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Tax Planning Under the Tax Cuts and Jobs Act: Flow-Throughs Are the Answer to Everything

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The tax reform bills introduced in the House of Representatives and the Senate dramatically reduce the corporate tax rate from 35% to 20% and create added incentives for taxpayers to invest capital into U.S. businesses with expanded expensing and reduced flow-through rates. The tax reductions for capital income would largely be paid for by increased taxes on labor. Employees would be denied state and local income tax deductions, and high-income employees would be subject to a 6% surtax under the House bill;[1] under the Senate bill, employees would be taxable on many forms of deferred compensation and, under both bills, public companies and tax-exempt organizations would be subject to punitive excise taxes on high salaries paid to their executives.

But the bills were drafted quickly, Congress is rushing to get them passed by the end of the year, and the Internal Revenue Code is a complicated thing. As it turns out, some of the "pay-fors" – the increased taxes that generate revenue to pay for the corporate tax reduction and capital-investing incentives – are completely avoidable through the use of pass-throughs. In fact, a drafting glitch may provide pass-through hedge fund investors with an inadvertent tax reduction.

Using a Pass-Through to Avoid the Excise Tax on Tax-Exempt Entities That Hire Well-Paid Employees.

Both bills deny deductions to public companies (and private companies that issue public debt) that pay compensation of more than $1 million to any employee. The bills also impose a 20% excise tax on tax-exempt organizations that pay salaries in excess of $1 million.

However, these penalties are entirely avoidable if the public company or tax-exempt organization uses a partnership to pay its executives.

Assume that a university pays its president a salary of more than $1 million. Under both bills, the hospital would be subject to an excise tax of 20% on the excess. To avoid this tax, the university forms an LLC that is treated as a partnership for tax purposes. The members of the LLC are all of the professors, the president, and the university. The president and professors invest very modest sums. Students write their tuition checks out to the LLC. The university controls the LLC. At the end of the year, the university allocates the income of the LLC among the professors, the president, and the university and it turns out that the income allocated is the same as the salaries they received. The president gets his $1+ million.

This structure appears to entirely bypass the 20% excise tax. The excise tax applies only to employees, and the president is not an employee; he or she is a partner in a partnership with the university.

This arrangement also does not appear to jeopardize the tax-exempt status of the university or subject it to tax. In Revenue Ruling 98-15, the IRS approved joint ventures between tax-exempts and non-exempt organizations. Although there are differences between the LLC and the joint venture described in Revenue Ruling 98-15, because the university controls it and it conducts exempt activities (education), its income would appear to be exempt income to the university.

Finally, with a little structuring (described below), the president and the employees might be able to avoid the self-employment tax that normally apply to partners in a partnership.

Using a Pass-Through to Get Back the Deduction for Public and Private Company Compensation Paid to Well-Paid Employees.

A similar strategy is available for public and private companies subject to the $1 million cap on salaries. Public companies could operate through an “Up-C” structure. In an Up-C structure, the public shareholders invest in a corporation, but that corporation, in turn, owns an interest in a partnership. The well-paid executives would hold carried interests in the partnership, which would allocate a portion of the profits to the executives. Because the executives would not be employees of the corporation, and because the corporation would not be relying on a deduction, no deductions would be denied under the bill.

Private companies could avoid the denial of compensation deductions more simply by operating in partnership form, issuing carried interests to its executives, and allocating income to the executives. An executive would get three added benefits from this structure. First, as explained below, he or she could effectively achieve vested deferred compensation without current tax, which the Senate bill would prohibit. Second, he or she would have a carried interest and could receive capital gain treatment and unless his or her employer is a money manager, he or she wouldn't be subject to the bill's three year requirement for long-term capital gains from carried interests. Finally, as described below, the executive might be able to avoid self-employment tax.

Using Carried Interests in Pass-Throughs to Achieve Deferred Compensation.

Under current law, an employee may receive an "unfunded promise to pay" from an employer, and subject to the rules of section 409A and 457A, so long as the promise is subject to the creditors of the employer, the employee is not taxable in respect of it, even if it is vested. The Senate bill would impose tax on employees that receive unfunded promises to pay from their employers as soon as the promise vests. However, as alluded to above, if the employer is a partnership, or forms a partnership to employ the employee, the employee can receive a carried interest from the partnership, defer current tax, and possibly receive long-term capital gains.

Using Carried Interests to Avoid Self-Employment Tax.

Under current law, employees are subject to social security and Medicare withholding and general partners are subject to self-employment tax. However, limited partners are not subject to self-employment tax. This allows individual partners in a service partnership to own very small general partnership interests (like 1% or less collectively) and very large (99% or more collectively) limited partnership interests and take the position that income allocated to them in their capacity as limited partners escapes self-employment tax. The original version of the House bill would have changed this rule and imposed self-employment tax on the limited partners, but this was deleted in the Chairman's mark. The Senate bill retains current law. Thus, both bills still permit their individual partners to avoid self-employment tax.

Reduced Tax Rate for Investors in Mark-to-Market Hedge Funds.

An unusual set of drafting glitches appear to qualify the flow-through investors in hedge funds that elect to be taxed on a mark-to-market basis for the reduced blended rate of 35.22% under the House bill, or the 17.4% deduction under the Senate bill, in respect of their gains. This result appears entirely unintended. The explanation that follows is quite technical, and is based on the House bill because the Senate has not yet released the text for its bill yet.

The reduced 25% rate under the House bill applies to the “capital percentage of any net business income derived from any active business activity”. “Active business activity” is any business activity that is not a passive business activity. A hedge fund that is a trader is treated as engaged in a trade or business for tax purposes. That activity is a business activity. A “passive business activity” is any passive activity as defined in section 469(c) (without regard to paragraphs (3) and (6)(B)). Under regulations section 1.469-1T(e)(6), the activity of trading personal property is not a passive activity. So a hedge fund that is a trader is engaged in an active business activity.

Net business income is the net amount of any income, gain, deduction and loss with respect to business activity, excluding certain investment income. Investment income is defined in section 4(c)(3) as capital gains and losses, dividends and dividend equivalents, interest (other than interest income that is properly allocable to a trade or business), certain commodity income, certain notional principal contract income, and certain annuity income. A hedge fund would normally generate capital gains and losses. However, section 475(f) permits a trader to elect to be subject to mark-to-market taxation, and all mark-to-market gain and loss to be ordinary gain and loss. Thus, a fund that has elected under section 475(f) never has capital gain or loss. This is the point that the drafters apparently missed. The net amount of mark-to-market gains and losses is net business income. (The interest income from a fund that is engaged in a lending business also might escape being treated as investment income.)

Under the House bill, investors in a pass-through that is not engaged in a specified service activity may treat 30% of their income from the pass-through as entitled to the 25% rate; the remaining 70% is subject to ordinary income treatment. This gives rise to a blended rate of 35.22% ([25% * 30%] + [75% * 39.6%]).

If a hedge fund is deemed to be engaged in a specified service activity, then its capital percentage would be deemed to be zero and the 25% rate would be unavailable. Specified service activity means any activity involving the performance of services described in section 1202(e)(3)(A), including investing, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(c)(2)). Section 1202(e)(3) describes any trade or business involving the performance of services and includes the fields of consulting and financial services.

There are two ways to read the definition of specified service activity. On the one hand, if specified service activity includes any activity involving the performance of services described in section 1202(e)(3)(A), **and, in addition,** any trading in securities, regardless of whether that activity involves the performance of services, then hedge funds' capital percentage would be deemed to be zero because they do trade in securities. On the other hand, if specified service activity means any activity involving the performance of services described in section 1202(e)(3)(A) as well as the performance of trading services (which is not specifically listed in section 1202(e)(3)(A)), then a hedge fund would not be engaged in a specified service activity.

The words and apparent intent of the statute are more consistent with the latter than the former interpretation. The carve-out for specified service activity appears to be designed to prevent labor-intensive industries from benefitting from the 25% rate. While section 1202(e)(3)(A) includes the performance of financial services, it is unclear whether that term includes security trading services and so it appears that the drafters specifically included trading services in the definition of specified service activity in order to prevent hedge fund managers from benefitting from the 25% rate. They were not addressing hedge funds investors in this definition; they thought they had already addressed hedge fund investors by excluding investment income from the definition of net business income. However, as mentioned above, they inadvertently missed mark-to-market gains under section 475. (They might also have missed interest income earned by a fund that makes loans.)

Thus, hedge funds that elect mark-to-market under section 475(f) get a tax reduction under the bill as drafted. Their trading gains are taxed at the highest marginal rate of 39.6% under current law, but as drafted, the bill arguably reduces the rate to 35.22%. To fix this apparently technical error, the drafters should expand section 4(c)(3) to include gains and losses taken into account under section 475 by reason of an election under section 475(f). In any event, the drafters should address the issue. Even if my interpretation is wrong, absent some clarification, there will be hedge funds that take this position, and they will be difficult to catch.

We don't yet have the text of the Senate bill, but the definitions and mechanics appear to be the same, except that the Senate bill provides a 17.4% deduction rather than a reduced rate and limits the deduction to "50 percent of the W-2 wages of the taxpayer". I assume that the drafters meant "50% of the W-2 wages of the **flow-through**". This requirement would mean that, instead of the hedge fund having a general partner that receives allocations, and a separate investment manager that receives fixed compensation, the individuals that own those entities would have to become employees of the hedge fund. That would require them to pay self-employment tax, but because doing so would dramatically reduce the tax rate of individual investors in the hedge fund, they might be willing.

[1] The bill would phase out the 12% bracket for individuals with an adjusted gross income of $600,000 and for married couples with adjusted gross income of $1.2 million by imposing a 6% surtax on income over the thresholds until the benefit of the 12% bracket is eliminated.

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