That Confusing 'Pass-Through' Provision

By Eugene Steuerle *Thu, Jan 11, 2018*

Because Congress insisted on producing the new tax bill in less than two months, JCT, IRS, and Treasury were overwhelmed and did not complete a proper complexity analysis, writes our guest columnist, a former Social Security official.

Among the most complex provisions of the Tax Cuts and Jobs Act (TCJA) is its special tax deduction for pass-through businesses. In an attempt to prevent the new tax break from turning into a run on the Treasury, Congress created a set of complicated "guardrails" to limit its use.

Almost all tax experts agree that many businesses will need to consult tax lawyers and accountants for years to come, with perhaps millions changing their form of ownership. Some taxpayers will also create multiple layers of corporations, partnerships and other pass-through businesses, with varying degrees of ownership, to minimize their tax burden.

Yet, the official "complexity analysis" that accompanies the just-passed TCJA falls far short of telling the real story of how challenging this provision will be for many business owners.

In 1998, a Republican Congress required the staff of the Joint Committee on Taxation, in consultation with the Internal Revenue Service and the Treasury Department, to provide a tax complexity analysis "for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference…that…has widespread applicability to individuals and small businesses." The analysis is supposed to include added costs and additional recordkeeping for taxpayers and the need for regulatory guidance.

As required, JCT did produce such an analysis just before the House passed the TCJA and again just before Congress adopted a final bill. But because Congress insisted on producing the TCJA in less than two months, JCT, IRS, and Treasury were overwhelmed with the other work and simply did not complete a proper complexity analysis. The pass-through provisions are the most striking example of this failure.

Some provisions of the new law attempt to deter workers from converting themselves into a business or independent contractor to benefit from this tax break. Others attempt to separate "owners" from "workers" even when both make the same amount of money from the same partnership. Limits are placed on "personal service" companies. Other limits are based on taxable income or wages paid.

Meanwhile, because Congress created a new corporate tax rate that is significantly lower than the individual income tax rate, businesses must make a series of choices to decide whether to organize as pass-throughs at all. The analysis says the provision will affect "over 10% of small business tax returns." But a number between 10% and 100% is not very informative.

Notwithstanding all those issues, here is JCT's **full analysis**:

It is estimated that the provision will affect over ten percent of small business tax returns. It is not anticipated that individuals will need to keep additional records due to the provision. It should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision.

It may, however, increase the number of questions that taxpayers ask the IRS, such as how to calculate qualified business income and how to apply the phase-ins of the W–2 wage (or W–2 wage and capital) limit and of the exclusion of service business income in the case of taxpayers with taxable income exceeding the threshold amount of $157,500 (twice that amount or $315,000 in the case of a joint return), indexed.

This increased volume of questions could have an adverse impact on other elements of IRS's operation, such as the levels of taxpayer service. The provision should not increase the tax preparation costs for most individuals.

The IRS will need to add to the individual income tax forms package a new worksheet so that taxpayers can calculate their qualified business income, as well as the phase-ins. This worksheet will require a series of calculations.

The analysis asserts that "[i]t is not anticipated that individuals will need to keep additional records" and "[i]t should not result in an increase in disputes with the IRS nor will regulatory guidance be necessary."

This seems implausible at best. Its claim that "[t]he provision should not increase the tax preparation costs for most individuals" is downright misleading. Since most individuals are not business owners, it is self-evident that their costs won't increase due to this provision.

But the real question, which the analysis does not answer, is what about those individuals who are business owners? Perhaps most importantly, the analysis is silent on the required planning "costs to taxpayers" that nearly always exceed those associated simply with filing tax returns.

As a former Treasury official, I greatly respect those nonpartisan offices that serve the public so well, such as the JCT and the Treasury's Office of Tax Policy. I once dedicated a book to IRS personnel, who do the thankless task of reducing the share of the taxes borne by honest taxpayers. So, I do not make this criticism lightly.

In this case, these agencies have more work to do to fulfill the spirit of the law, not just its letter. More important, Congress needs to legislate in a way that allows staff to fulfill the 1998 mandate.

(Thanks to Robert Pear of The New York Times*, who first asked me about the House bill's complexity analysis.)*