where it would be taxed at a higher rate.

Jay Hatfield, the chief executive and co-founder of Infrastructure Capital Advisors, which runs two mutual funds and three hedge funds in New York, is preparing to change the tax structure of his business. “The language that I saw implied that businesses like ours won’t get any relief under the rules because financial service companies are under professional services,” he said.

He plans to convert his pass-through business to a C corporation, which will allow him to pay lower taxes and have more money to invest in the business. He has five employees and plans to hire two more.

“It makes sense from an economic perspective,” Mr. Hatfield said. “You’re increasing the incentive to save and invest and decreasing the relative incentive to consume.”

He said his decision was not driven entirely by taxes, but he was persuaded to make the transition now by what could be a huge difference between paying his taxes as a corporation and as an individual.

“It’s like you have to incorporate in New York State,” he said, because of the great difference between the top individual tax rate and the corporate tax rate.

There are ways for small-business owners to manipulate the proposals solely to save on taxes.

Mr. Reitmeyer is working on creating a structure for a lending company that would allow bonuses for its senior executives to be taxed at the much lower 25 percent rate.

This would be done by dividing the assets of the firm between the existing corporation and a new pass-through company. The senior executives would be passive investors in that new company, which could then pay them “distributions” — or bonuses — at the 25 percent rate. Other employees, however, would still pay regular tax rates on their income.

Business owners in the Northeast and in California who pay state and local taxes are able to deduct those payments on their federal taxes, but they might see those deductions eliminated in the final tax bill. Structures like the C corporation will be even more appealing as a way for business owners to reduce their tax bill. Mr. Reitmeyer said the moves could hark back to the early 1980s, a heyday for tax-avoiding structures.

Yet for many small businesses, owners do not earn enough to benefit from the 25 percent tax rate. If the proposed 17.4 percent deduction in the Senate bill survives, small-business owners could incorporate and benefit from that deduction.

One amendment in the proposed bill reduces the bottom rate to 9 percent, from 12 percent, for smaller businesses. But the bigger advantage remains for those who can go to 25 percent from 39.6 percent.

If all of this seems confusing, take heart — it is equally frustrating to tax experts. “The pass-through section is the worst piece of legislation I’ve seen in 30 years,” said Steven M. Rosenthal, a former member of the Joint Committee on Taxation and a fellow at the Tax Policy Center in Washington.

“It’s addressing a non-problem,” Mr. Rosenthal added. Owners of pass-through businesses believe they deserve a lower tax rate, he said, but they could elect to be a corporation tax-free if they wanted.

He pointed out that the same economic activity could now be taxed at three different rates, depending on whether it was generated by a company, a pass-through entity or an individual.

Another worrying aspect is the rush by Republicans to enact tax change — previous efforts have taken years — which could lead to mistakes that the Internal Revenue Service will need time to correct.

“The loopholes and glitches will be preserved until the I.R.S. comes out with technical corrections,” Mr. Rosenthal said. “They take years, sometimes a decade, to get to technical corrections.”

Worse, from a behavioral standpoint, is what happens if certain provisions are delayed for a year or two while others are enacted in a few months. People will take losses in one year to maximize the tax benefit and wait to sell a company until the tax rate drops.

“They’re trying to fit all these goodies into a $1.5 trillion package, and it doesn’t fit,” said Ivan A. Sacks, head of the private client and tax group and chairman of the law firm Withers Worldwide. “So what they’re doing is waiting on some of these changes. That’s not stimulative.”

It may not be for business owners, but it’s sure to give accountants and lawyers a rush of work.