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Section 199A Deduction: Economic Effects and Policy Options

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SUMMARY

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Section 199A Deduction: Economic Effects and Policy Options

Section 199A of the federal tax code allows owners of pass-through businesses to deduct up to 20% of qualified business income (QBI) from their taxable income in calculating their individual income tax liability. The deduction was established by the 2017 tax revision (P.L. 115-97) and is available from 2018 to 2025.

Calculating the deduction can be complicated. The maximum deduction is equal to 20% of an eligible business's QBI, provided the deduction does not exceed 20% of a taxpayer's taxable income, excluding long-term capital gains. If a pass-through business owner's taxable income is not greater than the deduction's lower income threshold, then the owner may claim the maximum deduction. The lower income threshold can increase over time because it is indexed for inflation; in 2020, it is set at $326,600 for joint filers and $163,300 for all other filers. If taxable income falls between the lower income threshold and the deduction's upper income threshold ($426,600 for joint filers and $213,300 for all other filers in 2020), then two other limits apply. One limit concerns businesses classified as a "selected service trade and business" (SSTB); the other limit is based on an owner's share of an eligible business's W-2 wages and the unadjusted basis of its tangible, depreciable assets (known as the wage and qualified property [WQP] limit). For QBI from SSTBs and non-SSTBs, the maximum deduction decreases as these limits are phased in. If taxable income exceeds the upper income threshold, no SSTB qualified business income is eligible for the deduction, and the deduction for non-SSTB QBI cannot exceed the greater of 50% of the owner's share of a business's W-2 wages, or 25% of those wages plus 2.5% of the owner's share of the business's unadjusted basis of qualified capital assets.

This report addresses the Section 199A deduction's possible economic effects, addressing the deduction's impact on (1) investment and employment, (2) horizontal and vertical equity in the federal income tax, and (3) tax administration (as it concerns the cost to taxpayers of complying with tax laws and the cost to the federal government of enforcing such compliance). The report ends with a discussion of policy options, as Congress considers whether the deduction should be retained beyond 2025 and whether and how to modify it if the deduction is retained.

Regarding investment, there are no estimates of how the deduction has affected pass-through business investment. Although the deduction seems to have improved investment incentives for numerous pass-through firms, it is not clear to what extent that effect has carried over to actual spending on new investments. Available evidence suggests that the deduction has likely stimulated no more than a modest rise in investment.

Regarding jobs, there are no estimates of how the deduction has affected job creation among pass-through firms. It is unclear whether the deduction, combined with the temporary individual income tax cuts under the 2017 tax law, has boosted demand for labor. In theory, the deduction could indirectly contribute to increases in employment over time through any new investment and business expansion it stimulates. This process can take at least a year or two to play out.

Regarding equity in the federal income tax, the Section 199A deduction appears to reduce vertical equity, which is the principle that someone's tax burden should rise with income. Support for this view comes from evidence that a significant majority of pass-through business profits go to high-income persons. The deduction also appears to reduce horizontal equity, which is the principle that individuals with similar incomes should be taxed at similar rates. Owing to the deduction, a wage earner is taxed at a higher rate than a pass-through business owner with the same taxable income, everything else being equal.

Regarding tax compliance, the deduction's complexity might produce two outcomes, with conflicting revenue effects. On the one hand, the complexity may deter a number of eligible business owners from claiming the deduction. On the other hand, many upper-income pass-through business owners may hire tax advisers to help them find exploitable loopholes in the deduction's rules.

Regarding tax administration, the Section 199A deduction's complexity may put added pressure on the Internal Revenue Service (IRS) to increase its resources for examinations and collections. Owing to substantial cuts in the IRS's enforcement budget since FY2010, audits of high-income individuals and pass-through business owners have decreased by large margins, raising questions about the ability of the IRS to adequately enforce as complicated a tax preference as the Section 199A deduction.

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Introduction

A key aim of the tax revision enacted in December 2017 (P.L. 115-97, often referred to as the Tax Cuts and Jobs Act, or TCJA) was to reduce the federal tax burden on corporate and noncorporate businesses. Many of the reduction's backers predicted that it would give businesses an added incentive to hire more workers and invest more in tangible and intangible depreciable assets. The law sought to reduce the business tax burden in two ways.

For corporations, the law permanently cut the top income tax rate for firms subject to the corporate tax (also known as Subchapter C corporations) from a top rate of 35% (with a graduated rate structure) to a single rate of 21%, a 40% decrease. Corporate profits that are not retained by the business are taxed twice: once at the corporate level and a second time at the individual level when profits are distributed to shareholders as dividends or long-term capital gains.

The 2017 tax revision temporarily lowered the tax burden on noncorporate (or pass-through) businesses by cutting every individual income tax rate except the lowest rate (10%) and creating a new deduction under Internal Revenue Code (IRC) Section 199A for pass-through business profits.[1] The deduction is intended to lower effective tax rates for pass-through business profits by as much as 20%.[2] For pass-through business owners taxed at the highest statutory rate, the maximum deduction and the individual income tax rate cuts lower the top effective rate from 37% to 29.6%, which is about 25% below the top statutory rate under pre-TCJA tax law. Both the individual rate cuts and the deduction are scheduled to expire at the end of 2025. Pass-through business profits are taxed only at the individual level of owners.

This report addresses the Section 199A deduction's possible economic effects. More specifically, it mainly addresses the deduction's impact on (1) investment and employment, (2) horizontal and vertical equity in the federal income tax, and (3) tax administration (as it concerns the cost to taxpayers of complying with tax laws and the cost to the federal government of enforcing such compliance). The report ends with a discussion of policy options for Congress, as it considers whether the deduction should be retained beyond 2025 and whether and how to modify it if the deduction is retained.

[1] For more details on the structure of the Section 199A deduction, see CRS Report R46402, *The Section 199A Deduction: How It Works and Illustrative Examples*, by Gary Guenther.

[2] Effective tax rates (ETRs) serve a crucial purpose in the analysis of the economic effects of tax provisions. They measure an individual's or corporation's tax burden, which is the percentage of taxable income that is actually taken by taxes. An ETR does this by applying to a taxpayer's statutory tax rate any tax preferences the taxpayer could claim in determining taxable income. As such, the effective rate is typically lower than the statutory rate, because tax preferences are intended to increase the welfare of designated groups or to encourage individuals or businesses to engage in certain activities. These preferences can take the form of tax credits, special deductions, exclusions, deferrals, and preferential tax rates.

Generally, an ETR can be average (AETR) or marginal (METR). In the case of businesses, the former shows the tax burden on a firm's taxable income from old and new investments, whereas the latter shows the tax burden on an additional dollar of income from new investments only. Both approaches are used in this report. Each is clearly labeled when it is used.

Structure of the Deduction

In general, Section 199A permits individuals, trusts, and estates with pass-through business income to deduct up to 20% of their qualified business income (QBI) in determining their federal income tax liability. Current law requires pass-through business owners to report their share of net income on their individual tax returns, regardless of whether the income is distributed to them. In general, QBI is equivalent to net income for a pass-through business. The deduction is available from 2018 to 2025, after which it expires. The deduction is claimed on Form 1040 after an eligible taxpayer takes either the standard deduction or the sum of her or his itemized deductions. Generally, use of the deduction depends on a pass-through business owner's taxable income, the nature of her or his business, and the owner's share of the business's W-2 wages and the original cost (or unadjusted basis) of the business's depreciable capital assets.[3]

The **maximum deduction** is the lesser of

- 20% of an owner's QBI, or
- 20% of taxable income, excluding any net capital gains.

Two other limitations may apply to the maximum deduction, reducing the amount of the deduction that may be taken. They are

- A **wage and qualified property limitation** (WQP), which reduces the maximum deduction an owner may claim based on the owner's share of a business's W-2 wages and the unadjusted basis (or original cost) of its qualified assets); and
- A **specified service trade or business (SSTB) limitation**, which reduces the maximum deduction an owner may claim for qualified income from SSTBs. An SSTB is any trade or business primarily engaged in accounting; health; law; actuarial science; athletics; brokerage services; consulting; financial services; the performing arts; investing and investment management; or trading or dealing in securities, partnership interests, or commodities. An SSTB can also be a trade or business whose principal asset is the reputation or skill of one or more of a firm's owners or employees.

The SSTB and WQP limitations begin to apply when a pass-through owner's taxable income exceeds a lower income threshold, and they phase in until taxable income exceeds an upper income threshold. When this happens, the deduction is subject to the limitations' full impact.

The deduction applies to an owner's QBI, which is the net result of combining an eligible business's items of income, deduction (excluding the Section 199A deduction), loss, and gain in a tax year. Only income items connected to a trade or business conducted in the United States (including Puerto Rico) are eligible for the deduction. QBI does *not* include

- wage income;
- reasonable compensation received by an S corporation shareholder for services provided to the business;
- guaranteed payments to a partner from a partnership for services provided to the business; or
- investment income unrelated to a pass-through business.

[3] W-2 wages are the total wages paid by a company that are subject to withholding, elective deferrals, and deferred compensation. The unadjusted basis of depreciable, tangible assets refers to the cost of such assets when a company acquires them.

Economic Effects of the Deduction

This section analyzes the Section 199A deduction's economic impact under six categories: investment, employment, equity, tax administration and compliance, budgetary impact, and industry effects.

Investment

Proponents of the 2017 tax law's business tax cuts have maintained that they are a key to faster and more robust economic growth in the long run.[4] The linchpin of this process is increased investment in more productive capital. In the proponents' view, these cuts should lead many firms to invest more in tangible and intangible assets than they otherwise would. This added investment would expand the firms' capital stock, everything else being equal, and equip workers at these firms with more productive capital assets, enhancing their productivity. According to proponents, rising productivity would result in greater output, higher real wages, and faster job growth, a process that would not necessarily be immediate.[5]

Taxes directly affect investment through their impact on the user cost of capital and business cash flow. The user cost of capital represents the after-tax rate of return an investment has to earn to attract investors. It takes into account the real interest rate, economic depreciation for assets acquired through an investment, the marginal effect of taxes, and the opportunity cost of using funds for that purpose. In this case, the opportunity cost is equivalent to the rate investors could earn from an index fund whose ratio of debt to equity matches the debt-to-equity ratio for financing a new investment.

The deduction, combined with the reduced individual income tax rates under the 2017 tax law, reduces the user cost of capital for eligible pass-through businesses, expanding the portfolio of investments a firm could profitably undertake. As such, the law improves investment incentives for these firms. The boost, however, may be limited by the temporary nature of the reduction in effective tax rates for pass-through business income.

An indicator of the extent to which income taxes affect investment incentives is the effective tax rate (ETR) for the returns to a specific investment. The ETR for a new investment is the difference between its pretax rate of return and its after-tax rate of return, divided by the pretax rate of return. It is generated on the basis of assumptions about real interest rates, method of financing, desired after-tax rate of return for an investment, and individual and corporate tax rates. Under current federal tax law, ETRs vary by type of asset, method of financing, and form of business organization. A reduction in an investment's ETR enhances a firm's incentive to undertake the investment.

As **Table 1** shows, the 2017 tax revision lowered ETRs for corporate and noncorporate investments in a range of tangible assets, financed either by equity alone or by a typical mix of debt and equity.[6] The reduced ETRs for noncorporate investment reflect the combined effect of the Section 199A deduction, the individual income tax rate cuts, and the availability of 100% expensing for tangible assets with a recovery period of 20 years or less (e.g., off-the-shelf

[4] See Scott Hodge, "The Positive Economic Growth Effects of the Tax Cuts and Jobs Act," written testimony of Jane Gravelle before the Joint Economic Committee, *Tax Foundation*, September 6, 2018, pp. 2-3.

[5] See Council of Economic Advisers, *The Growth Effects of Corporate Tax Reform and Implications for Wages*, Executive Office of the President, October 2017.

[6] CRS Report R45736, *The Economic Effects of the 2017 Tax Revision: Preliminary Observations*, by Jane G. Gravelle and Donald J. Marples, p. 17.

software and equipment). These estimates apply to every provision in the 2017 law that affects after-tax returns on investment, which means that they do not clarify to what extent the deduction itself lowered ETRs. For investments financed by a typical mix of debt and equity, the 2017 tax law provided a stronger tax incentive for pass-through businesses to invest in tangible assets like structures and equipment, but not in the development of intangible assets like patents.

Table 1. Effective Tax Rates by Type of Asset

Asset	Corporations: Pre-TJCA Law	Corporations: Current Law	Pass-through Firms: Pre-TCJA Law	Pass-through Firms: Current Law
100% Equity Financed				
Equipment	13.4%	0.0%	14.4%	0.0%
Public Utility Structures	14.2	0.0	15.2	0.0
Nonresidential Structures	30.8	18.5	32.1	26.2
Intangibles	-63.3	-63.3	-63.3	-63.3
Debt and Equity Financed				
Equipment	-0.9	-9.6	-0.6	-14.3
Public Utility Structures	-0.9	-9.6	-0.6	-14.3
Nonresidential Structures	19.2	10.7	20.2	15.7
Intangibles	-116.3	-95.4	-111.2	-109.0

Source: CRS Report R45736, *The Economic Effects of the 2017 Tax Revision: Preliminary Observations*, by Jane G. Gravelle and Donald J. Marples, Table A-1.

Notes: The calculations are based on corporate tax rates of 34.14% under pre-TCJA law (including the now-repealed Section 199 production activities deduction) and 21% under current law; pass-through tax rates of 37% under pre-TCJA law and 30% under current law (based on information from the Congressional Budget Office); a real after-tax rate of return of 7% for equity; an interest rate of 7.5%; a 2% inflation rate; and a debt financing share of 36%.

It would be incorrect to conclude from the estimates in **Table 1** that the 2017 tax revision in general and the Section 199A deduction in particular have uniformly increased the incentive to invest among pass-through firms. Depending on the nature of the asset and how an investment is financed, the deduction can diminish or enhance that incentive.

On the one hand, the deduction operates as a temporary tax cut for pass-through firms. As such, it might act as a disincentive to invest at the margin in the case of a fully debt-financed investment in assets eligible for 100% expensing, such as equipment and certain commercial building improvement property. In this case, the reduced tax rate from the deduction has the unintended effect of discouraging new investment by decreasing the value of deductions for interest payments. According to one estimate, the 2017 tax revision increased the weighted average ETR for all noncorporate investments financed entirely from debt from 19% under previous law to 25% under current law, nearly a 32% increase.[7]

[7] Jason DeBaker and Roy Kasher, "Effective Tax Rates on Business Investment Under the Tax Cuts and Jobs Act," American Enterprise Institute, *AEI Economic Perspectives*, May 2018, Table 2, p. 4.

On the other hand, the deduction has nearly the opposite incentive effect in the case of a fully equity-financed investment in assets whose cost cannot be expensed, such as structures and land. The reduced ETR from the deduction bolsters the incentive for pass-through businesses to invest in those assets, because the value of interest deductions plays no role.

The Section 199A deduction is not an efficient way to spur new investment. It boosts the incentive to invest for many pass-through businesses at the cost of lowering the tax burden on returns from investments firms made before the deduction was enacted. This reduction represents a windfall gain that does not necessarily encourage firms to make new investments, although it might expand the cash flow of firms claiming the deduction.

Evidence of the 2017 Tax Revision's Impact on Investment

Though the 2017 tax revision arguably has enhanced—to varying degrees—investment incentives among many pass-through firms, it is unclear to what extent those firms have invested in more depreciable capital assets than they otherwise would have done since 2018. There are no publicly available estimates.

Some insight into the deduction's investment effects might be gained from the few available studies of the investment effects of the entire 2017 tax revision. Because the law has increased the investment incentives of many corporations and pass-through firms, it seems reasonable to assume that their investments have trended similarly since 2018. But the magnitude of those investments has varied widely. According to data from the Federal Reserve Bank of St. Louis, nonfinancial corporate gross business fixed investment was 4.8 times greater than nonfinancial noncorporate gross business fixed investment in 2019.[8]

A 2019 study by the International Monetary Fund (IMF) found that U.S. investment in tangible and intangible business assets (also referred to as nonresidential fixed investment) at the end of 2018 was 4.5% greater than many economic forecasters had anticipated one year earlier. In addition, growth in U.S. nonresidential fixed investment was faster than growth in such investment in other advanced countries in the same period. The IMF researchers attributed much of this stronger-than-expected growth to an increase in aggregate demand in 2018, combined with forecasts of continued robust demand growth in the next few years.[9] In their view, reductions in the user cost of capital from the 2017 tax revision played a "relatively minor role."

A 2019 Congressional Research Service report on the 2017 tax revision's economic effects arrived at a similar conclusion. It argued that the rise in business investment in the first half of 2018 (see **Table 2**) was likely due to forces that had little to do with the investment incentives in the 2017 tax law. According to the report, the 7% rise in nonresidential fixed investment in 2018 "may not have primarily reflected the 'supply-side effects' of the act."[10]

The report cited several reasons why the law's investment incentives were unlikely drivers of this growth. First, growth rates in nonresidential fixed investment and its components tend to be volatile, making it difficult to determine why they performed as they did from one quarter to the next. Second, the fastest growth in investment since the enactment of the 2017 law happened during the first two quarters of 2018, a result that is difficult to reconcile with the longer planning

[8] See https://alfred.stlouisfed.org/series?seid=NNBGFNQ027S and https://fred.stlouisfed.org/series/BOGZ1FA105019005Q.

[9] Emanuel Kopp et al., *U.S. Investment Since the Tax Cuts and Jobs Act of 2017*, International Monetary Fund, IMF Working Paper WP/19/120, May 2019.

[10] See CRS Report R45736, *The Economic Effects of the 2017 Tax Revision: Preliminary Observations*, by Jane G. Gravelle and Donald J. Marples.

timelines typical for new investments. Third, reported growth in investment in equipment, structures, and research and development (R&D) in 2018 and 2019 did not match expectations based on estimated changes in the user cost of capital under the 2017 tax revision. According to the report, the user cost of capital declined by 2.7% for equipment, 11.7% for structures, and 3.4% for R&D. Yet R&D investment in 2018 and 2019 grew by 14.0%, followed by growth rates of 10.1% for equipment and 3.1% for structures. If the 2017 tax law's investment incentives were the primary driving force for these increases, investment in structures would have grown at the fastest rate, and R&D investment would have grown at the slowest rate.

A 2020 report by Jason Furman further questioned the idea that the 2017 tax revision has spurred a large increase in new business investment, on the grounds that data on domestic investment since 2016 do not validate that idea. Furman noted that nonresidential fixed investment grew at a faster annual average rate (3.9%) in the eight quarters before the 2017 tax law was passed than it did in the subsequent eight quarters (2.8%).[11]

As did the CRS report, Furman also noted that there was no correlation between estimated reductions in the user cost of capital under the 2017 tax law and the performance of the components of nonresidential fixed investment. In the eight quarters after the 2017 law was enacted, investment in intellectual property was 2.4 percentage points higher than it was in the previous eight quarters, even though such investment had the smallest reduction in ETR (5 percentage points). By contrast, investment in the components with the largest reductions in ETR (16.9 percentage points for software and equipment and 10.8 percentage points for nonresidential structures) decreased by 2.9 percentage points, as measured by the difference between their combined annual average growth rate in 2016-2017 and in 2018-2019. Furman concluded that these results offered "no support for the view that the tax rate cuts and full expensing in the 2017 tax law had stimulated substantial increases in business investment."

Table 2. Percentage Change in U.S. Real Nonresidential Fixed Investment from the Previous Quarter

Year	1st Quarter	2nd Quarter	3RD Quarter	4th Quarter
2016	-0.6(%)	4.0(%)	5.6(%)	0.7(%)
2017	6.6	4.4	2.4	8.4
2018	8.8	7.9	2.1	4.8
2019	4.4	-1.0	-2.3	-2.3
2020	-6.7	-29.2	28.5[a]	NA

Source: Bureau of Economic Analysis

Notes: Nonresidential fixed investment covers acquisition by the private sector of nonresidential structures, equipment, and intellectual property products such as patents or trademarks.

a. Preliminary.

The three studies suggest that the Section 199A deduction has delivered no more than a modest boost to noncorporate business investment since 2018. This stimulus is difficult to parse from available data on domestic business investment. An exploration of the impact of the deduction's temporary status on pass-through business investment may provide useful information for policymakers.

[11] Prepared testimony of Jason Furman, in U.S. Congress, House Committee on Ways and Means, *The Disappearing Corporate Income Tax*, hearings, 116th Cong., 2nd sess., February 11, 2020 (Washington, DC: GPO, 2020), Table 2, p. 8.

Employment

The deduction is not a subsidy for job creation, so its direct effect on the labor market is likely to be minimal. In general, job creation depends on several forces. In the short run, the rate of job creation is linked to the level of economic output: when gross domestic product rises over an extended period, the rate of job creation eventually will increase. Technical change in the workplace is also linked to job creation: the better the fit between numerous firms' skill and knowledge requirements and individuals' work skills and experiences, the faster the rate of job creation in the short run.

In the long run, investment can play a critical role in job growth. Investment in this case refers to the acquisition and improvement of physical and human capital. Firms that equip their employees with more productive physical capital and provide them with the requisite training, at their expense or the expense of another entity such as local, state, or federal governments, can expect rises in worker productivity. Productivity growth is a key element in long-term growth in output, wages, and jobs. It can take some time for this process to play out.

The combined effect of the Section 199A deduction and the individual income tax rate cuts under P.L. 115-97 is to increase investment incentives and cash flow for most pass-through firms. Economic theory holds that a firm is more likely to take advantage of these tax reductions when demand for its output is growing than when demand is falling. This suggests that demand growth, rather than enhanced investment tax incentives, is a more potent driver of job creation in the private sector over time. From this perspective, a better predictor of the jobs created by the 2017 tax revision is its overall impact on consumer spending, which typically accounts for between 65% and 70% of U.S. gross domestic product.

Some have argued that job creation is "the strongest and most coherent policy rationale for the TCJA in general and for the Section 199A deduction in particular."[12] Yet that perspective is not reflected in the deduction's structure. Specifically, three of the deduction's features arguably restrain its job-creating potential. First, pass-through business owners with taxable incomes below the lower income threshold can benefit from the deduction without creating a single job. Second, owners of SSTBs with taxable incomes above the upper income threshold cannot benefit from the deduction, regardless of how many jobs they create. Third, high-income owners of non-SSTBs can benefit from the deduction without creating a single job if they invest enough in qualified capital assets.

Tax Administration and Taxpayer Compliance

The Section 199A deduction has implications for the cost and complexity of tax administration and taxpayer compliance.

Tax Administration

The Internal Revenue Service (IRS) is responsible for implementing and enforcing the deduction. This involves two essential tasks: (1) establishing regulations for using the deduction and explaining them clearly to taxpayers; and (2) enforcing taxpayer compliance with those rules, mainly through audits.

[12] Rodney P. Mock and David G. Chamberlain, "Section 199A: Job Creator or Tax Giveaway?" Tax Notes, December 10, 2018, p. 1309.

There are no known estimates of the cost to the IRS of administering the deduction, but it may be significant. Extensive audits may be necessary to ensure that claims for the deduction are legitimate and correct in amount for the following reasons:

- the complexity of the deduction's final regulations (TD 9847);
- remaining uncertainties about the specific activities that do and do not qualify for it; and
- a lack of clarity among pass-through business owners about how the rules may affect them and the deduction's potential benefits.

Health care is one of the industries likely to attract added scrutiny from the IRS. For example, as pointed out in TD 9487, the legitimacy of claims for the deduction by assisted living facilities and outpatient surgery centers appears to depend on the balance between income they earn as health-care providers and income they earn from nonmedical services provided to residents or patients. The validity of such a claim is likely to hinge on relevant facts and circumstances.

Some are concerned that the IRS lacks the resources needed to audit claims for the deduction at a rate that might deter tax evasion or questionable tax avoidance. It is uncertain whether Congress will provide those resources in the next few years. Since 2010, the IRS's enforcement budget has scarcely grown in current dollars and has shrunk about 30% in inflation-adjusted dollars. This reduction in real resources has led to declines and sharp fluctuations in key enforcement indicators, such as IRS audit rates for high-income individuals.[13]

Taxpayer Compliance

The Section 199A deduction's complexity and continuing uncertainty about eligibility may have two effects on pass-through business owners. First, these considerations may deter large numbers of eligible taxpayers from claiming the deduction. Such an outcome may have suppressed claims for the deduction in the 2018 tax year, when lower-income pass-through business owners did not benefit from the deduction to the extent they should have.

In a report on filing for the 2018 tax year, the Treasury Inspector General for Tax Administration (TIGTA) found that 887,991 tax returns, processed as of May 2, 2019, did not claim the Section 199A deduction, even though the filers appeared to be eligible for it, according to information reported in the returns.[14] Each return included a form associated with a pass-through business (Schedule C or Schedule F) showing a profit. Moreover, all the returns reported taxable income at or below the lower income threshold for 2018: $315,000 for joint filers and $157,500 for all other filers.

It is not clear why so many eligible taxpayers did not claim the deduction when they were eligible to do so. IRS managers contacted by TIGTA suggested several possible explanations for this failure:

- taxpayers did not understand that they were eligible to claim the deduction;

[13] Between FY2008 and FY2018, IRS staffing levels for exams and collection dropped by 25%, and for prefiling assistance and education by 23%. During the same period, the audit rate for individual tax returns with business income of $200,000 or more fell from 3.1% in FY2008 to 1.9% in FY2018. Most pass-through business profits are earned by individuals reporting relatively high levels of business income. In FY2008, visits to Taxpayer Assistance Centers and taxpayer assistance calls totaled 99.3 million; in FY2018, by contrast, the total was 57.8 million.

[14] U.S. Department of the Treasury, Treasury Inspector General for Tax Administration, *Results of the 2019 Filing Season*, ref. no. 2020-44-07, January 22, 2020, p. 14.

- software they used to prepare their returns was unclear about what constitutes QBI;
- some trade or business income was earned outside the United States; and
- taxpayers elected not to claim the credit because it seemed too difficult to calculate.

According to TIGTA, the findings indicated that the IRS needed to boost its outreach and education efforts regarding the deduction's availability.

A second effect of the complex rules for the deduction is their compliance cost. It may be high enough to convince some eligible business owners not to take the credit. Although there are no known estimates of the cost of taking the deduction, it could vary considerably among pass-through business owners. Among the factors to consider when filing a claim are the number of trades and businesses someone owns, the eligibility of each one under Section 199A, and the amount of each eligible business's W-2 wages and unadjusted basis of qualified property allocable to the owner. The recordkeeping needed to substantiate a claim for the deduction might be the biggest obstacle for many small business owners.[15]

In general, eligible taxpayers with taxable incomes at or below the lower income threshold for the deduction may face the lowest compliance cost in using the Section 199A deduction. For many of them, taking the deduction may be as simple as calculating 20% of their combined QBI and 20% of their taxable income less any net capital gain, and claiming the smaller of the two amounts.

The compliance cost is likely to increase when an owner's taxable income lies between the lower income threshold and the upper income threshold. In this case, the SSTB and WQP limits for the deduction phase in, making the deduction's calculation more complicated.

For taxable income above the upper income threshold, no deduction is allowed for SSTB profits, and the deduction for a non-SSTB is limited to the greater of 50% of the firm's W-2 wages attributable to a business owner, or 25% of those wages plus 2.5% of the owner's share of the business's unadjusted basis of qualified property.

Numerous high-income owners of SSTBs, or of a mix of SSTBs and non-SSTBs, may hire tax planners to find ways to benefit from the deduction that may or may not strictly comply with the law and IRS regulations. Some planning strategies might entail combining or separating pass-through businesses to qualify for the deduction. Tax planning of this sort can be expensive. In general, large pass-through businesses may find it easier than small ones to afford tax counsel to help them restructure their operations so they can claim the deduction, or claim a larger deduction. Disparities in access to effective tax planning arguably represent one way in which the Section 199A deduction unintentionally picks winners and losers among pass-through business owners.

Complexity

The complexity of a tax system cannot be measured directly. But, as the Joint Committee on Taxation explained in a 2015 report, complexity of this sort can be assessed indirectly by applying several factors. The key ones are (1) complexity in the economy, which often sets the

[15] One example of this challenge is the difficulty some tax practitioners have had tracking the various losses (e.g., passive-activity-loss and disallowed business deduction carryforwards) that can reduce current-year QBI. For more details, see Eric Yauch, "Tracking Losses and Undue Complexity—Is 199A Even Worth It," Tax Notes, March 19, 2020.

stage for the adoption of complicated tax rules; (2) enactment of tax benefits as incentives for engaging in desired activities; (3) repeated extension of temporary tax provisions; (4) frequent changes in tax law; (5) statutory tax provisions that leave the determination of key issues to the IRS instead of Congress; and (6) lack of clarity in tax law.[16]

In this analytical framework, most would agree that the Section 199A deduction is a complex tax provision. It is temporary (the deduction expires at the end of 2025); Congress has given the IRS broad authority to set rules for the deduction; and there is a lack of clarity in some of the rules governing the use of the deduction, impeding its uptake.

Equity Effects

Public finance economists analyze the federal income tax's equity effects from two perspectives: vertical equity and horizontal equity. Vertical equity refers to the rise in someone's taxes as her or his income goes up. Under a progressive income tax, households are taxed according to their ability to save and consume, and tax burdens rise with income. Horizontal equity requires that taxpayers with similar abilities to save and consume have similar tax burdens.

Horizontal Equity

The deduction diminishes horizontal equity in the federal income tax in two ways. First, it reduces horizontal equity in the taxation of wage earners and pass-through business owners by lowering the tax burden of owners by up to 20% relative to the tax burden of individuals with the same income, but from wages.[17]

To illustrate this point, assume that a sole proprietor and an employee have the same taxable income ($100,000 in 2020), and that the former's income comes solely from QBI for a retail business she owns and the latter's income is from wages only. Under the federal individual income tax rate schedules for 2020, the sole proprietor is eligible for the maximum Section 199A deduction, which reduces her top marginal tax rate from 24% to 19.2% (24% x 0.8). By contrast, the employee cannot claim the deduction, making him subject to a top marginal tax rate of 24.0%. Under pre-TCJA tax law, both taxpayers would have been subject to the same marginal rate.

Second, the deduction diminishes horizontal equity by excluding SSTB profits received by high-income individuals. The exclusion may be intended to prevent the sheltering of income by upper-income professional service providers whose income bears a similarity to wage income. Nonetheless, it means that SSTB owners cannot benefit from the deduction because their taxable income is too high, whereas non-SSTB owners with similar taxable income can benefit. Thus, under current law, a high-income SSTB owner and a high-income non-SSTB owner with the same taxable income and the same QBI would face different effective tax rates on the returns from their investments.

Vertical Equity

Among income groups, available evidence indicates that high-income persons are likely to capture much of the overall tax benefit from the Section 199A deduction. Such an outcome would be consistent with what is known about the distribution of pass-through business profits among

[16] Joint Committee on Taxation, *Complexity in the Federal Tax System*, JCX-49-15, March 6, 2015.

[17] Andrew Velarde, "Passthrough Abandonment of Horizontal Equity Means It's Game On," Tax Notes, May 18, 2018.

households ranked by income. It would also suggest that the deduction does little to promote vertical equity among individual taxpayers.

The evidence comes from several sources. According to a 2015 report by Michael Cooper et al., 69% of pass-through business income went to the top 1% of households ranked by income in 2011.[18] A more recent analysis by the Tax Policy Center (TPC) estimated that the top 1% of taxpayers received 52% of pass-through business income in 2017. Half of that share (or 26% of pass-through business income) was captured by the top 0.1% of taxpayers.[19]

More recent studies by the TPC and the Joint Committee on Taxation (JCT) further support the view that high-income households are likely to disproportionately benefit from the deduction. The TPC estimated that 90.2% of the total benefit from the Section 199A deduction in 2018 accrued to taxpayers in the top 20% of households ranked by income; the top 1% received 55.4% of the benefit; and the top 0.1% captured 27.6%.[20]

The JCT has issued two estimates of the deduction's distributional effects. Both come to the same conclusion: although most claims for the deduction will come from lower-income individuals, the bulk of the tax savings will go to higher-income individuals. In April 2018, the committee estimated that 44% of the benefit from the deduction was likely to go to persons with incomes of $1 million or more in 2018, and that their share would rise to 52% by 2024.[21] In both years, however, taxpayers with gross incomes between $50,000 and $200,000 would account for 64% of claims for the deduction.

Then in March 2019, the JCT estimated claims for the deduction in 2019.[22] The committee concluded that 68.4% of taxpayers with pass-through business income would be eligible for the deduction, and that the deduction would apply to most (91.5%) of that income. The ineligible income would result from the application of the SSTB and WQP limits. According to the analysis, more than 95% of taxpayers claiming the deduction in 2019 would have taxable incomes below the lower income threshold, leaving a small minority (4.9%) of claims subject to the SSTB and WQP limitations. Nevertheless, the JCT estimated that taxpayers with incomes above the lower income threshold would realize 66% of the tax savings from the deduction that year.

According to individual income tax return data for 2018, there were 18.7 million claims for the deduction worth a total of nearly $150 billion.[23] The average deduction was almost $8,000, but the amount varied considerably among income groups. For taxpayers with AGIs below $200,000, the average deduction came to $3,136. The average amount rose to $15,396 for taxpayers with AGIs between $200,000 and $1 million. Of the 356,000 taxpayers with AGIs above $1 million who took the deduction, the average amount was $157,257. The average deduction rose to $1.04 million for the 15,000 taxpayers with AGIs above $10 million who claimed it.

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[18] Michael Cooper et al., "Business in the United States: Who Owns It, and How Much Tax Do They Pay?" *Tax Policy and the Economy*, vol. 30, no. 1 (October 2015), p. 94.

[19] Urban-Brookings Tax Policy Center, Table T17-0080: Sources of Flow-Through Business Income by Expanded Cash Income Percentile, March 20, 2017.

[20] Urban-Brookings Tax Policy Center, Table T18-0213: Tax Benefit of the 20 Percent Deduction for Qualified Pass-Through Business Income, October 16, 2018.

[21] U.S. Congress, Joint Committee on Taxation, *Tables Related to the Federal Tax System As in Effect 2017 through 2026*, JCX-32-18 (Washington, DC: April 23, 2018), Table 3, p. 4.

[22] Joint Committee on Taxation, *Overview of Deduction for Qualified Business Income: Section 199A*, March 2019.

[23] Martin A. Sullivan, "Economic Analysis: 19 Million Taxpayers Take the Passthrough Deduction," Tax Notes, September 14, 2020.

Impact on Federal Budget

Because the deduction reduces the tax burden on many pass-through business owners, its net effect on federal revenue is likely to be negative, relative to baseline revenue projections without the deduction.

The JCT estimated that the deduction would result in a $414.5 billion revenue loss from FY2018 to FY2027. This represented more than 28% of the total revenue loss in that period of $1.455 trillion from the 2017 tax revision.[24]

According to a 2019 TPC analysis, the Section 199A deduction is likely to rank third in size among all business tax expenditures from FY2019 to FY2022.[25] The rankings were based on the estimated cumulative revenue loss for each tax expenditure identified by the JCT. The three-year total for the deduction was $225.8 billion, exceeded only by the depreciation of equipment in excess of the alternative depreciation system ($253.2 billion) and the reduced tax rate on active income of controlled foreign corporations ($309.2 billion).

The Section 199A deduction provides an incentive for high-income wage earners to become pass-through business owners, and for C corporations to reorganize as pass-through businesses. Although there are no estimates of the revenue effect of either change in tax status, some shift among taxpayers from wage earner to independent contractor and from C corporation to pass-through entity may occur from 2018 to 2025. Whatever shift materializes is likely to have implications for the deduction's revenue effect over time.

Impact Among Industries

At least one publicly available study has examined the Section 199A deduction's implications for industries. The Treasury Department's Office of Tax Analysis (OTA) has assessed to what extent taxpayers who reported pass-through business income on their 2016 tax returns would have benefited from the deduction if it had been available that year.[26] The study was based on a sample of 780,000 taxpayers deemed representative of taxpayers who reported pass-through business income to the IRS for 2016. OTA identified the industries that would have realized the greatest tax savings from the deduction. A key assumption was that pass-through business owners would not have altered their economic decisions in 2016 in response to the deduction.

According to the study, an estimated 17.8 million businesses would have been eligible for the deduction in 2016.[27] Nearly 62% of them would have realized tax savings from the deduction. The tax savings would have totaled $34.5 billion (2018 dollars), after allowing for the SSTB and WQP limitations. Without the limitations, the tax savings would have been 82% larger. Taxpayers

[24] U.S. Congress, Joint Committee on Taxation, *General Explanation of P.L. 115-97*, JCS-1-18 (Washington, DC: GPO, December 2018), pp. 434-441.

[25] Frank Samartino and Eric Toder, *What Are the Largest Business Tax Expenditures?* Tax Policy Center, July 17, 2019. The study defined a business tax expenditure as a tax provision that affects the measurement of taxable business income, such as special deductions, deferrals of income recognition, or credits that businesses or their owners may claim against their business tax liabilities.

[26] Lucas Goodman et al., *Simulating the 199A Deduction for Pass-through Owners*, Treasury Department Office of Tax Analysis, Working Paper 118, May 2019. (Hereinafter referred to as Goodman et al., *Simulating the 199A Deduction for Pass-through Owners*.)

[27] Goodman et al., *Simulating the 199A Deduction for Pass-through Owners*, p. 18.

in the top 5% of income would have received about 72% of the total tax savings, with 47% going to taxpayers in the top 1% and 23% to taxpayers in the top 0.1%.

The tax savings from the deduction with the SSTB and WQP limitations would have been largest for (1) professional services, (2) real estate, (3) construction, (4) retail trade, and (5) manufacturing.[28] A somewhat different ranking resulted when the tax savings were calculated without those limitations: (1) professional services, (2) real estate, (3) health, (4) finance and insurance, and (5) construction. Not surprisingly, the impact of the limitations varied among industries. For example, the tax savings with the two limitations were 54% lower than the tax savings without the limitations for professional services, but for retail trade the difference was 10%. This variation reflected differences among industries in (1) the percentage of firms classified as an SSTB, (2) the income distribution of pass-through business owners, and (3) the mix of depreciable, tangible assets and labor.[29]

Industries also differed in the percentage of firms that would have benefited from the Section 199A deduction. Without the two limitations, this percentage ranged from 43.6% for mining, oil, and gas to 73.2% for non-SSTB professional services. Three other industries had percentages above 70%: education (72.6%), wholesale trade (71.4%), and manufacturing (71.3%).

Some of the industries with large tax savings (e.g., professional services) contained many SSTBs. The OTA authors attributed this outcome to two other findings. These industries had some subindustries with few SSTBs. In addition, most pass-through business owners in these industries who benefited from the Section 199A deduction had taxable incomes below the lower income threshold, allowing them to claim the maximum deduction.

The deduction's disparate effect among industries raises the question of whether it picks winners and losers among pass-through businesses. Some argue that the deduction does so in two ways. One pathway involves access to professional tax advice for claiming the deduction, which tends to be costly. Business owners who cannot afford such advice may be at a disadvantage relative to owners who can afford it. A second pathway is the denial of the deduction to professional service firms owned by higher-income persons. Lower-income owners of the same kinds of businesses can benefit from the deduction, in many cases without the SSTB and WQP limits, whereas higher-income owners cannot. There is no apparent economic justification for conditioning the use of a business tax preference (like the deduction) on the taxable income of business owners.

Worker Classification and Independent Contractors

The Section 199A deduction applies to qualified business income, not wage income. As a result, the deduction has the potential to spur an increase in the number of individuals classified as independent contractors. Starting in the 1980s, many larger U.S.-based companies began to restructure their businesses around "core competencies," which were activities that were likely to produce the largest returns for stockholders. Other activities (e.g., facilities maintenance, accounting, human resources, and janitorial services) were outsourced to subcontractors (including independent contractors). Some have called this restructuring *workplace fissuring*,

[28] It may come as a surprise that the OTA analysis found that professional services would have realized the largest tax savings (with and without limitations) from the deduction, if it had been available in 2016. The industry encompasses firms primarily engaged in law, accounting, and consulting, each one considered an SSTB. But Goodman et al. found that professional services included subgroups that were not deemed SSTBs, such as computer and specialized design services and advertising. They also noted that many SSTB owners had taxable incomes below the 2018 lower income threshold for the deduction, allowing them to claim the maximum deduction.

[29] Goodman et al., *Simulating the 199A Deduction for Pass-through Owners*, p. 17.

which refers to a process that allows an employer to obtain needed services by hiring outside suppliers rather than using its own employees, possibly cutting labor costs. This process can lead to individuals who work as contractors or temporary workers receiving lower wages and reduced benefits (including worker training) for performing essentially the same services that they did for former employers and other firms.[30]

There are several reasons why it is unlikely that the Section 199A deduction will spur an increase in persons classified as independent contractors.

First, the final regulations for Section 199A clarified the circumstances under which someone who worked as an employee and then switches to an independent contractor could benefit from the deduction. An individual who works as an independent contractor and provides essentially the same services to a former employer or a related entity is presumed (under the regulations) to be providing services as an employee. Consequently, this person cannot claim the Section 199A deduction. This *presumption* can be challenged (or rebutted), but the burden of proof is on the self-employed person. She or he must prove to the IRS (e.g., through records such as partnership agreements and work contracts) that she or he did not work as an employee for at least three years after her or his most recent employer stopped treating the individual as an employee for the purpose of the federal payroll tax.

Second, only independent contractors with taxable incomes below the lower income threshold ($326,300 for joint filers and $163,300 for all other filers in 2020) can claim the maximum deduction.

Third, the tax savings from the deduction may be insufficient to offset the potential disadvantages of working as an independent contractor. These disadvantages include few legal protections for many independent contractors regarding the minimum wage, overtime, sexual harassment, and workplace safety. Employers that provide benefits to employees (e.g., paid family and medical leave, unemployment insurance, workers' compensation, health insurance, and retirement benefits to full-time employees) are not required to provide them to independent contractors. And independent contractors must pay the entire 15.3% payroll tax, whereas employees share the tax equally with employers, each paying 7.65%.

Fourth, the Section 199A deduction offers employers no safe harbor for classifying workers as independent contractors. This means that a company can classify an employee as an independent contractor for tax purposes only if the worker's relationship with the company satisfies a 20-factor test focused on the degree of control the company has over the services an independent contractor provides and the company's method of payment for those services.[31]

Policy Options

As noted earlier, the Section 199A deduction is due to expire at the end of 2025. Congress has a variety of options regarding the deduction. These include

- allowing the deduction to expire, as scheduled, at the end of 2025;
- permanently extending the deduction without changes;

[30] David Weil, "How To Make Employment Fair in An Age of Contracting and Temp Work" *Harvard Business Review*, March 24, 2017, https://hbr.org/2017/03/making-employment-a-fair-deal-in-the-age-of-contracting-subcontracting-and-temp-work.

[31] For details on this test, see IRS, "Understanding Employee vs. Contractor Designation," July 20, 2017, at https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation.

- permanently extending the deduction and modifying its structure; and
- repealing the deduction and replacing it with a less complicated system for taxing noncorporate business income.

Permanently Extend the Deduction with No Changes

Many of the firms that now benefit from the Section 199A deduction might ask Congress for a permanent extension. A key consideration with this option is the revenue cost of such an extension. A 2020 TPC study estimated a permanent extension of the deduction in its current form would reduce tax revenue by a total of $1.7 trillion from 2026 to 2040.[32] Income shifting would account for $279 billion (or 16.4%) of that amount. This shifting reflects the incentives the deduction gives wage earners and corporations to switch to pass-through status to take advantage of lower tax rates on pass-through business profits.

Retain the Deduction with Design Changes

Another policy option is to permanently extend the Section 199A deduction with changes to its structure intended to expand its potential economic benefits at a lower compliance cost. In one example of such an approach, the Tax Foundation would make two changes in the deduction.[33] First, the deduction would be made available to all owners of pass-through firms on the same terms. Second, the deduction would be based on a firm's investment in a tax year.

Under the proposal, pass-through business owners would have two choices for calculating their Section 199A deduction: (1) a "simplified deduction," or (2) a deduction based on the amount of new investment in a year. Those choosing the former would be allowed to deduct 100% of their QBI up to a fixed amount, indexed for inflation—for example, $6,000 for joint filers and $3,000 for all other filers. Those choosing the latter would be allowed to deduct 20% of their QBI as they can under current law. But QBI in this case would be based on the adjusted basis of qualified property a business acquired during the year. An owner would calculate her or his share of the total amount of this property at the end of the year for each business she or he owns and multiply the aggregate amount by a fixed rate of return. The resulting dollar amount would determine an owner's QBI eligible for the deduction. In this scenario, the deduction would encourage firms to expand their capital stock over time.

Others have suggested retaining the deduction but modifying it to enhance its job-creation potential. Among the options are to (1) require that pass-through business owners pay W-2 wages in order to be eligible for the deduction, and (2) allow all pass-through business income (including SSTB income).

Replace the Deduction with a Different System for Taxing Business Profits

Congress might also choose to replace the deduction with a new system for taxing noncorporate business profits. Such a revision could serve a variety of policy aims. The choices include simplifying business taxation, removing the incentive in current law for pass-through businesses

[32] Benjamin Page, Jeffrey Rohaly, Thornton Matheson, and Aravind Boddupalli, *Tax Incentives for Pass-through Income*, Tax Policy Center, July 15, 2020, p. 8.

[33] Scott Greenberg and Nicole Kaeding, *Reforming the Pass-Through Deduction*, Tax Foundation, Fiscal Fact No. 593, June 2019, pp. 22-23.

to reclassify wages as profits eligible for the deduction and for workers to become independent contractors, raising more revenue, and providing larger subsidies for business activities (R&D investment) that may speed up economic growth and productivity growth.

Eric Toder of the TPC has proposed two options for altering the current system of noncorporate business taxation.[34] One option would be to repeal the deduction and tax all privately held C corporations as pass-through entities. Noncorporate business profits would be taxed at the same rates as wage income. Special rules would be needed to tax the accumulated profits of C corporations required to switch to pass-through status. The profits of publicly traded C corporations would continue to be taxed at the current rate of 21%, and their owners would continue to face a second level of tax on any dividends they receive and long-term gains they realize.

A second option would be to tax wage income and pass-through business profits at the same rates but to continue to tax privately held C corporations as they are currently taxed.[35] Privately held C corporation profits would be allocated to stockholders and taxed under the individual tax, whether or not they are distributed. This tax treatment already applies to pass-through business profits. The income tax for publicly held C corporations would operate as a withholding tax for which shareholders would claim a credit when they file their individual tax returns. A two-level income tax would still apply to the profits of publicly traded C corporations distributed to shareholders.

Toder's proposal would not equalize the tax treatment of pass-through business profits and publicly held C corporation profits. Achieving complete neutrality would require taxing income received by shareholders from publicly held C corporations on an accrual basis to prevent shareholders from accumulating tax-preferred income within corporations.

Some proposals would do more than modify the taxation of pass-through business profits. For example, Jason Furman advocates making broader changes in business taxation to raise more revenue, lay the foundation for more robust U.S. economic growth in coming years, and simplify tax compliance for small business owners. His proposal calls for the following permanent changes in business taxation:

- expanding 100% expensing allowances to include structures and all intangible assets, make this treatment permanent, and disallow all interest deductions linked to new investment;
- increasing the corporate tax rate to 28%;
- requiring all large firms to file as a C corporation, while giving smaller firms the choice to file as a C corporation or a pass-through entity;
- eliminating the Section 199A deduction;
- closing "corporate loopholes, including tax extenders"; and
- enhancing the R&D tax credit under Section 41 by increasing the rate of the alternative simplified credit from 14% to 20%.[36]

[34] Eric Toder, "Eliminate the Deduction for Qualified Business Income and Require Most Firms To Be Taxed as Pass-throughs," Tax Policy Center, *TaxVox Blog*, June 4, 2018.

[35] Ibid.

[36] Prepared testimony of Jason Furman, in U.S. Congress, House Committee on Ways and Means, *The Disappearing Corporate Income Tax*, hearings, 116th Cong., 2nd sess., February 11, 2020 (Washington, DC: GPO, 2020).

Furman's proposal would introduce more stability in the taxation of business profits than current law provides. It also would establish greater neutrality in the taxation of business investment returns, increase tax incentives for investing in R&D, and eliminate the current tax incentive for using debt to finance new investments. But by increasing effective tax rates for pass-through business profits by as much as 20%, his proposal would risk lowering tax incentives for pass-through business investment at least through the end of 2025.

The policy issues associated with the Section 199A deduction, coupled with the backing it enjoys within certain segments of the noncorporate business sector, raise the possibility that Congress may face pressure to retain the deduction, but with changes in its structure that make it easier to claim, available to more businesses, less prone to gaming, and perhaps a more robust tool for encouraging new investment and job creation among pass-through firms. A likely consideration in any action Congress takes is the revenue cost. Whatever action Congress chooses to take may have significant implications for businesses that account for considerable shares of domestic business income and employment.[37]

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[37] According to data compiled by the Tax Foundation, in 2014, pass-through firms represented 86% of all U.S. firms and employed 57% of the U.S. private-sector workforce; in 2012, pass-through firms (as a whole) earned 48% more net income than C corporations did: $1.63 trillion compared to $1.10 trillion. See Scott Greenberg, "Pass-Through Businesses: Data and Policy," *Tax Foundation*, January 17, 2017, https://taxfoundation.org/pass-through-businesses-data-and-policy/.