TAXES
Gray Areas Abound

Is Trump Tax Loophole Open To Interpretation?

How should tax pros handle pass-through business deductions?

BY BLOOMBERG NEWS

If exploiting a tax loophole is as much an art as a science, then the tax planning profession is poised for a creative renaissance.

The inspiration is the tax law signed by President Donald Trump in December. The patrons are affluent Americans who can afford advice from the nation's more ingenious accountants, tax lawyers and financial advisors.

And the new medium they're experimenting with? A 20% deduction for so-called pass-through businesses, whose income is taxed on firm-owners' personal returns.

It's early days, and the Internal Revenue Service has yet to issue guidance on how to interpret the hastily passed law. That hasn't stopped tax pros from circulating proposals and riffing on each other's ideas, as the industry seeks to coalesce around strategies that will save their clients money while standing up to scrutiny by the IRS and judges. Some pass-through owners may be instructed to group together their diverse businesses to minimize their tax bills, while others may be told to split pieces off.

"I'm sure folks will try to push the edge of the envelope," said Mark Nash, a tax partner at PricewaterhouseCoopers. "They always do."

Trump and Congressional Republicans have said middle-class Americans and small businesses will be the biggest beneficiaries under the $1.5 trillion tax cut. But the strategies under consideration to take advantage of the 20% pass-through deduction show how top earners could ultimately reap the biggest gains.

'Principal Asset'

All taxpayers who earn less than $157,500, or $315,000 for a married couple, can now deduct 20% of the income they receive via passthrough businesses from their overall taxable income. If taxpayers earn above those amounts and aren't service professionals, they must meet tests to take the full deduction. The size of their deduction depends on how much they pay in employee wages or how much they've invested in capital like real estate.

For "service professionals," the break fully phases out if they earn more than $207,500 if they're single, or $415,000 if they're married.

There's ambiguity with the rules, though. For example: What's a service business? The tax code already specifies an official list that includes health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services and brokerage services. But that language is "broad and vague and the IRS has never provided guidance as to what those terms mean," Nash said.

Plus, that section of the new legislation ends with a puzzling coda. Also excluded are "any trade or business" where the "principal asset" is the "reputation or skill" of its employees or owners. Few are really sure what this means.

"If I put 10 professionals in a room, I'm going to have 10 different ideas of what's going to be excluded," said Edward Reitmeyer, a tax partner at accounting firm Marcum.

That kind of confusion creates opportunities to work around the service definitions or to re-cast businesses in ways that arguably fall outside the excluded categories.

Office Real Estate

One strategy being discussed is to combine diverse businesses into a single entity. Let's say you're an accountant who also invests in real estate, managing hotels and other properties. Depending on how the IRS writes the regulations, it might make sense to put everything in one company, according to Richard Kollauf, director of business advisory at BMO Private Bank.

Instead of appearing to the IRS to be an accountant — a service-based profession that wouldn't qualify for the pass-through break over the income limit — you look more like a real estate magnate, who would qualify because of large capital investments.

Or, if your business makes the majority of its money through your service profession, the opposite strategy could work. By breaking different businesses apart, service business owners could have at least some of their income qualify for the pass-through deduction. A medical practice might do a fair amount of debt collection or other back-office support.