Pass-Through “Parity” Argument Is Misguided and Misleading
Deduction Should Expire as Scheduled

By Samantha Jacoby

The 2017 tax law’s 20 percent deduction for pass-through business income exemplifies the worst flaws of the law: it’s skewed to the rich, costs significant revenue, and has failed to deliver its promised economic benefits.1 And the pass-through deduction relies on a flawed rationale — that pass-through businesses needed a special new tax break to maintain “parity,” or a level playing field, with corporations.2 But this parity argument has always been misguided — and misleading.

The centerpiece of the 2017 tax law was its permanent cut in the corporate tax rate from 35 percent to 21 percent, at a cost of $1.3 trillion over a decade.3 But more than half of business income flows to businesses organized as pass-through entities (such as partnerships, S corporations, and sole proprietorships),4 which are not subject to the corporate tax. Instead, their income “passes through” the business and is reported on owners’ individual tax returns.

Before the 2017 tax law, this income was generally taxed at the same rates as wage and salary income; wages and salaries are taxed at a top rate of 37 percent under the 2017 tax law. Because the corporate rate reduction did not affect these owners, business lobbyists argued that a special pass-through tax break was needed to maintain “parity” with corporations. As a result, the law added the

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pass-through deduction, which effectively cuts the top tax rate on qualifying pass-through income by a fifth, to 29.6 percent.

But pass-throughs do not need a special tax cut. Research suggests that even without the deduction, pass-throughs would face similar effective tax rates relative to corporations, and if pass-through business owners believe they would be better off as a corporation, they can make a tax-free election to treat their business as a corporation for federal income tax purposes. Moreover, by taxing business owners at a lower top rate than employees, the deduction creates new disparities and creates new opportunities for tax avoidance.

For these and other reasons, tax experts across the ideological spectrum agree that the pass-through deduction is seriously flawed.5 It has been termed “the worst provision ever even to be seriously proposed in the history of the federal income tax.”6 It should end as scheduled in 2025.

The “Parity” Argument Is Incoherent

The argument that pass-throughs need an extra tax break to maintain parity with corporations is based on a comparison of pass-through and corporate tax rates, but it fails to fully account for all the benefits pass-through businesses receive relative to corporations.

Corporations are taxed twice: profits are taxed first at the business level (the corporate tax), with after-tax profits taxed a second time when shareholders receive the remainder as dividends.7 (See Figure 1.) In contrast, pass-through business income “passes through” the business and is taxed only once, on an owner’s individual income tax return. When accounting for both layers of corporate tax, a tax rate comparison typically results in lower tax rates for pass-through businesses claiming the deduction relative to corporations.8


7 The 21 percent corporate rate and dividend taxes yield an overall rate of 39.8 percent, which is comparable to the tax rate that would apply to pass-throughs without the 20 percent deduction. This combined rate is calculated by adding the 21 percent corporate tax rate and 18.8 percent, which is the 23.8 percent top tax rate on dividends (20 percent plus the 3.8 percent NIIT) multiplied by the 79 percent of post-tax corporate income remaining after subtracting the corporate tax payment.

8 Karen C. Burke, “Section 199A and Choice of Passsthrough Entity,” Tax Lawyer, 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3432013. The pass-through deduction allows a qualifying pass-through owner to subtract 20 percent of pass-through income, which yields a 29.6 percent top rate on this income. Some pass-through income of high-earning taxpayers is subject to the 3.8 percent NIIT or SECA tax, but a large share is exempt.
Moreover, effective tax rates — i.e., actual taxes paid as a share of profits — provide a better comparison than headline statutory rates by showing the effect of tax deductions and other breaks on taxes paid. For example, pass-through businesses generally receive a larger tax benefit per dollar of deductions than corporations do: corporations receive a benefit of 21 cents per dollar of deduction, while high-income pass-through business owners claim deductions at the higher applicable marginal income tax rate.

Many pass-through businesses can lower their taxes by taking advantage of a separate loophole that lets owners avoid both the 3.8 percent Medicare SECA (Self-Employment Contributions Act) tax and the 3.8 percent net investment income tax (NIIT), which taxes unearned or passive forms of income such as capital gains and dividends. Sole proprietors, for example, pay SECA taxes on all the earnings of their businesses, but S corporation owners only pay such taxes on their business’s earnings that they characterize as “reasonable compensation.” The remaining amounts — characterized as profits — are not subject to SECA taxes or the NIIT. This gives S corporation

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10 For businesses that qualify for the pass-through deduction, the value of a deduction is 29.6 cents per dollar of deduction, and non-qualifying businesses receive a benefit of 37 cents per dollar of deduction under current law.
owners a large incentive to underreport their compensation, creating a “multi-billion-dollar employment tax loophole” that “dramatically erodes the employment tax base.”

Moreover, determining whether an S corporation owner has improperly classified wages as business profits requires the IRS to conduct a time- and resource-intensive audit of a business, and such audits are rarely conducted — encouraging owners to continue pushing the boundary between lawful tax avoidance and unlawful evasion.

These and other tax benefits mean that pass-through businesses would continue to face effective tax rates that are comparable to or lower than corporate tax rates, even if the pass-through deduction and the cut in the top tax rate end on schedule after 2025, according to American Enterprise Institute economist Kyle Pomerleau.

**Responding to a False Parity Problem Has Made a Real Disparity Larger**

The argument for parity ignores an important economic reality: most pass-through business income is economically more like wage and salary income than corporate income. That’s because, like wage and salary income, pass-through business income is predominantly derived from owners’ labor, while corporate income is predominantly derived from capital.

For example, imagine two business partners who form a pass-through business to invest in real estate. Each partner invests cash — or capital — in the business to help get it off the ground. But they also provide labor to the business, working long hours meeting with potential investors, finding potential sites, obtaining licenses and permits, and hiring contractors. Their eventual profits will partly reflect their initial capital investment, but a much larger share will reflect their labor.

About three-quarters of high earners’ pass-through income is a form of labor income, according to a 2019 study from economists at Treasury and in academia, which means a more neutral tax system would tax pass-through business income like wages and salaries. The Joint Committee on Taxation (JCT) even acknowledged this in its “Blue Book,” a comprehensive technical description of the 2017 tax law, noting that an across-the-board rate cut for pass-through businesses would unfairly cut taxes on the owners’ labor income:

> While the corporate tax is a tax on capital income, the tax on income from noncorporate businesses may fall on both labor income and capital income. Treating corporate and noncorporate business income more similarly to each other under the Federal income tax can make labor and capital behave more similarly and therefore more like employees and shareholders.

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The 2017 law does include several “guardrails” ostensibly aimed at limiting owners’ ability to claim the deduction for their labor income. But like many other parts of the hastily drafted law, the guardrails fall well short of their intended goal. More than 91 percent of pass-through business income will qualify for the deduction even with the guardrails, according to JCT.

As a recent report from the Congressional Research Service (CRS) noted, the deduction “taxes wage earners and pass-through business owners with similar income at different rates, even though there is no apparent economic justification for such disparate treatment.” (See Figure 2.) Pass-through business owners have an unfair tax advantage over employees, encouraging the owners to game the deduction by shifting even more of their labor income into pass-through businesses.

If Pass-Through Businesses Want Corporate Tax Treatment, They Can Choose It

The owners of a pass-through business can choose to have their business treated — and taxed — as a corporation if they think that will make them better off. As tax expert Michael Schler noted, “by merely checking a box on a tax form, a pass-through business can elect, on a tax-free basis, to be a C corporation and obtain” the 21 percent corporate tax rate.
Thus far, however, there has not been a mass exodus of businesses shifting from pass-through to corporate business form. As commentators have suggested, the various tax and other benefits associated with pass-through businesses make it unlikely that the relatively low corporate rate will encourage many pass-throughs to convert to corporate status. Law professor Karen Burke, for example, has noted that “partnerships continue to offer unrivaled benefits” and “are likely to remain ‘king’ in sophisticated tax planning.”

Policymakers who wish to support “parity” between pass-through businesses and corporations could consider requiring large pass-through businesses to be treated as corporations for tax purposes, while continuing to let smaller businesses elect pass-through treatment. The Obama Administration proposed a similar reform in 2012.

CRS has estimated that requiring pass-through businesses with more than $50 million in receipts to pay the corporate income tax would only affect 0.3 percent of S corporations and 0.2 percent of partnerships. But because pass-through income is heavily tilted to these high-earning entities, the proposal would affect much larger shares of S corporation and partnership receipts: 30 percent and 41 percent, respectively. Thus, it could raise significant revenue, particularly if paired with an increase in the corporate tax rate.

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22 Ibid.