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Reforming the Pass-Through Deduction

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Summary

- The Tax Cuts and Jobs Act of 2017 created a deduction for households with income from pass-through businesses – companies such as partnerships, S corporations, and sole proprietorships, which are not subject to the corporate income tax.

- The pass-through deduction allows taxpayers to exclude up to 20 percent of their pass-through business income from federal income tax. The deduction is subject to several limits, intended to prevent abuse, which are based on the economic sector of each business, the amount of business wages paid, and the original cost of business property. These limits only apply to upper-income taxpayers.

- The design of the pass-through deduction leaves room for improvement. The rules for claiming the deduction are relatively complex, and will arbitrarily favor certain economic activities over others. Meanwhile, it is unlikely that the current limits on the deduction will be sufficient to prevent abuse. Finally, several features of the provision's design will diminish its economic effect.

- Lawmakers should consider reforming the pass-through deduction, in order to make the taxation of pass-through businesses less complex, less prone to abuse, more neutral, and more economically efficient.

- One option for reform would be to limit the pass-through deduction based on how much businesses have invested and whether the investment costs have already been deducted. Under this proposal, businesses would only be able to claim a larger pass-through deduction if they invest more – which would likely make the pass-through deduction less prone to abuse and more economically efficient.

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Introduction

One of the most controversial parts of the Tax Cuts and Jobs Act of 2017 was the creation of a deduction for pass-through business income.

Known as the "pass-through deduction" or "Section 199A," this provision will reduce taxes for more than 17 million households that receive income from pass-through businesses – companies that are not subject to the corporate income tax.[1] The deduction is expected to lower federal revenue by $414 billion over the next 10 years.[2]

Supporters of the deduction argue that it delivers much-needed tax relief to American businesses and helps put the pass-through sector on an equal footing with the largest multinational corporations. Opponents of the provision contend that it creates an arbitrary tax preference for pass-through business income over other sources of income, and that it overwhelmingly benefits wealthy households.

This paper does not aim to resolve the debate over whether the creation of a deduction for pass-through business income was justified. Rather, it focuses on the *design* of the new pass-through deduction – the rules that determine which businesses and households see the largest tax benefits under the provision.

There are at least four criteria by which the design of the pass-through deduction can be evaluated:

1. Simplicity: Are the rules for computing the deduction simple and straightforward, or will they add more complexity to the tax filing process?

2. Administrability: Will only *bona fide* business income benefit from deduction, or will the deduction be used by households to avoid taxes on nonbusiness sources of income?

3. Neutrality: Will the deduction provide evenhanded tax treatment for all economic activities, or will it create tax preferences for certain forms of income?

4. Economic Efficiency: Does the structure of the deduction encourage business investment and growth, or is it unlikely to have a large economic effect?

On each of these criteria, the design of the pass-through deduction leaves room for improvement.

The complexity of the pass-through deduction will vary widely for different groups of taxpayers. On the one hand, the deduction will be relatively simple to compute for most lower- and middle-income households. However, upper-income households will face substantial complexity in determining how large a deduction they can claim.

1 Joint Committee on Taxation, "Tables Related to the Federal Tax System as in Effect 2017 through 2026," April 24, 2018, https://www.jct.gov/publications.html?func=startdown&id=5093.

2 Joint Committee on Taxation, "Estimated Budget Effects Of The Conference Agreement For H.R. 1, The 'Tax Cuts and Jobs Act,'" Dec. 18, 2017, https://www.jct.gov/publications.html?func=startdown&id=5053.

Administrability is likely to be a key challenge for the pass-through deduction in coming years. The deduction creates a strong incentive for taxpayers to categorize as much income as possible as "pass-through business income," to maximize their tax benefit. While the deduction includes several limits intended to discourage this sort of creative accounting, it is unlikely that the current rules will be sufficient to prevent abuse of the provision.

In terms of neutrality, the deduction will add new tax preferences for certain economic activities over others. For example, the deduction distinguishes between specified service businesses (such as lawyers and doctors) and non-service businesses (such as manufacturers and farmers), limiting the tax benefit for the first category.

Finally, the economic effect of the pass-through deduction will likely be limited, due to several design features of the provision. For instance, the deduction will actually increase marginal tax rates on some upper-income households, who will see their tax benefit shrink with each additional dollar they earn. In addition, the size of the tax benefit that businesses receive is not always related to the amount they invest, which will limit the ability of the deduction to encourage business investment and growth.

All in all, it is clear that the design of the pass-through deduction deserves further examination by lawmakers. In this paper, we describe the major features of the provision, as well as evaluating its strengths and shortcomings. We conclude with a discussion of potential reforms to make the pass-through deduction less complex, less prone to abuse, more neutral, and more economically efficient.

Description of Current Law

Section 199A of the federal tax code allows taxpayers to deduct up to 20 percent of certain business income.[3] This provision, known as the "pass-through deduction," was created by the Tax Cuts and Jobs Act of 2017, and is intended to reduce taxes for households with income from pass-through businesses – companies that are not subject to the corporate income tax.[4]

The rules for calculating the pass-through deduction are complex. While most sources of pass-through business income are eligible for the deduction, some do not qualify. Moreover, upper-income households face a number of limitations on the deduction, which are intended to prevent abuse of the provision. One limit restricts the deduction for specified service businesses, such as law firms and medical practices. Another limit restricts the deduction based on the amount of wages paid by each business and the original cost of each business's property.

3 26 U.S.C. §199A. Not all "taxpayers" are eligible for the pass-through deduction. Specifically, while households, estates, and trusts are all eligible to claim the deduction, C corporations that receive income from pass-through businesses are ineligible.

4 P.L. 115-97, §11011. Technically, the title of the legislation was "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." However, the law is commonly referred to as the Tax Cuts and Jobs Act, which was the law's title through most of the legislative process.

It is important to note that, as of the publication of this paper, the Internal Revenue Service (IRS) has not yet issued many key regulations pertaining to the pass-through deduction.[5] As a result, there are still a number of important unresolved questions about how the pass-through deduction will function in practice. However, the major elements of the provision are clear enough to be described and analyzed.

An Overview of Pass-Through Businesses

To understand the pass-through deduction, it is useful to begin with a discussion of pass-through businesses and their role in the U.S. economy.

Pass-through businesses are companies that are not subject to the corporate income tax. Rather than paying income taxes on the business level, these businesses "pass" their income "through" to their owners, who report the income on their personal tax returns. As a result, income from pass-through businesses is taxed under the individual income tax.

The vast majority of companies in the United States are pass-through businesses: 28.3 million out of the 30.8 million private business establishments that operated in the United States in 2014. Pass-through businesses account for over half of business income in the United States and employ over half of the private-sector workforce.[6]

Pass-through businesses fall into three categories. *Sole proprietorships* are unincorporated businesses owned by a single individual, typically self-employed. *Partnerships* are unincorporated businesses with multiple owners. *S corporations* are incorporated businesses that must satisfy several requirements in order to qualify as pass-through businesses.

The tax rate that applies to pass-through business income depends on who the business owners are. Pass-through businesses with owners in higher tax brackets generally have their income taxed at higher rates, while those with owners in lower tax brackets are subject to lower rates.

5 Nathan J. Richman, "Passthrough Deduction Regs Expected Within Weeks," *Tax Notes Today*, June 11, 2018, https://www.taxnotes.com/tax-notes-today/partnerships/passthrough-deduction-regs-expected-within-weeks/2018/06/11/2844y.

6 Scott Greenberg, "Pass-Through Businesses: Data and Policy," Tax Foundation, Jan. 17, 2017, https://taxfoundation.org/pass-through-businesses-data-and-policy/.

Computation of the Pass-Through Deduction

The deduction created by the Tax Cuts and Jobs Act lowers taxes for taxpayers with income from pass-through businesses (as well as certain other business income, as discussed below). While many aspects of the provision are quite complex, the actual computation of the deduction is relatively straightforward.

To determine a household's pass-through deduction, the following two amounts are compared:

1. 20 percent of the household's eligible business income

2. 20 percent of the household's taxable ordinary income (calculated before taking the pass-through deduction into account)

A household's pass-through deduction is equal to whichever of these two amounts is smaller.[7]

To take an example, imagine a self-employed architect who earns $40,000 of eligible business income in 2018, with no other sources of income. If the architect is a single filer, she can claim a standard deduction of $12,000, leaving her with $28,000 in taxable income, before taking the pass-through deduction into account. The architect then compares:

1. $8,000, or 20 percent of her eligible business income of $40,000

2. $5,600, or 20 percent of her taxable ordinary income of $28,000

Thus, the architect is able to claim a pass-through deduction of $5,600, the smaller of the two amounts.[8]

7 However, certain households that receive payments from agricultural cooperatives may have their deduction limited to 100 percent of taxable income, rather than to 20 percent of taxable ordinary income. More broadly, Section 199A includes a number of different rules that apply to agricultural cooperatives and households that receive payments from them – most of which are not discussed in this paper.

8 It is worth noting that the pass-through deduction lowers households' taxable income, but does not affect households' adjusted gross income, which is used in the computation of a number of other federal tax provisions.

TABLE 1

The Effect of the Pass-Through Deduction on Income Taxes Owed

Sample Calculations for a Single Filer with $40,000 of Pass-Through Business Income in 2018

Without the Pass-Through Deduction		With the Pass-Through Deduction	
Business income	$40,000	Business income	$40,000
Standard deduction	-$12,000	Standard deduction	-$12,000
		Taxable ordinary income, computed without regard to the pass-through deduction	$28,000
		Pass-through deduction	-$5,600
Taxable income	**$28,000**	**Taxable income**	**$22,400**
Income subject to the 10% bracket	$9,525	Income subject to the 10% bracket	$9,525
Income subject to the 12% bracket	$18,475	Income subject to the 12% bracket	$12,875
Tax from the 10% bracket	$952.50	Tax from the 10% bracket	$952.50
Tax from the 12% bracket	$2,217.00	Tax from the 12% bracket	$1,545.00
Total income taxes owed	**$3,169.50**	**Total income taxes owed**	**$2,497.50**
Total Tax Savings from the Pass-Through Deduction:			**$672.00**

Note: Calculations assume that the filer has no dependents, takes the standard deduction, and has no sources of income other than pass-through business income.

The pass-through deduction will lead to substantially lower taxes for many households with business income. For example, in the case described above, the pass-through deduction would lower the architect's total federal income tax from $3,170 to $2,498 – reducing her income tax liability by more than 21 percent.

The Pass-Through Deduction is Equivalent to a Marginal Rate Reduction

Before passage of the Tax Cuts and Jobs Act, income from pass-through businesses was subject to the same marginal income tax rates as other sources of personal income, such as wages and salaries.

To illustrate how this used to work, consider a household in the 10 percent tax bracket that earned income from both a salaried job and a pass-through business. Under prior law, if the household earned an additional dollar of wages, it would have paid an additional 10 cents in income tax. If the household had instead earned an additional dollar of pass-through business income, its income tax situation would have been identical: an additional 10 cents in income tax owed.

However, as a result of the Tax Cuts and Jobs Act, the tax rate on an additional dollar of pass-through business income is now lower than the rate on an additional dollar of wage income. In other words, the pass-through deduction effectively creates a reduced marginal tax rate schedule for business income.

To see why, consider the same household in the 10 percent bracket. If the household earns an additional dollar of pass-through business income, its gross income will go up by a dollar. However, in addition, the pass-through deduction available to the household will increase by 20 cents. As a result, the household's taxable income will only increase by 80 cents with each additional dollar of pass-through income. All in all, because of the pass-through deduction, the household will only pay 8 cents of tax on an additional dollar of pass-through income, compared to 10 cents of tax on an additional dollar of wages.

The same logic applies for households in every tax bracket: the pass-through deduction will lead to a marginal tax rate on eligible pass-through business income that is 20 percent lower than the corresponding marginal tax rate on ordinary income. For taxpayers in the top bracket, the pass-through deduction will lead to a marginal tax rate of 29.6 percent on each additional dollar of eligible pass-through income, compared to the marginal tax rate of 37 percent that applies to other sources of income.

TABLE 2.

Federal Marginal Income Tax Rates, by Source of Income, 2018

Marginal tax rate on ordinary income	Marginal tax rate on business income eligible for the pass-through deduction	Bracket thresholds for single filers	Bracket thresholds for married joint filers
10.0 percent	8.0 percent	$0 - $9,525	$0 - $19,050
12.0 percent	9.6 percent	$9,525 - $38,700	$19,050 - $77,400
22.0 percent	17.6 percent	$38,700 - $82,500	$77,400 - $165,000
24.0 percent	19.2 percent	$82,500 - $157,500	$165,000 - $315,000
32.0 percent	25.6 percent	$157,500 - $200,000	$315,000 - $400,000
35.0 percent	28.0 percent	$200,000 - $500,000	$400,000 - $600,000
37.0 percent	29.6 percent	$500,000 +	$600,000 +

Note: Bracket thresholds refer to ranges of household taxable income.

Business Income Eligible for the Deduction

In practice, the calculation of the pass-through deduction can be much more complicated than simply multiplying business income by 20 percent. For one thing, there are a number of rules that define what income counts as "business income" for the purposes of the provision. Some of these rules are intended to minimize opportunities for taxpayers to abuse the provision by disguising labor income as "business income."

In general, Section 199A allows taxpayers to calculate their deduction based on how much income they receive from a "trade or business" other than "the trade or business of performing services as an employee."[9] In simpler terms, this means that taxpayers' income from pass-through businesses is eligible for the deduction, while their income from employment is not.

There are other sources of income that are eligible for the deduction as well, in addition to pass-through business income. For instance, dividends that taxpayers receive from real estate investment trusts (REITs) – which are not generally considered pass-through businesses – are eligible. In addition, it seems likely that taxpayers will be allowed to claim the deduction on their rental income – even though rental activities are not always considered a "trade or business" under current regulations.[10]

On the other hand, Section 199A specifies several sources of personal income that are ineligible for the pass-through deduction. For instance, capital gain income is ineligible for the deduction, even if the capital gains arise from a pass-through business activity. Dividend income is also ineligible for the deduction, as is interest income that is not "properly allocable to a trade or business."[11]

In addition, two categories of payments by businesses to owners are not allowed to count toward owners' "business income" for the purposes of calculating the pass-through deduction. One is "reasonable compensation" paid by businesses to owners – a definition that applies to S corporations, which are required to pay their active business owners reasonable compensation for the work they do for the business.[12] Similarly, "guaranteed payments" from partnerships to their partners are not counted as business income when calculating the pass-through deduction.

This last restriction can be thought of as a guardrail, aimed at combating abuse of the pass-through deduction. In effect, it is an attempt to distinguish between business income (profits that owners receive) and labor income (compensation that owners receive for the work they do for their companies), and to disallow the latter from being eligible for the provision. For most lower- and middle-income households, the restriction on deducting "reasonable compensation" and "guaranteed payments" is the only significant guardrail that applies to the pass-through deduction.

9 26 U.S.C. §199A(d).

10 Tony Nitti, "Understanding the new Sec. 199A business income deduction," *The Tax Adviser*, April 1, 2018, https://www.thetaxadviser.com/issues/2018/apr/understanding-sec-199A-business-income-deduction.html.

11 26 U.S.C. §199A(c)(3)(B). While it is not entirely clear why these items of income are specifically listed as ineligible for the pass-through deduction, it is easy enough to speculate. For instance, capital gains and dividends often arise from C corporations, and Congress presumably did not want Section 199A to benefit business income that was already seeing the benefit of a lower corporate rate. (Note that it is possible that capital gains from the sale of §1231 assets may end up being eligible for the pass-through deduction. See Nitti, "Understanding the new Sec. 199A business income deduction.")

12 Internal Revenue Service, "S Corporation Compensation and Medical Insurance Issues," https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues.

Limits on Upper-Income Households

Upper-income households are subject to two additional limits on the pass-through deduction, intended, in part, to prevent abuse of the provision. Both limits begin phasing in for taxpayers with taxable income over $157,500 (or $315,000 for married joint filers). The limits apply in full for taxpayers with taxable income over $207,500 (or $415,000 for married joint filers).[13]

The first limit applies to upper-income households that receive income from a "specified service trade or business." Specifically, households above the $157,500/$315,000 threshold are restricted or disallowed from counting income from certain service businesses in their calculation of the pass-through deduction.[14]

While the IRS has not yet determined the exact definition of which business activities will be categorized as specified services, Section 199A points to the following categories:

- "Any trade or business involving the performance of services in the fields of health, law … accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services."[15]
- "Any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees."[16]
- "Any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities."[17]

Income from these sources is ineligible for the pass-through deduction, for households making above the $157,500/$315,000 threshold.

The second limit (known as the "wage or wage/capital limit") focuses on whether households receive income from businesses that have engaged in substantial real economic activities – specifically, paying wages and investing in tangible property. Upper-income households may see their pass-through deduction limited if the businesses that they own pay relatively little in wages and have relatively little property.

13 Here, "taxable income" refers to households' taxable income prior to the computation of the pass-through deduction. The dollar amounts in this paragraph are indexed annually for inflation.

14 It is not yet known whether "specified service trade or business" is a definition that will be applied to each business activity or to each business entity. In other words, it is unclear how Section 199A will apply to businesses that conduct multiple activities, some of which are specified services and others of which are not. See American Institute of CPAs, "Request for Immediate Guidance Regarding IRC Section 199A – Deduction for Qualified Business Income of Pass-Through Entities," Feb. 21, 2018, https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180221-aicpa-sec-99a-qbi-comment-letter-faq.pdf.

15 26 U.S.C. §1202(e)(3)(A). The words "engineering" and "architecture" are omitted from this list, as they are specifically excluded from the category of specified service businesses by Section 199A.

16 Ibid.

17 26 U.S.C. §199A(d)(2)(B).

To determine whether the wage or wage/capital limit applies, a household is required to calculate two items. First, it must determine its share of the "W-2 wages" paid by each business that it receives income from. Second, it must calculate its share of the "unadjusted basis" in the tangible property held by each business – which is a measure of how much each business's equipment, machines, and real estate originally cost. After determining these two items, households compare the following two amounts, for each "trade or business" that they receive income from:

1. 50 percent of the household's share of the W-2 wages paid by each business

2. 25 percent of the household's share of the W-2 wages paid by each business, plus 2.5 percent of the household's share of the unadjusted basis in tangible property held by each business

The pass-through deduction that a household can claim on income from any business is limited to whichever of these two amounts is larger.

There are some easy rules of thumb that can be used to determine if a business will fall under the wage or wage/capital limit. For instance, if a business's wages are greater than 40 percent of its profits, the business will not fall under the limit. Similarly, if the unadjusted basis of a business's tangible property is greater than 800 percent of its annual profits, the business will not fall under the limit.

To show how these limits may work in practice, it may be useful to imagine a concrete example:

> The Smiths are a married household. One spouse earns $205,000 in wages. The other spouse owns a 50 percent stake in a consulting firm, which is organized as a partnership. In 2018, the consulting firm earned $400,000 in income and paid $600,000 in W-2 wages to its employees.
>
> The Smiths' share of income from the consulting firm is $200,000, and the household's total adjusted gross income is $405,000. The Smiths contribute $10,000 to traditional IRAs and claim $40,000 in itemized deductions. As a result, their taxable income is $355,000 prior to the computation of the pass-through deduction.
>
> The Smiths first calculate their tentative deduction under Section 199A. They do so calculating 20 percent of their qualified business income ($40,000, or 20 percent times $200,000) and 20 percent of their taxable ordinary income ($71,000, or 20 percent times $355,000). The Smiths' tentative pass-through deduction is the smaller of these amounts: $40,000.
>
> Because the Smiths' taxable income is over $315,000, they are potentially subject to the limits on the pass-through deduction that apply to upper-income households.
>
> The Smiths' share of W-2 wages paid by the consulting firm is $300,000. The Smiths multiply this total by 50 percent, to arrive at $150,000. Because this figure is larger than the Smiths' tentative pass-through deduction of $40,000, the Smiths are not subject to the wage or wage/capital limit.
>
> However, all of the Smiths' business income is subject to the specified service business limit. If the Smiths' taxable income were greater than $415,000, they would not be allowed to claim any pass-through deduction at all. But because the Smiths' taxable income is within the phaseout range of $315,000 and $415,000, they are still allowed to claim a portion of the pass-through deduction.
>
> The Smiths subtract their taxable income ($355,000) from $415,000, and divide the result ($60,000) by the width of the phaseout range ($100,000). As a result, the Smiths are allowed to claim the pass-through deduction on 60 percent of their business income.
>
> The Smiths multiply their $200,000 of specified service business income by 60 percent, to arrive at $120,000 of qualified business income. They are then able to deduct 20 percent of their qualified business income.
>
> All in all, the Smiths are able to claim a pass-through deduction of $24,000.

It should be noted that some business income is exempted from both the specified service business limit and the wage or wage/capital limit. Specifically, income from real estate investment trusts (REITs), certain publicly traded partnerships, and certain agricultural and horticultural cooperatives is exempt from both limits. It is not entirely clear why lawmakers chose to exempt these sources of business income from the generally applicable limitations.

Expiration of the Deduction

Under current law, almost all the provisions of the Tax Cuts and Jobs Act that modify the individual income tax are scheduled to expire after December 31, 2025. The pass-through deduction is one of these provisions: as currently written, it will no longer be available to households beginning in 2026.

Of course, it is quite possible that lawmakers may choose to extend the deduction beyond 2025, or even to make the provision into permanent law. However, until lawmakers make a conclusive determination about the status of the pass-through deduction, households and businesses will face substantial uncertainty about the future of the provision.

Evaluating the Design of the Pass-Through Deduction

To evaluate the merits and drawbacks of the pass-through deduction, there are two sets of questions that are worthy of consideration.

The first set of questions concerns the *existence and size* of the pass-through deduction: Should the tax code include a deduction specifically for households with pass-through business income? Was Congress right to prioritize providing tax relief for pass-through businesses? Is the size of the deduction too generous, or not generous enough?

The second set of questions concerns the *design* of the pass-through deduction: Are the rules for calculating the deduction overly complex? Will the provision be easy to administer and difficult to abuse? Does the deduction offer evenhanded tax treatment for different business activities? Will the deduction provide strong incentives for business investment and growth?

This paper focuses on the second set of questions – on the rules and definitions that determine how the pass-through deduction is calculated for different businesses and households. This is a rich topic for analysis: after all, in creating the pass-through deduction, lawmakers made dozens of distinct choices about the structure of the provision. These choices shape how the benefits of the deduction are distributed, as well as the incentives that the deduction creates for taxpayers.

When evaluating the design of the pass-through deduction, we discuss four criteria: simplicity, administrability, neutrality, and efficiency. While these are not the only measures by which the deduction can be assessed, they are four widely-accepted norms for what well-designed tax policy should look like.[18]

18 See, for instance, Nick Fiore, "Guiding Principles of Good Tax Policy," *Journal of Accountancy*, Feb. 1, 2002, https://www.journalofaccountancy.com/issues/2002/feb/guidingprinciplesofgoodtaxpolicy.html.

Simplicity

Every new tax provision introduces additional complexity to the federal tax code, but some provisions are more complicated than others. The simplest tax provisions require only a few paragraphs of IRS instructions and perhaps an additional line on the Form 1040. The most complicated tax provisions, on the other hand, can lead to hundreds of pages of IRS regulations and the creation of new subspecialties in the field of tax law.

In the case of the pass-through deduction, the complexity of the provision will vary significantly for different taxpayers. On the one hand, for most lower- and middle-income households, the deduction will be relatively simple to calculate. However, the deduction is considerably more complicated for households with taxable income over $157,500 (or $315,000 for married joint filers).

Households making below the $157,500/$315,000 threshold will generally be able to compute their pass-through deduction in a few simple steps. In many cases, the calculation will be no more complex than multiplying business income by 20 percent, multiplying ordinary taxable income by 20 percent, and deducting whichever amount is smaller.

However, this is not to say that, for low- and middle-income households, computing the pass-through deduction will be entirely without complications. For instance, these households may still face some tricky definitional questions, such as how much of their interest income is "properly allocable to a trade or business." In addition, the provision may lead to confusing computational questions in some cases, such as how to calculate the deduction in years when a business runs a net operating loss. Finally, to the extent that the pass-through deduction encourages more intensive tax planning by low- and middle-income business owners, it could indirectly add to tax compliance burdens.

That said, the pass-through deduction becomes considerably more complicated once a household's income approaches the $157,500/$315,000 threshold. Above that threshold, the "specified service trade or business" limit and the "wage or wage/capital" limit begin to phase in. Both of these limits will likely create substantial complexities for upper-income households with business income.

Both of these limits establish a number of new definitions that businesses will be required to navigate. For instance, in many cases, it may be difficult to determine if a given economic activity counts as a "specified service trade or business." Such a determination may be especially hard in the context of companies that engage in multiple activities – only some of which are specified services – which are hard to disentangle from one another.

In addition, both limits are likely to necessitate considerable tax planning by some businesses that wish to avoid falling under them. In general, companies will have an incentive to try to disaggregate parts of their business for the purposes of the "specified service" limit, so as to ensure that non-service activities are not lumped in with service activities. But companies will also have an incentive to try to aggregate various parts of their business for the purposes of the "wage or wage/capital" limit, so that wages and property from one part of the business can count toward satisfying the limit for other parts of the business. These two incentives will create complex tax planning challenges for some companies, as they try to maximize the deduction.

There are additional complications created by the limits on the pass-through deduction for households that fall in or near the limit phase-in range (between $157,500 and $207,500 of taxable income, or between $315,000 and $415,000 for married joint filers). Because the limit phase-in is based on taxable income, these households will have to consider whether to time their other deductions strategically in years when they fall in the phaseout range.[19] Some married households that fall in the phaseout range will even have to consider whether to file separately for the purposes of maximizing the benefit of the pass-through deduction.[20]

These are only some of the examples of the complexities created by the pass-through deduction for upper-income households with business income. It is quite likely that businesses with upper-income owners will need to expend additional time and resources on tax preparation, in order to determine how large a pass-through deduction they are able to claim.

Administrability

The pass-through deduction creates a large incentive for taxpayers to categorize as much income as possible as "pass-through business income," in order to maximize their tax benefit. This presents an issue for the administrability of the tax system, because it is unlikely that the current limits on the deduction will be sufficient to prevent abuse.

As discussed above, the pass-through deduction leads to lower marginal tax rates on income from pass-through businesses than the rates that apply to income from other sources. For instance, for households in the highest tax bracket, the top federal income tax rate on eligible pass-through business income is 29.6 percent, compared to a top rate of 37 percent on ordinary income. This is a large difference, and creates a substantial incentive for households to find ways to characterize their earnings as business income, rather than ordinary income.

There are a number of opportunities for taxpayers to increase the share of their income that comes from pass-through businesses. Current employees may look for ways to terminate their employment and shift to working as independent contractors. Similarly, workers looking for new jobs will now have an increased incentive to choose independent contractor opportunities over traditional employment, due to the tax advantages of the former.[21] Meanwhile, business owners will look for ways to minimize any payments they receive from their companies which are not categorized as pass-through business income. For instance, active owners of S corporations will have an increased incentive to reduce their "reasonable compensation," so as to report more "business income."

For low- and middle-income households, the pass-through deduction itself contains few rules that would discourage these strategies for recategorizing ordinary income as business income. This is because the primary anti-abuse measures in the pass-through deduction only apply to households

19 As discussed below, the phase-in of the deduction's limits is equivalent to a large increase in the marginal tax rate of households in the phaseout range. As a result, households that claim the pass-through deduction will find it in their best interests to time their other deductions (such as itemized deductions and contributions to traditional IRAs) in years when they fall in the phaseout range, in order to take deductions against the highest possible marginal tax rate.

20 Laura Saunders, "When 'Married, Filing Separately' Lowers Your Tax Bill," *The Wall Street Journal*, Feb. 23, 2018, https://www.wsj.com/articles/when-married-filing-separately-lowers-your-tax-bill-1519381801.

21 In general, independent contractor relationships do not include the same benefits that often come with traditional employment. However, some individuals choose to be independent contractors already, and it is likely that this number will increase as a result of the pass-through deduction.

with taxable income over $157,500 (or $315,000 for married joint filers). For households making below these thresholds, the largest obstacles to recategorizing ordinary income as business income will come from other parts of federal and state law: for instance, some efforts to restructure employment arrangements as independent contractor relationships may run afoul of IRS regulations or federal employment law.[22]

It is important to note that the majority of households with pass-through business income will fall under the $157,500/$315,000 threshold.[23] The fact that most business owners will not be subject to the main anti-abuse rules of the pass-through deduction does not bode well for the administrability of the provision.

Even for upper-income households, there is reason to be concerned about whether the current limits on the pass-through deduction will be sufficient to prevent abuse. The "specified service" limit and the "wage or wage/capital" limit are meant to prevent households from disguising labor income as pass-through business income, in order to claim a larger deduction. However, both rules may be subject to gaming.

The "specified service" limit is designed to single out industries where most of the value added comes from skilled labor, rather than business investment. Presumably, lawmakers were worried that income from these industries was too similar to personal labor income, and that it would be trivial for high-income employees in these industries to simply set up their own pass-through businesses for the purpose of claiming the deduction.

However, in many cases, it is inherently difficult to determine what industry a given business activity falls into; this is especially tough in cases where businesses engage in multiple, interrelated activities. It is likely that businesses will employ creative strategies to ensure that their activities fall on the right side of the line, when possible.

One often-discussed scenario is the case of a law firm that owns its own building. Generally speaking, the law firm would be categorized as a service business and denied the benefit of the pass-through deduction. However, the law firm could spin off its real estate holdings into a separate business, which would then charge the law firm very high rent to use its facilities. Because the real estate business would not count as a service business, this would be an effective way for the partners of the law firm to transform their service business income into non-service business income.[24] It is unclear whether or how forthcoming regulations from the IRS will deal with this scenario.

22 Internal Revenue Service, "Understanding Employee vs. Contractor Designation," July 20, 2017, https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation; Ellen Rosner Feig, "Employee vs. Independent Contractor: Differences You Need to Know," LegalZoom, October 2009, https://www.legalzoom.com/articles/employee-vs-independent-contractor-differences-you-need-to-know.

23 According to the Tax Policy Center, 30.8 million of the 38.0 million households with pass-through business income have under $200,000 in expanded cash income, which is probably a good ballpark estimate for the number of households that will be exempt from the "specified service" and "wage or wage/capital" limits. See Tax Policy Center, "T17-0076 - Distribution of Business Income, by Expanded Cash Income Level; Current Law, 2017," March 20, 2017, https://www.taxpolicycenter.org/model-estimates/distribution-business-income-march-2017/t17-0076-distribution-business-income.

24 Ruth Simon and Richard Rubin, "Crack and Pack: How Companies Are Mastering the New Tax Code," *The Wall Street Journal*, April 3, 2018, https://www.wsj.com/articles/crack-and-pack-how-companies-are-mastering-the-new-tax-code-1522768287.

The "wage or wage/capital" limit is meant to verify whether businesses are engaging in real economic activities – such as paying wages or investing in property. The idea here is that if a high-income household earns $10 million from an LLC with no employees and no property holdings, the income is unlikely to have come from a *bona fide* business.

However, one shortcoming of the limit is that many businesses will have more than enough wages to satisfy the W-2 wage requirement – creating an incentive for the excess wages to be diverted to other households and businesses that fall short of the W-2 wage limit. For instance, one business with high profits but low wages could try to acquire a portion of another business with low profits and high wages, in order to maximize the total pass-through deduction that the owners of the businesses receive. This particular maneuver might be difficult if the IRS determines that the two companies remain separate "trades or businesses" even after the acquisition, but more sophisticated variants might succeed.

Another concern about the wage limitation is that it is possible that compensation paid by an S corporation to its owners will count toward a business's "W-2 wages."[25] As a result, pass-through businesses that fall under the wage limitation could simply pay a portion of the business profits to their owners as wages, in order to increase the size of the pass-through deduction they receive. For instance, a business that earns $10 million but has no employees might choose to pay the owners $2.9 million in wages. The owners' "business income" would drop from $10 million to $7.1 million, but the business would have $2.9 million of W-2 wages, which would be enough to allow the owners to increase their pass-through deduction from $0 to over $1.4 million.

Finally, income from real estate investment trusts and publicly traded partnerships is exempt from the "wage or wage/capital limitation" – a detail that could reduce the effectiveness of the limit.

All of this analysis is preliminary, because the IRS has not yet issued regulations that will define how the limits on the pass-through deduction will operate in practice. However, there is already reason to be concerned about the administrability of the provision – especially given the large incentive that households will have to categorize as much of their income as possible as business income.

Neutrality

Ideally, the federal tax code would be neutral between different economic activities: it would neither encourage nor discourage particular decisions by households and businesses, nor would it favor any sectors of the economy over others.[26] In practice, the current U.S. tax code veers far from this ideal: the code contains dozens of deductions, credits, and other provisions that offer tax advantages and disadvantages for specific activities. As a result, households and businesses often end up making decisions for tax reasons, rather than on the economic merits.

25 See discussion in Nitti, "Understanding the new Sec. 199A business income deduction."

26 In practice, it would be impossible for any tax system to be perfectly neutral. For instance, even a textbook flat tax would have the effect of discouraging labor and encouraging leisure. However, it is certainly possible to make incremental changes to a tax system that move it closer to neutrality.

When evaluating any new provision of the tax code, a key question is whether it makes the federal tax system more or less neutral. In the case of the pass-through deduction, the provision generally makes the federal tax system less neutral – although not entirely so.

One way in which the pass-through deduction makes the federal tax code less neutral is by providing new tax advantages for certain parts of the economy over others. This is because the deduction is restricted for "specified service" businesses, such as law firms and medical practices. This creates a tax preference for economic sectors that do not fall into the category of "specified services," such as manufacturing, retail, and construction.

There are some reasons why a distinction between service businesses and non-service businesses may have made sense in the context of trying to prevent abuse of the pass-through deduction. After all, all else being equal, a household's profits from a "specified service" business are probably more likely to represent disguised labor income than its profits from a non-service business would. However, the fact remains that the distinction between services and non-services is one that makes the federal tax code less neutral between sectors of the economy.

Another way in which the pass-through deduction makes the federal tax code less neutral is by creating a lower set of tax rates on pass-through business income than the tax rates that apply to wages and salaries. After all, while a household in the top income tax bracket faces a 37 percent marginal income tax rate on its wages and salaries, it will only be subject to a 29.6 percent rate on its eligible pass-through business income. This discrepancy creates a tax preference for households that earn their income from pass-through businesses, rather than from employment.

It should be noted that there is one sense in which the pass-through deduction makes the federal tax system *more* neutral: it lowers the tax code's penalty on business investment. Generally, the federal tax code does not allow businesses to deduct the full cost of their new investments, such as factories and machines – creating a tax disadvantage for businesses that want to invest.[27] Because the pass-through deduction will lower the tax rate that applies to the profits from business investments, it will reduce the total tax penalty on investment, making the federal tax system more neutral between investment and other business activities.[28] However, for reasons discussed in the next section of this paper, this effect is unlikely to be large.

All in all, the pass-through deduction, as currently designed, will generally make the federal tax code less neutral between sectors of the economy and between sources of income.

27 Scott Greenberg, "What is Depreciation, and Why Was it Mentioned in Sunday Night's Debate?" Tax Foundation, Oct. 10, 2016, https://taxfoundation.org/what-depreciation-and-why-was-it-mentioned-sunday-night-s-debate/.

28 To restate the last two paragraphs in more technical terms: the pass-through deduction makes the tax code less neutral by lowering rates on the supernormal return to pass-through investment; however, it also makes the tax code more neutral by lowering rates on the normal return to pass-through investment.

Here, "normal return" means the portion of an investment return below the investor's risk-free discount rate. An investor earning a normal return is not any better off; he has simply earned a large enough return to cover the cost of the initial investment, in present value terms. "Supernormal return" means the portion of an investment return that *does* represent an increase in the investor's welfare – the share of the return that exceeds the investor's risk-free discount rate.

Under a perfectly neutral tax code, supernormal returns would be taxed at the same rate schedule as all other income, so that all households whose consumption goes up by the same amount are subject to the same tax increase, no matter if they earned their money from labor or from supernormal returns to investment. Meanwhile, the normal return to investment would be excluded from taxation under a neutral tax code, because an investor earning a normal return does not experience an increase in welfare as a result. Thus, it follows that the pass-through deduction makes the tax treatment of supernormal pass-through returns less neutral, while making the tax treatment of normal returns more neutral.

Efficiency

A central goal of the Tax Cuts and Jobs Act was to increase the long-run size of the United States economy, by reducing the marginal tax burden on labor and investment.[29] In general, independent analyses have concluded that the overall effect of the legislation on the size of the U.S. economy will be positive.[30] However, some parts of the law are likely to have a larger economic effect than others.

The pass-through deduction is equivalent to a reduction in marginal tax rates on income from pass-through businesses. This will lower the cost of pass-through business investment in the United States, which would generally be expected to lead to a larger capital stock and ultimately a larger economy.[31] However, there are a number of design features of the pass-through deduction that will limit these positive economic effects.

For one thing, the pass-through deduction will not actually lead to lower marginal tax rates on all pass-through businesses. In fact, some upper-middle-income households with business income will actually see *higher* marginal tax rates as a result of the provision – due to the phase-in of the limits on the deduction.

The households at risk of seeing higher marginal tax rates as a result of the pass-through deduction are those with taxable income between $157,500 and $205,500, or married joint filers with taxable income between $315,000 and $415,000. As discussed above, households in this income range become gradually subject to two limits on the pass-through deduction: the "specified service" limit and the "wage or wage/capital" limit. If a household falls in this income range and is subject to one of these limits, each additional dollar that the household earns causes its pass-through deduction to become more limited.

As a result, in many cases, earning additional income can cause a household to lose a portion of its pass-through deduction, leading to higher federal taxes. This is effectively equivalent to a higher marginal tax rate on some households with business income.

For example, consider the married household shown in the left-hand column of the table below, which makes $430,000 from a pass-through business that is a "specified service." Under certain assumptions, the household is allowed to claim a pass-through deduction of $17,200, and ends up owing a total of $84,275 in federal income taxes.

Now, if the household's business income increases from $430,000 to $440,000, the "specified service" limit will continue to phase in. As shown in the right-hand column, the household's pass-through deduction would shrink from $17,200 to $8,800. This would cause its total income taxes to go up to $90,163 – an increase of $5,888.

29 House Republican Conference, "31 Reasons for Tax Reform," https://fairandsimple.gop/31-reasons-for-tax-reform/.

30 See Box B-2 in Congressional Budget Office, "The Budget and Economic Outlook: 2018 to 2028," April 2018, https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf.

31 For evidence that business investment decisions are sensitive to the after-tax rate of return, see, for instance, Eric Zwick and James Mahon, "Tax Policy and Heterogeneous Investment Behavior," *American Economic Review* 107, no. 1 (January 2017): 217-248; Giorgia Maffini et al., "The impact of investment incentives: evidence from UK corporation tax returns," Oxford University Centre for Business Taxation, January 2016; Eric Ohrn, "The Effect of Corporate Taxation on Investment and Financial Policy: Evidence from the DPAD," *American Economic Journal: Economic Policy* 10, no. 2 (May 2018): 272-301.

In effect, the household faces a marginal rate of almost 59 percent on its pass-through business income – a higher rate than it would have seen before passage of the Tax Cuts and Jobs Act.

TABLE 3.

Effect of the Pass-Through Deduction on Marginal Tax Rates for Households in the Deduction Phaseout Range

Sample Calculations for a Married Filer with $430,000 or $440,000 of Pass-Through Business Income from a Specified Service Business in 2018

With $430,000 of Business Income		With $440,000 of Business Income	
Specified service business income	$430,000	Specified service business income	$440,000
Itemized deductions	-$35,000	Itemized deductions	-$35,000
Taxable ordinary income, computed without regard to the pass-through deduction	$395,000	Taxable ordinary income, computed without regard to the pass-through deduction	$405,000
Percentage of business income eligible for the pass-through deduction	20%	Percentage of business income eligible for the pass-through deduction	10%
Pass-through deduction	-$17,200	Pass-through deduction	-$8,800
Taxable income	**$377,800**	**Taxable income**	**$396,200**
Income subject to the bottom four brackets	$315,000	Income subject to the bottom four brackets	$315,000
Income subject to the 32% bracket	$62,800	Income subject to the 32% bracket	$81,200
Tax from the bottom four brackets	$64,179	Tax from the bottom four brackets	$64,179
Tax from the 32% bracket	$20,096	Tax from the 32% bracket	$25,984
Total income taxes owed	**$84,275**	**Total income taxes owed**	**$90,163**
Additional income tax owed on an additional $10,000 of business income:			**$5,888**

Note: Calculations assume that the filer has no dependents and has no sources of income other than pass-through business income from a service business. The business is assumed not to be subject to the wage or wage/capital limit on the pass-through deduction.

If lower marginal tax rates lead to increased business investment in the United States, higher marginal tax rates should have the opposite effect. As such, the design of the phase-in of the "specified service" and "wage or wage/capital" limits is one feature that will limit the economic effect of the pass-through deduction.

Another major reason why the economic effect of the pass-through deduction may be limited is that the provision is temporary. Generally speaking, lowering marginal tax rates on businesses is only effective at encouraging investment if businesses are confident that the profits from their investments will receive the benefit of lower marginal tax rates in the future. If businesses are not certain whether they can rely on low marginal rates in future years, they may be significantly less likely to increase their investment levels – especially for long-lived investments that yield profits over the course of decades, like factories and office buildings.[32]

32 Alan Cole, "Why Temporary Corporate Income Tax Cuts Won't Generate Much Growth," Tax Foundation, June 12, 2017, https://taxfoundation.org/temporary-tax-cuts-corporate/.

As a result, the fact that the pass-through deduction is scheduled to expire in 2026 is likely to diminish the economic effect of the provision. If a business is considering whether to make an investment that will last 30 years, it may not want to count on a tax provision that will expire in eight.

A third feature of the design of the pass-through deduction that may have negative effects on economic efficiency is the fact that specified service businesses are partially barred from benefiting from the deduction. This will distort the distribution of new investment between economic sectors, leading to an inefficient allocation of capital.

Finally, it is worth noting that the basic design of the pass-through deduction is not necessarily oriented toward maximizing the provision's economic effect. Under standard economic theory, the business tax provisions with the most economic "bang for the buck" are those that are concentrated entirely on encouraging new business investment.[33] In the case of the pass-through deduction, however, the size of the deduction that a business receives is not necessarily related to the amount that it invests. In fact, a significant portion of the deduction goes to lowering taxes on profits from investments that businesses have already made in the past, rather than new investments going forward.

If the pass-through deduction were more squarely focused on encouraging new investment and less focused on lowering taxes on the returns to businesses' past investments, the provision could achieve the same economic effect with a smaller revenue loss, or a larger economic effect with the same revenue loss.

33 Kyle Pomerleau, "Why Full Expensing Encourages More Investment Than a Corporate Rate Cut," Tax Foundation, May 3, 2017, https://taxfoundation.org/full-expensing-corporate-rate-investment/.

Options for Reforming the Pass-Through Deduction

It is clear that the design of the pass-through deduction deserves further examination by lawmakers. In particular, if lawmakers are interested in extending the pass-through deduction after it expires at the end of 2025, they should strongly consider reforming the provision, rather than renewing it in its current form.[34]

When considering reforms to the pass-through deduction, lawmakers should look for ways to make the provision less complex, less prone to abuse, more neutral, and more economically efficient. Achieving these goals might involve replacing the current limits on the deduction entirely.

One option for reforming the pass-through deduction would be to enact a new limit on the deduction, based on how much businesses have invested and whether the investment costs have already been deducted. Under this proposal, businesses could only claim a larger pass-through deduction if they were to invest more in the United States – which would likely make the pass-through deduction less prone to abuse and more economically efficient. Because such a limit would ideally apply to households of all income levels, it could be accompanied by the creation of a "simplified deduction" for pass-through business income, to hold low- and middle-income business owners harmless.

Principles for Reforming the Pass-Through Deduction

Before delving into specific options to reform the pass-through deduction, it may be useful to outline a few principles that should guide efforts to improve the provision.

First, to the extent possible, lawmakers should avoid making the pass-through deduction more complex than it already is. Unfortunately, there is an inherent trade-off between simplicity and administrability, and some aspects of the deduction will inevitably be complicated. Nevertheless, policymakers should still look for ways to simplify the provision – such as basing the rules of the deduction off existing, well-defined tax concepts, rather than asking households to comply with new definitions. Lawmakers should also structure the rules of the provision so as to minimize businesses' incentives to engage in tax-motivated spin-offs, mergers, and income segregation between business activities.

Second, closing off opportunities for abuse of the pass-through deduction should be a top priority for lawmakers. To this end, any limits on the deduction should probably apply to households at all income levels, rather than just upper-income households. Lawmakers should also work to strengthen or replace the current anti-abuse limits on the deduction – which are imperfect heuristics for determining whether a household has earned *bona fide* business income, and which leave the door open for certain tax avoidance strategies.

34 As discussed above, this paper focuses on possible reforms to the *design* of the pass-through deduction, and does not touch on larger questions about the existence and size of the deduction. Nothing in this section is meant to imply that lawmakers should not also consider broader changes to the taxation of pass-through business – such as replacing the deduction with another form of tax relief for business owners, or eliminating the deduction entirely.

Third, in reforming the pass-through deduction, lawmakers should look to minimize tax preferences for specific sectors of the economy or particular sources of income. A more neutral version of the deduction might focus on offering businesses targeted relief from investment penalties in the tax code.

Fourth, to maximize the positive economic effects of the pass-through deduction, lawmakers should orient the provision toward encouraging new business investment. In addition, the structure of the deduction should be modified to avoid large marginal tax rate increases on upper-middle-income households with business income.

A Sample Reform Proposal

There are a number of avenues for reforming the pass-through deduction that lawmakers can explore. Here, we suggest one sample proposal for what a reform of the deduction might look like.

Under this proposal, households would have two options for how to calculate their pass-through deduction. The first involves a simplified "safe-harbor" deduction and the second is a more involved calculation based on businesses' capital investments. This type of bifurcated approach appears in other places in the tax code, such as the current deduction for home office expenses.[35]

Option 1 – Simplified Deduction

Households that choose to claim the "simplified deduction" would be allowed to deduct 100 percent of their qualifying pass-through business income up to a fixed dollar amount – perhaps $6,000 for married households filing jointly and $3,000 for other households.[36] In effect, households that choose this option would be allowed to exclude their first $6,000 or $3,000 of pass-through business income from federal income tax.

Option 2 – Capital Investment Limitation

Households that do not choose to claim the simplified deduction would instead be allowed to deduct 20 percent of their qualifying pass-through business income. But, for the purposes of this calculation, each household's qualified business income would be limited based on the "adjusted basis of business property" owned by the household.[37]

"Adjusted basis" is a measure that businesses already track and report when filing their taxes. It reflects how much a business has invested, as well as how much of the investment costs have already

35 Internal Revenue Service, "Home Office Deduction," https://www.irs.gov/businesses/small-businesses-self-employed/home-office-deduction.

36 These dollar amounts are arbitrary, and are based on an educated guess about what totals might hold most low- and middle-income business owners harmless, compared to current law. For additional information on the distribution of pass-through business income among households, see Tax Policy Center, "T17-0076."

37 Similar proposals are discussed by Daniel Halperin and Eric Toder. See Daniel Halperin, "Corporate Rate Reduction and Fairness to Pass-Through Entities," *Tax Notes* 147, no. 11 (April 21, 2015); Eric Toder, "Filling the Gap: Pass-Through Businesses and Tax Reform," Tax Policy Center, Jan. 3, 2017, https://www.taxpolicycenter.org/sites/default/files/publication/138506/2001156-filling-the-gap-pass-through-businesses-and-tax-reform.pdf.

been deducted. When a business has not been able to deduct most of the costs of its investments, the adjusted basis of the investments is high; when a business has been able to deduct the full cost of its investments, the adjusted basis is zero.

Under this proposal, the calculation of the pass-through deduction would still take place at the household level – but it would begin with information reported by pass-through businesses. At the end of each year, every pass-through business would add up and report its "adjusted basis of business property": the sum of the adjusted basis of all tangible assets, intangible assets, inventory, and land held by the business. Businesses with more than one owner would also calculate and report each owner's pro rata share of this total.

Then, each household would add up its shares of the "adjusted basis of business property" of each pass-through business in which it has an ownership stake. Once each household has calculated its aggregate "adjusted basis of business property," it would multiply this sum by a set rate of return (perhaps 5.5 percent).[38] The total would serve as the limit on how much of the household's pass-through business income would be eligible for the pass-through deduction in the subsequent tax year.

This "capital investment" limit would serve as a replacement for both of the limits that currently apply to the pass-through deduction. As such, the "specified service" limit and the "wage or wage/capital" limit would both be repealed.

The "capital investment" limit would apply to all households that do not choose to claim the simplified deduction, and would not be phased in based on household income level. It would also apply to all categories of pass-through business income, including REIT dividends, income from publicly traded partnerships, and cooperative dividends; unlike current law, these categories of income would not be exempted from limitation.

To prevent abuse, certain used assets acquired recently by a pass-through business would be ineligible to count toward the business's "adjusted basis of business assets." Specifically, used property acquired by a pass-through business after the date of legislative introduction of this proposal would not be taken into account when calculating "adjusted basis of business assets," for the first 10 years after the acquisition of the property. Without this restriction, some companies would immediately transfer substantial sums of assets from C corporations to pass-through businesses, in order to claim a larger 199A deduction.

38 A rate of 5.5 percent represents a typical household's nominal risk-free discount rate. It is not meant to represent a typical rate of return on business investment – which is often much higher. The choice of a relatively low rate of return means that not all business income will be eligible for the pass-through deduction. However, the choice of a low rate also means that lawmakers can be more confident that most of the income that does qualify for the pass-through deduction is, indeed, *bona fide* business income.

To illustrate how this proposal would work, consider the following example:

The Wilsons own a 60 percent stake in ABC Partnership, and have no other pass-through business income. ABC Partnership is a medical practice that owns its own building in an urban downtown; its assets include land, an office building, medical equipment, and goodwill.

- The firm purchased its land for $500,000 five years ago, and was not allowed to deduct the cost. The adjusted basis in the land at the end of last year remained **$500,000**.

- The firm purchased its office building for $1 million five years ago. Since then, it has taken $100,000 in depreciation deductions, and the adjusted basis in the building at the end of last year was **$900,000**.

- The firm purchased $500,000 of medical equipment four years ago. The equipment had a seven-year depreciation life, and the business has taken $280,000 of depreciation deduction on it. The adjusted basis of the machinery at the end of last year was **$220,000**.

- The firm also purchased $300,000 of equipment a year and a half ago. The equipment also had a seven-year depreciation life, and the business also chose to expense 50 percent of it under bonus expensing. The firm has taken $170,000 of depreciation deductions on the equipment, and the adjusted basis at the end of last year was **$130,000**.

- The firm has spent $20,000 on advertising and other costs to develop its reputation and goodwill, all of which were fully expensable. The firm's adjusted basis in its goodwill at the end of last year was **$0**.

In total, the firm's adjusted basis of business assets sums to $1.75 million. The Wilsons' share of adjusted basis of business assets held by ABC Partnership is $1.05 million. The Wilsons multiply $1.05 million by a rate of return of 5.5 percent, arriving at $57,750.

As such, the Wilsons are able to designate $57,750 in pass-through business income that is eligible for the deduction under section 199A. With a deduction percentage of 20 percent, the Wilsons are able to deduct $11,550 of pass-through business income.

Comments on the Sample Reform Proposal

This sample reform proposal is aimed at making the pass-through deduction simpler, less prone to abuse, more neutral, and more economically efficient.

In terms of simplicity, the proposal would make several improvements over current law. Lower- and middle-income households would be able to deduct a fixed dollar amount of pass-through business income, keeping the calculation of their deduction simple. Meanwhile, upper-income households would be able to calculate their deduction using tax information that businesses already report and keep track of (adjusted basis), rather than having to comply with new definitions. Notably, the deduction would be calculated solely on the household level, rather than separately for each business entity – which would reduce incentives for businesses to engage in spin-offs or mergers in order to increase their tax benefit.[39]

It also seems likely that this proposal would be less prone to abuse than the current pass-through deduction. In general, a business would have to increase its actual investment in order to claim a larger deduction.[40] If a household attempted to disguise labor income as "business income" for the purpose of claiming a larger pass-through deduction, this would show up as an excessively high return compared to the amount that the business actually invested; as a result, the disguised labor income would typically become ineligible for the deduction. While it is difficult to anticipate every possible avenue of business tax avoidance, there is good reason to believe that this proposal would be less prone to abuse than current law.

When it comes to neutrality, this proposal would offer the largest tax relief to the pass-through businesses that face the largest investment penalties under the current tax code. In other words, the less that a business is currently able to deduct the cost of its investments, the larger a pass-through deduction it would receive under this proposal.[41] This would increase the extent to which the pass-through deduction contributes to the neutrality of the federal tax code.[42] Meanwhile, the proposal would eliminate the "specified service" limit, and would not include any arbitrary distinctions between sectors of the economy.

Finally, from an economic standpoint, there is a good case that this proposal would contribute more to the growth of the U.S. economy than current law. In general, it would increase the portion of the pass-through deduction that is aimed at encouraging new business investment; companies would have to increase their investment spending in order to claim a larger deduction. In addition, because

39 Under this proposal, there would still be an incentive for households to alter their portfolio choices to maximize the deduction they receive. However, this would presumably be less disruptive than tax-motivated reorganizations at the business level.

40 It seems likely that most pass-through businesses would fall under the "capital investment" limit, meaning that few companies would find themselves with excess adjusted basis that could be diverted to other pass-through businesses. Compare to the current W-2 limit, where the existence of many firms with excess W-2 wages may incentivize businesses to engage in creative transactions to claim a share of other companies' excess wages, rather than simply increasing their own payroll.

41 This is one of the primary advantages of using "adjusted basis" in designing an anti-abuse limit for the pass-through deduction, rather than other measures of business capital such as "unadjusted basis" and "fair market value." These latter two measures do not take into account the extent to which businesses have already been able to deduct their investment costs. As a result, if eligibility for the pass-through deduction were determined based on one of these two measures, there would be a risk of giving businesses an overly generous tax benefit on their investments. For instance, an investment that has already been expensed should not also allow a business to claim a larger pass-through deduction; this would be equivalent to allowing a business to deduct an amount greater than the cost of the investment. However, this situation can occur under the current "wage or wage/capital" limit on the pass-through deduction, which is determined using "unadjusted basis."

42 In technical terms, this proposal would decrease the average federal tax rate on the "normal return" to business investment, while increasing the average federal tax rate on the "supernormal return" to business investment. Both of these effects would make the federal tax code more neutral (see note 28).

the "capital investment" limit applies to all households and is not phased in, this proposal would eliminate the marginal tax increases on upper-middle-income households that are a feature of the current deduction.

It should be noted that the proposal described above would generally reduce the amount of income eligible for the pass-through deduction – which would reduce the overall size of the deduction, all else being equal. If lawmakers are interested in making these structural changes to the pass-through deduction while keeping the size of the provision the same, there is an easy fix: they could adopt this proposal while concurrently increasing the deduction percentage above 20 percent, to make the overall effect revenue-neutral.

Ultimately, any effort to reform the pass-through deduction will be an exercise in prioritization. The reform proposal described here prioritizes businesses that have made new investments – which also happens to be a relatively promising strategy for preventing abuse of the deduction.

Conclusion

It will likely take years for the tax policy community to come to a complete understanding of how exactly the pass-through deduction is working in practice. After all, the major regulations pertaining to the deduction have not yet been issued, and households have not yet gone through the process of computing the deduction for the first time.

Despite this, it is possible to evaluate the pass-through deduction based on what we know so far about the major components of the provision. And it is clear, from a preliminary assessment, that several aspects of the design of the deduction leave room for improvement.

Lawmakers should reexamine the pass-through deduction, with an eye toward improving the provision's simplicity, administrability, neutrality, and efficiency. At a minimum, if lawmakers are interested in extending the pass-through deduction after its scheduled expiration at the end of 2025, they should make sure to consider whether and how the provision ought to be reformed.