Early Evidence on the 199A Deduction for Pass-through Owners

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Disclaimer: The views expressed in this paper are those of the authors and do not necessarily reflect the views of the U.S. Department of the Treasury.

Overview of §199A

- TCJA established §199A (replacing §199), effective 2018-2025
- 20% deduction on pass-through business income
  - Qualifying Business Income (QBI):
    Sole proprietorships, S corporations, partnerships
  - Excluded: wage income, guaranteed payments, capital gains
- Reduces top marginal tax rate from 37% to 29.6%
- Deduction limited by several "guardrails" starting at...
  - \$315,000 (married)
  - \$157,500 (unmarried)

199A Guardrails

	Non-Service Sector	Service Sector
Below Threshold	✓	✓
Above Threshold	Wage/capital limitation	X

- Service Sector = health, law, investment management, etc.
- Wage/capital limitation: must have sufficient W or K to get full 199A deduction
  - $D = \min\left(0.2y, \max(0.5W, 0.25W + 0.025K)\right)$
  - $W =$ W-2 wages paid (including wages to owners)
  - $K \approx$ tangible capital

RESEARCH AGENDA

- Longer term:
  - Use guardrails to identify the effects of 199A on both "real" economic activity and "sheltering" behavior
- Today:
  - Mechanical analysis as if §199A applied in 2016
  - 2018: takeup of the deduction (imperfect)
  - 2018: changes in owner compensation (mostly not?)
  - 2018: contractor / wage earner switching (maybe not?)

Simulating §199A using 2016 Data

- OTA Working Paper #118
- Static analysis ⇒ no behavior

Key Results

- 18 million tax units receive $35 billion tax savings
- Ranking by AGI, bottom four quintiles have...
  - 60% of beneficiaries
  - 10% of tax savings
- Ranking by AGI, top one percent has...
  - 47% of tax savings
  - 64% of tax savings *if guardrails did not apply*

199A: Role of Guardrails

	2016 Static Tax Savings (1)
No limitations:	\$62.85 billion
Add ordinary income limit:	\$57.38 billion
Guardrails:	
Add service restriction:	\$40.05 billion
Add income exception:	\$44.02 billion
Add wage limitation:	\$33.36 billion
Baseline: Add capital exception:	\$34.50 billion
Allow aggregation (upper bound):	\$37.18 billion

Now let’s look at 2018 outcomes...

What data do we have now?

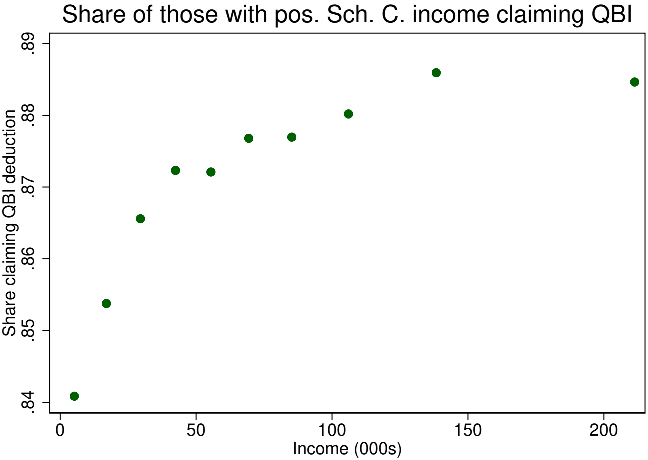
- Issue: some, but not all, of the 2018 data is currently available.
- We have most Forms 1040, but many business owners file an extension with a deadline of October 15.
  - For tax-year 2016: by September 1, 2017, 94 % of Forms 1040, 80 % of Schedule C income, and 57 % of Schedule E (partnership, S corp, and rents/royalties) income was observed.
  - Currently, we can say something about "most" filers, but we are missing a lot of pass-through income.
- Similar issues for Form 1099-MISCs and Schedule K1s.
- We have most of the 2018 W2's. For tax-year 2016, by September 1, 2017: 97% of Forms W-2 and 98% of the wages were filed.

First 2018 result: take-up

Takeup of 199A by Schedule C filers 2018 Data

- Focus on a simple case: Schedule C filers with net profits, positive taxable income, income below the phaseouts, and no other pass-through income.
- Eligibility for the 199A deduction generally should be 100 percent
- Yet, takeup is nontrivially below 100 percent.

TAKEUP OF 199A BY SCHEDULE C FILERS



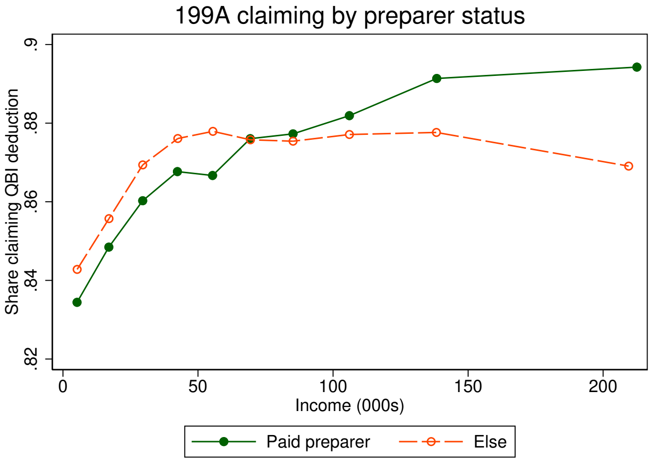
Notes: Sample is restricted to those with positive Schedule C income, and no income on Schedules E or F, with positive taxable income (disregarding 199A), and positive tax liability. Income is doubled for filing statuses other than married filing jointly.

Takeup by Preparation Method

	Share of simple C filers that claim 199A deduction	Share of observations
	(1)	(2)
Paid preparer	0.869	0.600
Self: paper	0.352	0.017
Self: e-file	0.894	0.371
VITA/TCE/IRS	0.966	0.012

Notes: Sample is restricted to those with positive Schedule C income, and no negative income on Schedules E or F, with positive taxable income (disregarding 199A), positive tax liability, and with taxable income (disregarding 199A) less than \$300,000 (married) or \$150,000 (else).

Takeup of 199A by Schedule C filers



Notes: Sample is restricted to those with positive Schedule C income, and no income on Schedules E or F, with positive taxable income (disregarding 199A), and positive tax liability. Income is doubled for filing statuses other than married filing jointly. Filers using VITA/TCE/IRS are dropped.

Second 2018 result: compensation shifting

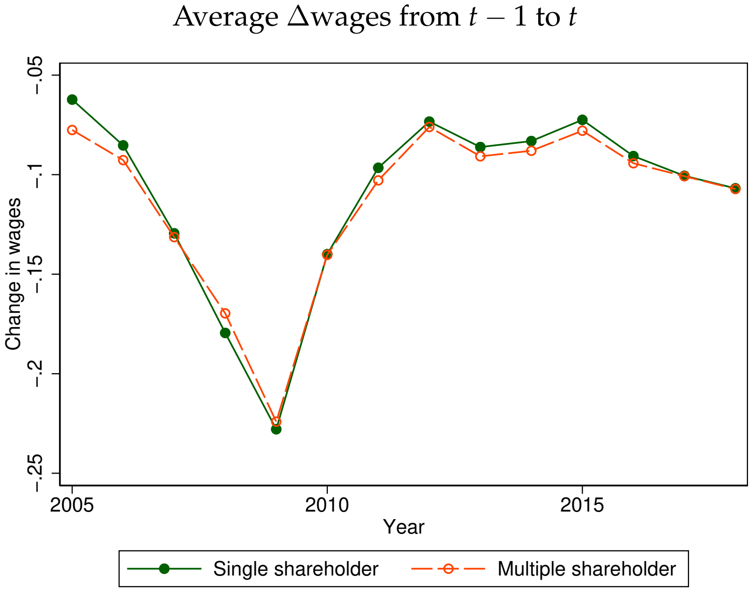
S Corporation Wages to Shareholders

- S corps must pay owners "reasonable compensation" in W-2 wages.
- Pre-199A incentive to reduce wages: payroll tax.
  - Owner wages are already less than arm's-length wages.
  - Bull & Burnham (2008); Auten, Splinter, & Nelson (2016); Smith, et al. (2019).
- Will wages fall further due to 199A?
- Identification strategy: compare 1-shareholder firms to multiple-shareholder firms.
  - Identify shareholders in $t - 1$

EMPIRICAL STRATEGY: DETAILS

- We don't have the 2018 K1s, but we do have (most) of the 2018 W-2s.
- For a given firm-year (*it*), identify shareholders as of $t-1$.
- Compute the change in wages from that firm to those shareholders from $t-1$ to t. Use percent-change-at-the-midpoint (DHS difference):
  - $y_{it} = \frac{w_{it} - w_{i,t-1}}{0.5(w_{it} + w_{i,t-1})}$

S Corp Wages Paid



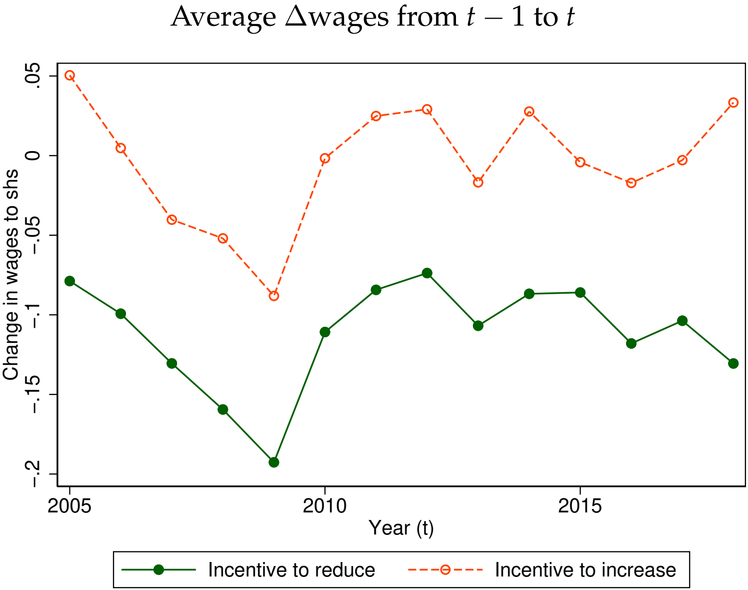
Some Actually Want to Increase Wages

- Want to increase wages paid if...
  - Non-Service Sector business
  - High-income owner (guardrails apply)
  - Not enough wages/capital to get full deduction (wages less than $\frac{2}{7}$ of wages + profits)

- Sample: restrict to non-Service Sector, above the phaseout threshold, one shareholder.

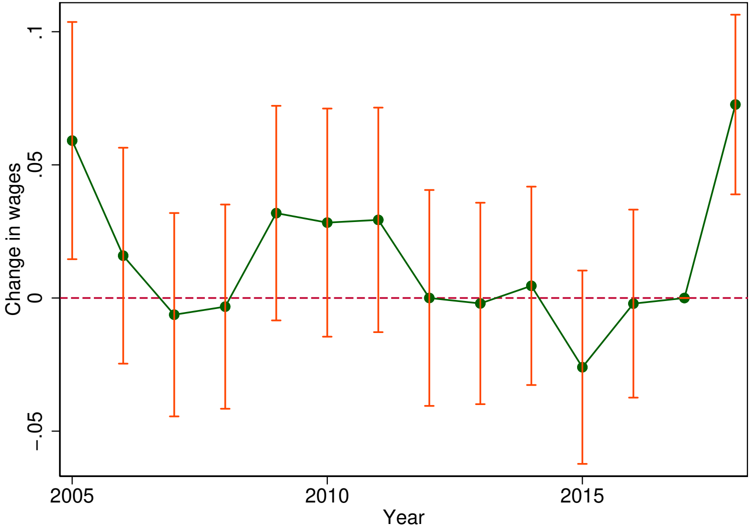
- Compare those who would have been bound by the wage/capital limitation at $t-1$ to others.

Increasing wages? :: raw result



INCREASING WAGES? :: EVENT-STUDY RESULT

Average difference in Δwages from $t-1$ to t (relative to 2017)



Third 2018 result: contractor / wage earner shifting

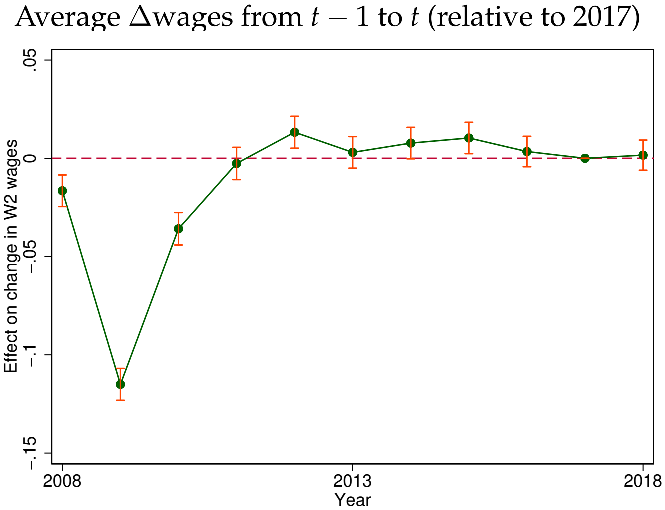
CONTRACTOR / WAGE EARNER SHIFTING

Independent contractors can claim 199A

Wage employees can't

- $\sim$98% of 2018 wages reported; $\sim$90%-95% of 1099-MISCs
- Strategy:
  - Identify individuals with W2 and 1099-MISC income in $t-1$
  - Observe their change in W2 wages from $t-1$ to t
- Time series, normalized to zero for $t = 2017$.

CONTRACTOR / WAGE EARNER SHIFTING



Notes: Sample limited to those with W2 and 1099-MISC earnings at $t - 1$

Where do we go from here?

- Effect of 199A on total pass-through income
  - Identify causal effect using the guardrails
- Other specific outcomes:
  - Changing industry labels
  - Changes in owner compensation for partners
  - "Cracking and packing": look for intensive margin changes in number of K1s
- Some of these don't have much identification beyond time series. But hypothesized effects are large, so if they're there, we expect to see them in the time series.