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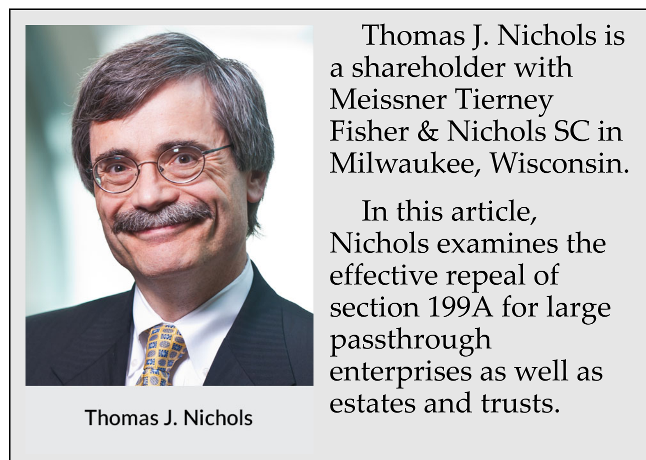
VIEWPOINT
tax notes federal

SOS: Save Our Section 199A

by Thomas J. Nichols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In this article, Nichols examines the effective repeal of section 199A for large passthrough enterprises as well as estates and trusts.

The Democrats will have to come up with revenue offsets in the next two weeks if they are going to fund all the entitlement and other spending — $3.5 trillion — contemplated in the recently adopted budget reconciliation instructions (the concurrent resolution)[1] on the schedule determined by leaders in both the Senate and House[2] — hence the mad rush to come up with pay-fors. Trying to accomplish this in less than a month should strike fear into the heart of anyone who cares about tax policy, especially if they believe (as I do) that a sound tax system is critical to a well-functioning economy that serves the needs of consumers as well as labor and capital providers. Of course, an increase in the tax on anything will tend to reduce the amount of that "thing," and income-producing activity is clearly no exception. Most people don't go to work for the sheer pleasure of it.

Therefore, it is important to determine whether any of the pay-fors might do more harm than good. That is certainly true regarding the limitations on the section 199A deduction in the substitute amendment introduced by House Ways and Means Committee Chair Richard E. Neal, D-Mass., on September 13, 2021 (the Neal amendment).[3] Significantly, no such changes were included in the administration's revenue proposals (the green book)[4] developed during the first half of this year. The Neal amendment would cap the 20 percent section 199A deduction at $500,000 for joint returns, $250,000 for married filing separate returns, $400,000 for all other individual returns, and at $10,000 for estates and trusts.[5]

The Neal amendment would also increase the top marginal rate from 37 percent to 39.6 percent[6] and add a 3 percent surcharge on all income above $5 million for individuals ($2.5 million if married filing separately) and $100,000 for all estates and trusts.[7] The Neal amendment would expand the net investment income tax to cover not only net investment income from passive investments but also earnings of working partners, LLC members, and S corporation shareholders whose modified adjusted gross incomes exceed $400,000 ($500,000 on a joint return), and almost all passthrough income of estates and trusts.[8] Let's recap. For those estate, trust, and high-income individual taxpayers targeted by the Neal amendment, the marginal federal income tax rate would increase from 29.6 percent[9] to 46.4 percent.[10] It is unrealistic to think that an increase of that magnitude will

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[1] S. Con. Res. 14, 117th Cong. (2021).

[2] H. Res. 601, 117th Cong. (2021).

[3] "Amendment in the Nature of a Substitute to the Committee Print Offered by Mr. Neal of Massachusetts" (Sept. 13, 2021).

[4] Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (May 2021).

[5] Neal amendment, *supra* note 3, at section 138204.

[6] *Id.* at section 138201.

[7] *Id.* at section 138206.

[8] *Id.* at section 138203.

[9] 37 percent * 80 percent = 29.6 percent.

[10] 39.6 percent + 3.8 percent + 3 percent = 46.4 percent.

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have no negative economic consequences for the employees, owners, and customers of the targeted businesses.

The purpose of this article is to focus on the potential impact of just one of those changes, the effective repeal of section 199A for large passthrough enterprises, as well as for estates and trusts.

Passthrough Business Suppression

Section 199A was enacted to provide rough parity between passthrough businesses (which are typically closely held by a small number of owners and often constitute new or multi-generational family businesses) on one hand, and C corporations (for which most taxable income is earned by publicly held entities[11]) on the other hand. Substantially limiting its scope — especially when tethered to the other drastic tax increases for estates, trusts, and high-income individuals described above — will unavoidably suppress the economic activity of the targeted businesses. More important, destroying the current rough parity between closely held passthrough businesses and publicly held C corporations will force even more closely held businesses into the distortive double tax C corporation regime.

Passthrough businesses represent 95 percent of the businesses in this country.[12] They employ an estimated 58 percent[13] of the nation's workforce and account for correspondingly high percentages of sales and profits.[14] The COVID-19 pandemic and its aftermath haven't been kind to the closely held business sector. Nearly one-third have had to close their doors, temporarily or permanently, during the pandemic.[15] No one can deny that the economy was doing well under the Tax Cuts and Jobs Act before the pandemic or that it is struggling to get back to those pre-pandemic employment levels now. Of the 22.4 million jobs that were lost at the onset of the pandemic, we have yet to replace the last 5.3 million.[16] We don't have precise information on the number of individuals employed by the businesses targeted by the Neal amendment — it's been only a couple of days, and we are not likely to have any better information before the scheduled vote at the end of September. However, I think it's clear that the number is well into the tens of millions. For example, the Tax Foundation has estimated that passthrough companies with more than 100 employees employ 18 million workers.[17]

No reputable economists take the position that increased taxes on businesses, especially an increase of this magnitude, will be borne exclusively by the owners. Some of that cost will be passed on to customers in the form of increased prices and to employees in the forms of reduced wages and lost jobs. Yes, only entrepreneurs with income over the threshold actually cut the checks, but that doesn't mean the rest of us don't pay a good deal of the cost. It is unrealistic to think that a 50 to 60 percent increase in marginal tax rates for these businesses won't have any negative effects on their current and prospective employees' income and employment.[18] Someone should really tell employees who consequently lose or don't even get a job that it's OK because there was no tax rate increase for their now-nonexistent income. Moreover, since for most businesses targeted by the Neal tax increases, the cap on the section 199A deduction is equal to 50 percent of W-2 compensation paid to employees, an upper-income entrepreneur has paid out at least $400 in wages for every $74 of tax benefit that entrepreneur derived under current law.

Section 199A was always intended to foster employment and growth in the thriving and important passthrough sector by not forcing businesses into the distortive double tax C corporation regime discussed below. A study by Robert J. Barrow and Jason Furman concluded that making the section 199A deduction and other provisions of the TCJA permanent would result in

[11] *Cf.* Aaron Krupkin and Adam Looney, "9 Facts About Pass-Through Businesses," Brookings Institution (May 15, 2017).

[12] *Id.*

[13] EY, "Large S Corporations and the Tax Cuts and Jobs Act" (Oct. 2019).

[14] *Id.*

[15] Sheryl Sandberg, "State of Small Business Report," Facebook (May 2020).

[16] EY, "U.S. Economic Conditions and Outlook" (Sept. 8, 2021).

[17] Kyle Pomerleau, "Some Pass-Through Businesses Are Significant Employers," Tax Foundation (Feb. 9, 2015).

[18] Richard Rubin, "Democratic Tax Plan Would Hit Million-Dollar Households Hardest, Analysis Shows," *The Wall Street Journal*, Sept. 14, 2021 ("The Joint Committee on Taxation assumes — as most economists do — that corporate taxes are paid in part by workers.").

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an almost 4 percent increase in passthrough productivity (from -0.8 percent to 3.1 percent).[19] Section 199A was not intended primarily to reduce the tax burden for entrepreneurs making less than $400,000. The TCJA did that directly by tax rate reductions. The tax burdens for married couples filing jointly with taxable incomes of $100,000, $200,000, and $300,000 were reduced dramatically from $23,528.50, $57,528.50, and $95,328.50 to $13,879, $36,579, and $60,579, respectively.[20]

Instead, as noted above, section 199A was designed to achieve rough tax parity for closely held businesses operating under the single tax passthrough regime. In that respect, it was generally successful, although the disparity between C corporations and passthrough businesses did change somewhat to the detriment of the latter. Whereas the effective tax rates for the large S corporations targeted by the Neal amendment and average C corporations were about the same before the TCJA, the effective tax rate for such large S corporations exceeded the rate paid by average C corporations by approximately 5 percent (33.8 percent versus 29 percent) after the TCJA. This differential would increase to over 12 percent if section 199A were to be repealed.[21]

Destroying this rough parity and forgoing the productivity benefits associated with allowing closely held businesses to continue to operate within the single tax passthrough tax regime (yes, even for bigger enterprises) isn't something that should be undertaken without a great deal of trepidation and thought.

Distortive Double Taxation

The C corporation double tax system is based on the convenient political fiction that if the government takes money away from corporations, no voter has to pay anything. That, of course, is not true, and most economists acknowledge that bifurcating taxation so that income taxes are paid on corporate profits twice, once when they are "earned" and again when they are "received," doesn't make a whole lot of economic sense and is distortive.[22]

This artificial distinction becomes extremely difficult to maintain in the closely held business context when the same person has complete control over both the corporate and personal checkbooks. This is why most[23] profitable privately held businesses switched to some type of single tax passthrough tax status (S corporation, partnership, sole proprietorship) after Congress enacted the bipartisan Tax Reform Act of 1986, which, for the first time, created rough tax parity between the individual and corporate rates.[24] This rough parity has been maintained ever since, although, as explained above, it would not have survived the TCJA were it not for section 199A.

The large majority of closely held business owners have chosen to continue to be taxed under the single tax passthrough regime, even though the relative top rate disparity has moved in favor of C corporations to the tune of at least 8.6 percent at the federal level (29.6 percent for passthrough businesses eligible for the section 199A deduction versus 21 percent for C corporations). That differential is still worth paying to avoid the distortive C corporation double tax system. Under the C corporation regime, owners of closely held businesses must constantly be on the lookout for pitfalls that might trigger that second tax at the shareholder level, which more than wipes out any initial tax savings from the lower C corporation rate.

[19] Robert J. Barro and Jason Furman, "The Macroeconomic Effects of the 2017 Tax Reform," Brookings Institution (Mar. 8, 2018).

[20] Section 1(h), (j).

[21] *Supra* note 13.

[22] Republican Staff on Senate Finance Committee, "Comprehensive Tax Reform for 2015 and Beyond," at ch. 5 (Dec. 2014); Pomerleau, "Eliminating Double Taxation Through Corporate Integration," Tax Foundation (Feb. 23, 2015).

[23] In 1986 only 24 percent of corporations were S corporations. By 2012 those proportions had completely flipped. A full 73 percent of all corporations had elected S status. IRS, "Tax Statistics."

[24] Tax Reform Act of 1986, sections 101 and 601.

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Expenses paid by C corporations that are recharacterized as personal can trigger double tax.[25] This includes compensation that is ultimately determined to be "unreasonable."[26] Moreover, retained earnings that are ultimately determined to exceed the "reasonable needs of the business" are subject to an additional 20 percent accumulated earnings tax on top of the other two taxes.[27]

Other rigidities inherent in the C corporation regime simply get in the way of legitimate business decisions. For example, pulling money out of a profitable C corporation to engage in a riskier business venture without jeopardizing the main family business, or simply to buy and maintain real estate independently to protect it from the vagaries of the main business, also triggers that dreaded second level of tax. Similarly, for a multi-generational family business when only some of the children and grandchildren are qualified for and interested in participating in the business (but the family still wants others to share in the economic benefits), the double taxation of profits imposes an often-unmanageable burden. Enabling such family and other closely held businesses to operate within the single tax passthrough system, rather than the distortive C corporation double tax system, was and is the primary motivation for enactment and retention of the section 199A deduction.

Passthrough parity accounts for the sea change in behavior that I and other practitioners observed in the aftermath of the Tax Reform Act of 1986. Closely held business owners jumped at the chance to be free of all these artificial tax complexities and concerns. The straightforward, single tax passthrough system allowed them to pay a single non-punitive tax immediately upon the realization of income and then go on with their lives. This is a major reason why they stuck with that system even after the disparity with C corporation marginal rates grew to almost 10 percent. Forcing those businesses back into the distortive C corporation double tax system violates the rule that you shouldn't try to fix something that is not broken. It is even more poorly advised when the replacement system has already been tried, is generally understood to be distortive, and was the reason why there was a bipartisan consensus to move away from that system for closely held businesses 35 years ago in the Tax Reform Act of 1986.

The Neal amendment would add further injury for multi-generational family businesses by almost eliminating the section 199A deduction for all estates and trusts and triggering the net investment income tax even for trusts where the trustee/beneficiary materially participates in the business,[28] not just those making more than $400,000. Trusts are a fundamental component of almost all well-designed family business succession plans, and estates of even low-income decedents would seem to be a terrible target in terms of overall tax fairness. This is what happens when major tax policy changes are thrown together in a couple of weeks.

I realize that there is an academic argument that, if you eliminate the section 199A deduction, passthrough business owners will simply be paying tax at the same rate as C corporation shareholders because the double tax paid on publicly held C corporation dividends is 39.8 percent,[29] which is actually more than the current top rate of 37 percent. That's an easy argument to make on a blackboard. However, it doesn't reflect reality in the marketplace.

The large majority of publicly held C corporation stock is held by wealthy people,

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[25] *Challenge Manufacturing Co. v. Commissioner*, 37 T.C. 650 (1962), *acq.*, 1962-2 C.B. 4 ("Expenditures made by a corporation for the personal benefit of its stockholders . . . may constitute taxable income in amounts equal to the fair value of the amounts involved.").

[26] *Donald Palmer Co. v. Commissioner*, T.C. Memo. 1995-65 ("The record indicates that Palmer was the key employee of petitioner. . . . Based on this record, petitioner has not demonstrated that the bonus of $818,533 constitutes reasonable compensation, and, thus, it is not entitled to deduct that amount under section 162(a)(1)."). *But cf. Elliotts Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983) ("It should not be assumed solely from Elliott's role as sole shareholder and the absence of dividends that the compensation payments necessarily contained disguised dividends. These are just two of many factors to be considered.").

[27] Sections 531, 537. *Northwestern Indiana Telephone Co. v. Commissioner*, T.C. Memo. 1996-168, *aff'd*, 127 F.3d 643 (7th Cir. 1997) ("These findings support the conclusion that NITCO allowed earnings to accumulate beyond its reasonable needs and that it did not show by a preponderance of the evidence that it did not have a tax avoidance purpose."). *But cf. Otto Candies LLC v. United States*, 288 F. Supp. 2d 730 (E.D. La. 2003) ("The entire record is compelling in that it demonstrates the many valid business reasons which caused the companies to retain funds and the companies' specific, definite, and feasible plans to use the retained funds for those valid business needs.").

[28] Neal amendment, *supra* note 3, at sections 138203, 138204.

[29] 21 percent + (1 - 21 percent) * 23.8 percent = 39.802 percent.

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foreigners, qualified plans, tax-exempt entities, and others who either never pay the second tax or do so on a greatly deferred or reduced basis. It is estimated that the wealthiest 10 percent of Americans own over 70 percent of the value of individually owned stocks.[30] They don't typically need to cash in their marketable securities to buy a car. In fact, the wealthiest of the wealthiest can donate their stock to charity and take a tax deduction for its value. Foreigners own 26 percent[31] of publicly held U.S. stock and generally pay only a 15 percent withholding tax on dividends from these C corporation investments (and nothing on the sales of their stocks at a profit in their home countries).[32]

Another 35 percent is owned by qualified plans that don't pay any immediate tax on dividends and stock sales,[33] and qualified plan beneficiaries generally pay tax on distributions and gains only after retirement. Another 4.9 percent is owned by tax-exempt entities[34] that typically never pay that second tax. Thus, the EY study cited earlier found that the net effective rate on publicly held C corporation income was substantially below that hypothetical maximum tax rate.[35]

Because repealing section 199A was among President Biden's campaign proposals but didn't find its way into the green book, it's safe to assume that campaign promise was vetted, probably pretty carefully, when the administration put together its budget proposals, and that at least some within the administration concluded that the additional revenue wouldn't be worth the damage that repeal would cause to family and other closely held businesses. Mindful of the admonition of our founding father and Supreme Court justice, John Marshall, that "the power to tax involves the power to destroy,"[36] it is reasonable to hope that Biden's initial, more-considered determination to leave well enough alone wouldn't be reversed in the week or so left for Congress to come up with trillions of pay-fors under the concurrent resolution. ■

[30] Tim Smart, "Who Owns Stocks in America? Mostly, It's the Wealthy and White," *U.S. News & World Report*, Mar. 15, 2021.

[31] Steven M. Rosenthal and Lydia S. Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," *Tax Notes*, May 16, 2016, p. 923.

[32] *See, e.g.*, U.K.-U.S. income tax treaty, art. 10 (2001).

[33] *Supra* note 31.

[34] *Id.* at 5.

[35] *Supra* note 13.

[36] *McCulloch v. Maryland*, 17 U.S. 316, 431 (1819).

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