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House, Senate Jockey for Pass-Through Position Before Tax Talks

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Pass-through taxation represents one of the biggest rifts between the House and Senate tax reform plans, a difference that will have to be resolved before a bill can become law.

The plans take starkly different approaches that could be hard to reconcile, leaving the Republican appointees to the conference committee to negotiate whether the House or Senate proposal will win the day.

Republicans see pass-through taxation as a priority issue but aren't united in a strategy moving forward. Lawmakers will have to walk a delicate line to find an approach that satisfies a wide range of priorities. Sens. Ron Johnson (R-Wis.) and Steve Daines (R-Mont.) want to see large breaks for pass-throughs, and House Freedom Caucus members Mark Meadows (R-N.C) and Jim Jordan (R-Ohio) are pushing for all pass-throughs to be treated equally, regardless of size or industry.

House and Senate Republicans envision their chamber's plan as coming out on top. A House aide said some groups that initially opposed the House bill now support it, after seeing the Senate approach. But a Senate aide said senators think their bill has the backing of the majority of business groups. The aides spoke on condition of anonymity because negotiations are ongoing.

These views could be attributed to a divide in the business community over the issue. Capital-intensive businesses, such as manufacturers, would be rewarded under the House plan. But pass-through owners making less than $500,000 would be subject to fewer rules and restrictions in the Senate plan.

The Senate would provide a 23 percent deduction on pass-through business income and relax rules for business owners earning less than $500,000 as joint filers, or $250,000 as individuals. Above those thresholds the deduction would be limited by the amount of wages the entity pays, and service companies, such as law and accounting firms, would be restricted from using the tax break.

The House plan would allow taxpayers to elect whether to take 70 percent of their income as wages and 30 percent at a 25 percent pass-through rate. The House bill would allow owners to take a higher percentage of income at the preferential rate if they have high levels of capital investment. There would also be a 9 percent rate for low-earning entity owners.

House Ways and Means Committee Chairman Kevin Brady (R-Texas), the head House delegate to the conference committee, told reporters Dec. 5 that the Senate proposal has some “strengths,” but that he also wants to see capital-intensive pass-throughs get the lowest rate, which is a feature of the House plan.

Daines said the Senate approach is “much cleaner” than the House approach. “The 70-30 rule can be very ambiguous and small business owners don’t like it. But they like the 23 percent discount.”

Path of Least Resistance

The pass-through approach in the final tax legislation is likely to be closer to the Senate’s version, according to Liam Donovan, a tax lobbyist at Bracewell LLP in Washington.

“Their package has cleared the all-important procedural traps under the Byrd Rule,” Donovan said. The Byrd Rule is a condition of the budget reconciliation process that prohibits legislation that increases the deficit outside the 10-year budget window.

One key fact helping the Senate plan is that it would be $120 billion cheaper than the House’s plan. “It’s all about the math,” said Joseph Perry, tax and business services leader at Marcum LLP. “The House will come closer to what the Senate plan is.”

The Joint Committee on Taxation estimates the Senate pass-through plan would cost $476.2 billion, though it would sunset in 2026. The House plan would cost $596.6 billion over a decade, according to JCT projections.

It’s difficult to tell which proposal—House or Senate—will end up being in a final tax bill, so Brian Reardon, president of the S Corporation Association, said he is offering tweaks to both plans. On the House bill, he is looking to replace the 70-30 approach with something that doesn’t rely on bright-line ratios. In the Senate plan, he is pushing lawmakers to allow trusts to be eligible for the pass-through deduction.

Sen. James N. Inhofe (R-Okla.) is preparing a letter to encourage members of the conference committee to expand the deduction to trusts with pass-through income, according to an email from his office. That change is expected to cost about $20 billion, the email said.

“A drawn out discussion in conference is not going to be conducive to getting a win” for Republicans because of the end-of-the year target for the tax reform bill, said Mark Heroux, a principal in the National Tax Services Group at Baker Tilly Virchow Krause LLP.

On the pass-through side, Heroux said the Senate’s deduction concept is “frustratingly complex.”

“When we’re supposed to get simple, this is anything but simple,” he said. However, he said, this complexity may be necessary in the pass-through space and preferable to the simpler approach taken by the House, which he described as “ripe for abuse.”

Heroux said the House provision could result in gaming similar to that seen in Kansas when the state lowered its pass-through rate to zero percent. The change incentivized wage earners to form their own businesses and provide labor services to their current employers to lower their state tax bills.

Conversion to C Corp

Both the House and Senate proposals include provisions that would make it easier for S corporations to convert to C corporations so they could take advantage of the proposed 20 percent corporate tax rate.

But this provision doesn’t assuage the concerns of people who think the bills don’t go far enough to provide as many benefits to pass-throughs as C corporations are getting under the bills. “Neither the House nor the Senate bills live up to the promise of the 25-percent pass-through rate proposed in the Framework,” the S Corporation Association said Dec. 4 in a blog post on its website.

In a separate blog post, the association said the idea that S corporations can simply convert to C corporations and get the lower 20 percent rate “ignores the reality of pass-through taxation.”

Because a newly converted company was recently an S corporation, all of its shareholders would likely be taxable, meaning the full double tax would still apply to them, the blog said.

“The result is largely the same as if the business elected to remain an S corporation. The effective tax is in the high thirties, and the only way to reward shareholders is to pay out dividends, draining additional resources from the company,” the association said.

Senate Expansion to MLPs

The Senate bill would allow publicly traded partnerships (PTPs) to take advantage of the 23 percent deduction. The benefit wouldn’t extend to private equity firms classified as PTPs, such as Blackstone Group LP and Carlyle Group LP, but oil and gas firms classified as master limited partnerships (MLPs) would be able to take advantage of the deduction.

This change puts MLPs on a level playing field with similar entities, such as real estate investment trusts, Donovan said.

“Most MLPs are structured in a way that would have prevented them from taking advantage of the pass-through deduction created in the Senate bill,” he said.

The Senate bill would limit the deduction based on the amount of wages paid. MLPs, which pay their investors and their employees from separate entities, wouldn’t be able to avail themselves of the deduction without this provision in the legislation.