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Prepare for total reworking of business taxes under GOP proposal

TAXING MATTERS
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President Donald Trump, along with the Republican-controlled Congress, has promised comprehensive tax reform, and the biggest changes to the tax code since the Tax Reform Act of 1986 may soon be a reality.

Trump's proposals are short on details, but a policy paper issued by Republicans in the House last summer (the so-called "blueprint") gives a roadmap for the potential approaches. While it's difficult to predict what could emerge from the legislative process, the blueprint provides a good starting point for understanding what may be coming down the pike.

The changes are radical and wide-ranging.

This article will focus on business tax planning and specifically on how the changes may affect choosing a form of entity for small to medium-sized businesses.

In order to understand the impact of the changes on business, it's essential to first understand the rate structure for individuals.

The blueprint, as part of its dramatic simplification of rate structures, would slash the top rate for individuals to 33 percent from the current 39.6 percent and repeal the alternative minimum tax.

"Active business income" from sole proprietorships and passthrough entities would be subject to an even lower cap of 25 percent. The blueprint does not address the critical question of how active business income is defined.

Significantly, however, the owner of an active business would be required to pay tax on reasonable compensation for his or her services at the standard rates above. The blueprint does not address how this would be determined, though this concept is a feature of current law (which has given rise to more than its fair share of disputes with the taxing authorities).

In addition to these changes for active income, the top rate for capital gain and dividends would be effectively reduced to 16.5 percent from the current 20 percent. In addition, with the demise of Obamacare, the 3.8 percent "Obamacare" tax on passive income would be eliminated.

These changes to individual rates set the stage for the proposed changes to business taxation.

The blueprint would tax all C corporations at a flat 20 percent rate. This would replace the current progressive rate structure which tops out at 35 percent. Trump's plan would go even further, trimming the rate to 15 percent. The corporate alternative minimum tax would be repealed.

In addition, the blueprint would allow write-off of all business investment in the year it is acquired. This would include all business assets, such as buildings and intellectual property, but exclude land.

Interest expense, however, would only be deductible against interest income. Net operating losses could be carried forward indefinitely.

These changes would upend the basic considerations new business owners use in choosing a legal form for their business.

Today, the top corporate and individual tax rates are similar. However, under the blueprint, the top corporate rate would be 13 points lower than the top individual rate and 5 points lower than the top rate on active business income.

The lower rate structure for corporations could create an incentive for business owners to incorporate.

If the income that is earned is reinvested in the business, no tax would currently be due since these expenses would be fully deductible, unlike under current law, which generally deems such costs must be capitalized.

However, income earned by a C corporation would still be subject to "double" tax if and when it is distributed. Today, corporations pay tax on their earnings at the maximum federal rate of 35 percent. When the after-tax proceeds are distributed to a shareholder, the shareholder pays tax at 20 percent, for a federal effective tax rate of about 50 percent.

The blueprint's proposed rate structure would mitigate this problem by reducing corporate and dividend tax rates but would not eliminate it, because individual income tax on dividends would still be due.

The total tax burden (20 percent corporate and 16.5 percent individual), would be pretty similar to the maximum 33 percent rate on individual income, especially after taking into account the fact that individual income tax is only imposed on the amounts remaining after the corporate tax has been paid. However, the 25 percent rate on "active business income" is still lower than the combined corporate and dividend rates. Therefore the use of a passthrough entity appears to remain more attractive.

For businesses earning investment income, the benefits would be even more dramatic, because, as under current law, there is no reduced tax rate for corporations on investment income.

Whether passthrough entities truly remain more attractive, however, will depend on whether the same benefits of immediate write-offs for investments apply to passthrough entities. The Republican blueprint does not address this, nor does it address other critical questions such as limitations on deduction of losses incurred by passthrough entities.

It is way too early to take any action based on tax reform proposals. While there is a great deal of alignment between Trump's proposals and the blueprint, key differences remain. While the blueprint contains much more detail than Trump's proposals, neither has been fully fleshed out.

However, given the Republican control of Congress and the White House, major changes to the tax law seem inevitable. As illustrated in this brief and preliminary discussion of the impact of these changes on choice of entity, these changes will reshape even the most basic tax planning decisions. Watch this column for updates as this process unfolds.

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