

How do business owners respond to a tax cut?

Examining the 199A deduction for pass-through firms

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OVERVIEW

- TCJA established §199A: Deduction *generally* equal to 20% of pass-through income (“qualifying business income”) for individual owners.
 - Sole proprietorships
 - S corporations
 - Partnerships
- Reduced top rate on qualified income from 37% to 29.6%.
- Created a tax wedge between wage income and business income.
- In 2019, \$150 billion deduction; 15% of returns claimed a deduction (IRS)

INTENDED AND UNINTENDED EFFECTS (SELECTED)

Opponents:

- Large share of benefits go to high-income taxpayers
- Encourages shifting between tax bases (eligible v. ineligible income)

Proponents:

- Is the pass-through equivalent of the 21% corporate rate
- Encourages real business activity

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Our paper: Most comprehensive effort to date to understand the effects of this large provision

OVERVIEW OF RESULTS

Clear evidence of avoidance on some margins but not others:

- Partners, but not most S corp. shareholders, reduced “compensation” in favor of 199A-eligible income.
- No appreciable increases in independent contracting

Overall:

- No large change in pass-through income.

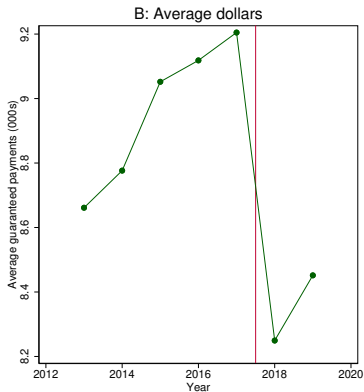
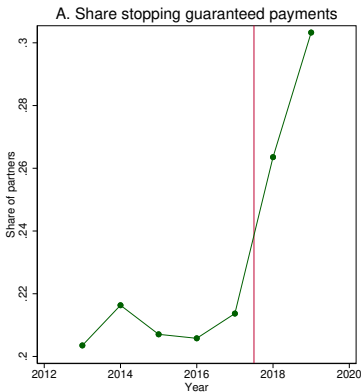
Real Effects:

- No identified effect on investment, non-owner wages, or employment

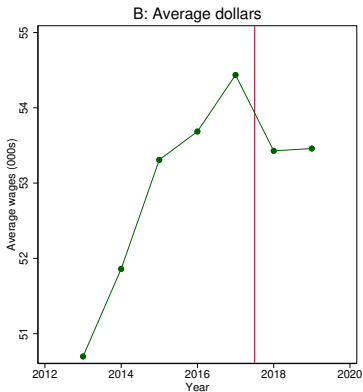
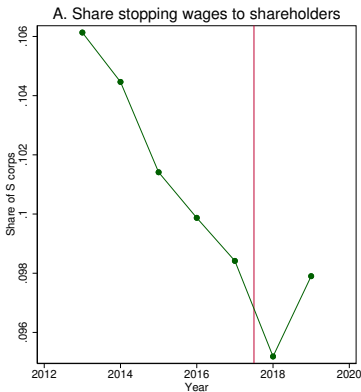
CHANGES IN OWNER COMPENSATION

- Owners have some discretion over compensation type and 199A altered incentives
- Owners receive profits and reasonable compensation as wages (S corporation owners) or optional guaranteed payments for services (partners)
- Expect reduction in both: neither is eligible for the deduction

BASIC TIME SERIES EVIDENCE ON GUARANTEED PAYMENTS TO PARTNERS



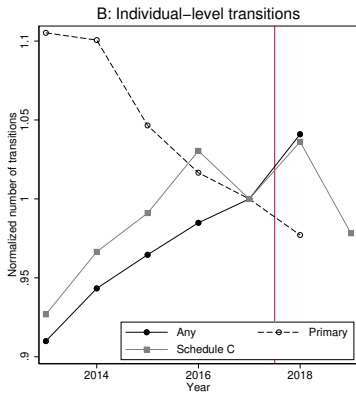
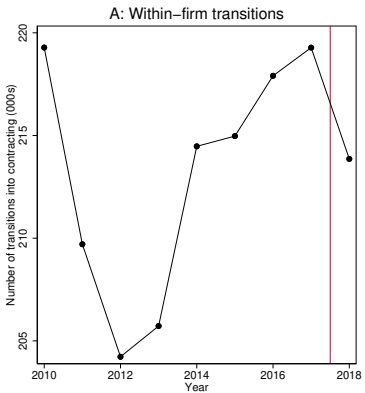
BASIC TIME SERIES EVIDENCE ON S CORPORATION WAGES TO SHAREHOLDERS



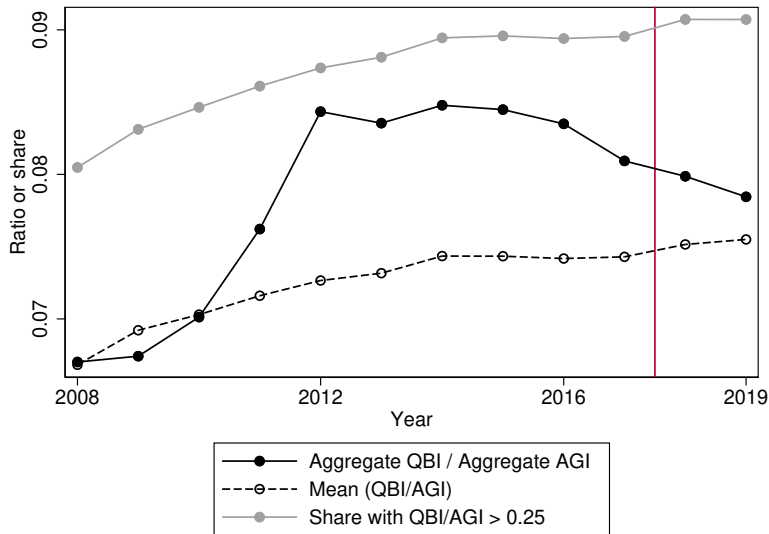
INCREASE IN CONTRACTING?

- Look at within EIN reclassification from employee (Form W-2 wages) to contractor (Form 1099-MISC NEC) and find no increase in 2018.
- Use an individual level taxpayer sample to look for increases in contractor status prevalence (any contracting income and primary source of income from contracting)

INCREASE IN CONTRACTING?



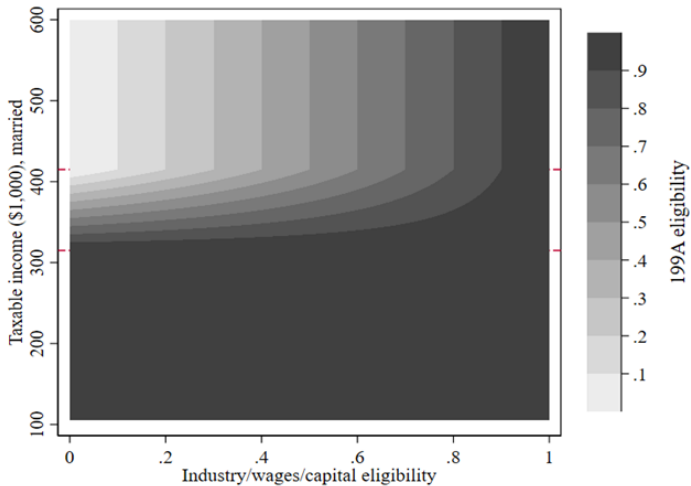
DID OVERALL PASS-THROUGH INCOME INCREASE?



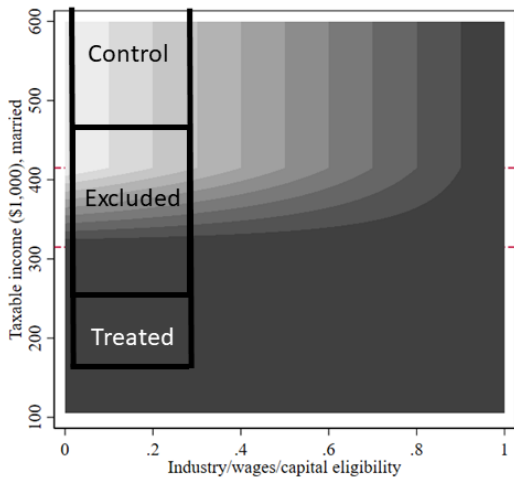
ESTIMATING A CAUSAL EFFECT

- Our analysis exploits two limitations that apply to high-income individuals (\$315,000 for married in 2018)
 - Service-sector business (“SSTB”) income not eligible (e.g. doctors and lawyers)
 - Non-SSTB income eligible, subject to additional limits based on wages paid and tangible capital.
- Loose rationale was to limit deduction for returns to labor

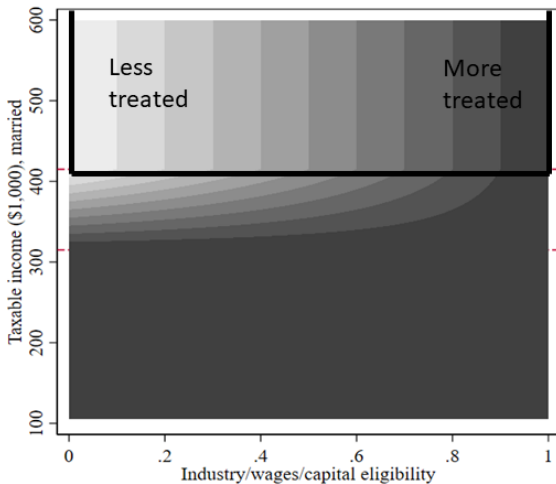
IN GRAPHICAL FORM



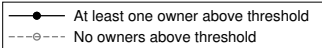
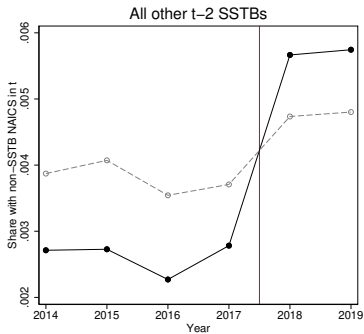
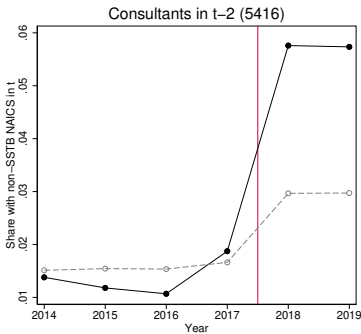
WITHIN LOW-ELIGIBLE INDUSTRIES, COMPARE HIGH-INCOME AND LOW-INCOME



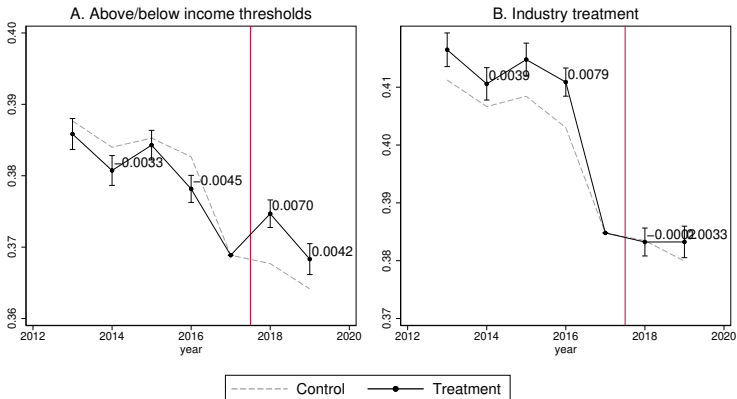
WITHIN “ABOVE”, COMPARE ACROSS INDUSTRIES



DETOUR: ONE MORE BEHAVIORAL EFFECT:



EFFECT OF SECTION 199A ON POTENTIAL QBI SCALED BY INCOME



Dependent variable: Ratio of potential QBI to AGI, censored at 0 and 1.

REAL EFFECTS-FIRM LEVEL

- Use S corporation dataset using similar identification strategy.
- Look at effects on investment, wages, and employment.
- Effect on investment is theoretically ambiguous
 - With full expensing, investment might not respond to the tax rate
 - With some costs non-deductible, it may increase investment
- Tax cut could lead to increased employment or wages (Risch (2024))

SUMMARY OF REAL EFFECTS RESULTS

Null effects.

- Can rule out investment responses more than about 0.3% of gross receipts.
- Can rule out wages paid (to non-shareholders) more than 0.25% of gross receipts.

CONTEXT AND CONCLUSIONS

- Large new wedge: responses on some avoidance margins but not others.
- These avoidance responses (or potential real responses) do not create a detectable change in overall QBI.
- Maybe 2019 is too early for some of the effects
 - Industry- and income-based identification strategies are problematic with data in 2020+.

THANK YOU

Questions and comments welcome

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