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Wyden Small Business Tax Fairness Act: Implications for Pass-through Business Owners

On July 20, 2021, Senate Finance Committee Chairman Ron Wyden (D-OR) introduced the *Small Business Tax Fairness Act* (S. 2387), which would make a number of revisions to the section 199A deduction, if enacted. While revisions to the deduction were not included in the Treasury Department's FY 2022 Greenbook, Biden Administration officials have noted that the absence should not be interpreted as a lack of support for limiting the deduction. President Biden proposed during the 2020 presidential campaign that the deduction should be eliminated for higher-income taxpayers.

The deduction was enacted in 2017 as part of the Tax Cuts and Jobs Act (TCJA) to equalize the effective tax rate between pass-through businesses and owners of C corporations. It allows individual owners of pass-through businesses, such as partnerships, LLCs, and S corporations, to claim a 20-percent deduction on their qualifying income. The deduction is limited at certain income levels depending on the business' payroll or investment in depreciable assets. Under current law, the deduction is scheduled to expire after 2025.

Small Business Tax Fairness Act

The new Wyden bill's primary proposed revisions to the deduction include:

- *Capping the Deduction* – The bill would create a new cap on the deduction for individuals with taxable income of $500,000, with the deduction phased out for individuals with taxable income (without taking into account the deduction) between $400,000 and $500,000. The cap applies to single and married taxpayers, which creates a substantial marriage penalty.
- *Eliminating the Wage and Investment Limitations* – The bill would drop the limitations on the deduction based on W-2 wages or investment in business assets that currently apply to individuals with taxable income exceeding $164,900 for singles ($329,800 for joint filers) in 2021. This would simplify the calculation of the deduction for taxpayers above the threshold and below the new $500,000 cap.
- *Expanding Qualifying Income* – The bill would eliminate the distinction between income from qualifying sources and income from disqualified specified services (e.g., health, law, accounting, consulting, financial services). Thus, all types of income would qualify up to the new $500,000 cap. The bill, however, does not address the existing questions with respect to when business activities constitute a qualifying trade or business, such as real-estate rental activity.
- *Simplifying the Calculation* – The bill would simplify the calculation of the deduction by shifting from a business-by-business basis to an aggregate approach, allowing taxpayers to group qualifying income from all pass-through businesses to determine the 20-percent deduction.

- *Excluding Certain Entities* – The bill would:
    - Bar trusts and estates from claiming the deduction. This was a significant issue in development TCJA since many smaller, family-owned businesses use trust ownership structures for succession planning. Additionally, trusts are generally taxed at higher rates than individuals on equivalent income.
    - Exclude publicly traded partnership (PTP) income from qualifying for the deduction, although the language is conflicting and unclear whether this was an intended result.

The bill includes a number of technical amendments, as well as modification to the deduction with respect to agricultural cooperatives and their patrons. The bill would be effective for taxable years beginning after the date of enactment.

Outlook for Enactment

Critics of the bill have noted that the cliff effect of the cap and the marriage penalty would be particularly harsh especially for business owners whose distributive share of the business' income exceed the threshold but who reinvest a significant portion of the profits for hiring and business expansion. If combined with the Administration's proposals to increase the top individual tax rate to 39.6 percent and expansion of the 3.8-percent net investment and self-employment taxes, the Wyden bill would increase the top effective tax rate on pass-through business owners from 29.6 percent to 43.4 percent – a 46.6-percent increase.

The bill also eliminates key hiring and investment incentives built into the section 199A deduction. As the economic recovery continues to take hold, some in Congress may question the timing and wisdom of eliminating such incentives.

As a stand-alone measure, the Wyden bill is unlikely to advance. Nevertheless, as Democrats look for revenue raisers to include in their proposed reconciliation bill later this year, some features of the bill may be attractive, especially capping the section 199A deduction at taxable income of $500,000. Politically, however, those feature would difficult to include without the taxpayer-favorable provisions, namely the simplifications to the deduction and expansion to all types of income, which would lose revenue and cut into the revenue gains the bill would achieve by capping the deduction. Thus, the bill's prospects will depend on the net amount of tax revenues it will provide.

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