For Every Gain, a Loss: New IRS Regulations Reduce the Cost of Tax Cuts For Pass-Through Business Owners

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The passage of the Tax Cuts and Jobs Act brought with it a new 20 percent deduction for income earned from a pass-through business. The IRS recently released proposed regulations that clarify some of the issues associated with the new deduction. Our model suggests that depending on the effectiveness of the regulations, the overall cost of the deduction could be reduced between $54 and $65 billion over the 10-year budget window.

Since its passage, there has been considerable discussion about the strategies taxpayers could take to lower their tax liability related to this deduction.1 The legislation defines the income eligible for the deduction as "Qualified Business Income" (QBI). Any income earned from a pass-through business is QBI if the income is earned as an owner rather than as an employee and the taxpayer's income falls below $157,500/$315,000 (single/married). If a taxpayer's income is above $157,500/$315,000 (single/married) then the income derived from a Specified Service Trade or Business (SSTB) is not QBI and does not qualify for the 20 percent deduction.

Two of the tax strategies that PWBM accounted for in our score of this provision are the conversion of employees to contract workers and 'cracking'. The first strategy involves employees creating new pass-through entities while maintaining their jobs in order to take advantage of the deduction. The second strategy involves splitting a business into two parts. The first part earns allowable QBI (like rental income or income from custodial services) and charges the highest defendable rate to the part of the business that earns disallowed QBI (like medical or legal services).2 Using this strategy, service providers can move profits away from the SSTB to a business that produces QBI to take advantage of the deduction.

The recently released IRS proposed regulations address these strategies. The regulations outline a set of rules to prevent abuse of the deduction. In general, the rules disallow the deduction if the employer-employee relationship pre- and post- conversion does not materially differ.3 In a similar way, the regulations limit the usefulness of the 'crack and pack' strategy. The regulations stipulate that if a business earning allowable QBI has at least 50 percent common ownership with an SSTB and provides 80 percent of its "property or services" to the commonly-owned SSTB it earns income from, then the business is considered an SSTB. Additionally, if a business has at least 50 percent common ownership with an SSTB any income earned from that SSTB is ineligible for the deduction.

The effectiveness of these proposed regulations will ultimately be decided by IRS action either through audit or litigation. However, it is useful to consider the potential revenue consequences of these regulations. As noted above, our previous estimates account for both of the above strategies. In order to estimate the potential revenue effects we remove certain behavior. We neither allow employees to convert to a pass-through with their current employer nor allow businesses to use the cracking strategy. If the IRS regulations successfully limit this behavior, the former potentially saves $13 billion in revenue over the 10-year budget window while the latter potentially saves $52 billion over the 10-year budget window, each relative to our baseline estimate that includes avoidance behavior. These effects are an upper bound, depending on if the regulations successfully limit behavior, on the revenue gains of the proposed regulations.

It is also important to consider the behavior of businesses that can not utilize the deduction. As we noted in our recent brief, those individuals and businesses that can not utilize the deduction have a greater incentive to elect to be taxed as C-corporations. The recent regulations identify those individuals and businesses more clearly. As such, we estimate that $11 billion in tax revenues is lost as these businesses convert to C-corporate status. This behavior yields a potential net revenue gain from the proposed regulations of $54 billion over the 10-year window.

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1. See Kamin, David, David Gamage, Ari D. Glogower, Rebecca M. Kysar, Darien Shanske, Reuven S. Avi-Yonah, Lily L. Batchelder, et al. "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation." SSRN Scholarly Paper. Rochester, NY: Social Science Research Network, December 7, 2017. https://papers.ssrn.com/abstract=3084187. ↩

2. Cracking is often used with 'packing.' Kamin et al use the term 'crack' to describe the strategy as we present it and 'packing' to describe a strategy where a disallowed service goes 'in-house' by adding allowable QBI to the SSTB. It is not clear from the regulations whether packing is disallowed. See Kamin et al for more details. ↩

3. As Tony Nitti notes, the regulations only address current employer-employee relationships; it does not stop employees from starting a relationship with a new firm. See Nitti, Tony. "IRS Provides Guidance On 20% Pass-Through Deduction, But Questions Remain." Forbes. Accessed August 22, 2018. https://www.forbes.com/sites/anthonynitti/2018/08/09/irs-provides-guidance-on-20-pass-through-deduction-but-questions-remain/. ↩