Reforming the Taxation of Pass-Through Businesses

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Executive Summary

The Trump administration and Congress are actively developing tax reform legislative proposals. One key issue policymakers will address is how to reform the tax treatment of pass-through businesses. Pass-through businesses are businesses, large and small (including S Corporations, partnerships, LLCs, and sole proprietorships), where the business itself does not pay tax but instead where taxes are paid directly by the individual owners of the business.

In this type of business structure, income, credits, and deductions realized by the businesses "pass through" to the individual owners, who pay tax on that income according to the tax rates and brackets on the individual side of the tax code, as opposed to the rate for C corporations. Thus, if tax reform eliminates or curtails business-related credits or deductions and does not provide them with a corresponding reduction in the tax rates, these types of businesses could experience a significant tax increase.

In 2013, the latest year for which IRS statistics are available, 3.6 million partnerships and 4.3 million S corporations filed tax returns. This compares with 5.9 million C corporations who filed tax returns that year.[1] These pass-through businesses include small start-ups and mom-and-pop businesses that represent the entrepreneurial spirit of the U.S. economy. How pass-through businesses are treated in any tax reform agenda is critical to the future of American business.

This paper provides a menu of options policymakers could consider when reforming the taxation of pass-through businesses. This paper does not assume that the tax rates for pass-through businesses have to be identical to those applied to income earned by individuals unrelated to the pass-through business. These options attempt to balance the desire to avoid tax increases on pass-through businesses while also ensuring that pass-through businesses do not become a means for wealthy individuals to avoid tax on income that should be properly subject to tax at individual tax rates. These options include:

- Limiting what types of businesses or business activity could benefit from lower tax rates on pass-through businesses;

- Creating incentives for the owners of pass-through businesses to reinvest profits into the business; and

- Rules to limit the total amount of income that could qualify for a lower pass-through rate.

Introduction

The Bipartisan Policy Center engaged in a yearlong examination of the issues surrounding corporate- and business-tax reform. BPC's goal throughout has been to increase and enhance the competitiveness of U.S. companies and workers, increase economic growth, and thereby increase job creation, wage growth, and investment.

This paper, which results from that effort, focuses on one aspect of business-tax reform: pass-through businesses. It is intended to identify the issues that must be confronted by policymakers when integrating corporate-tax reform with pass-through entities. It also provides policymakers with a range of options for addressing this integration as they reform the business aspects of the U.S. tax code.

The project focused on reform of the business-related aspects of the tax code and therefore is not dependent on tax reform that might make changes to the individual code. In addition, when considering the various policy options, it is necessary to be able to consider them in the context of what the current tax rate on C corporations would be after reform. For the purposes of this paper, BPC has assumed a post-reform corporate-tax rate of 25 percent.[2]

It is assumed that the revenue loss associated with lowering the corporate rate to the post-reform rate of 25 percent (an estimated reduction in tax revenues of approximately $1.2 trillion over ten years) would be offset, at least in part, by broadening the tax base.[3] This would be accomplished through the elimination or curtailment of credits, deductions, and other policies that businesses currently use to lower their effective tax rates. Because BPC's work focused on business-tax reform, it does not assume changes in individual tax rates. Therefore, any broadening of the tax base would increase the pass-through businesses' tax liability, without any offsetting benefit of a reduction in tax rates.[4]

This paper describes a series of options for addressing broad policy issues to ensure pass-through businesses are not made less competitive by tax reform that does not simultaneously lower individual rates.

Proposed options for four broad policy questions:

1. What tax rate should be applied to pass-through businesses?

2. What types of business activity should qualify for the pass-through tax rates?

3. What share of qualifying income should benefit from the pass-through tax rates?

4. What policies should be included to prevent abuse and simplify administration of the reformed code?

This paper also concludes with a discussion of other related policy changes that could be incorporated into the integration process.

Question 1: What Tax Rate Should Be Applied to Pass-Through Businesses?

Options for Tax Rates for Pass-Through Businesses

Effective Federal Marginal Tax Rates

BPC's work on business tax reform does not assume the elimination of the existing second layer of tax on corporate income that results from the taxation of dividends. As a result, the effective tax rate on corporate income paid out to shareholders may be higher than the 25 percent assumed in this paper, as this income is still subject to taxes on dividend income received by shareholders. Pass-through entities, which are not subject to corporate tax at the entity level, do not face this double-tax situation. As a result, policymakers may consider that full parity between the corporate rate and the maximum rate on the business income of pass-throughs is not essential.

Analysis by the Treasury Department has found that under current law, C corporations face an effective federal marginal tax rate of approximately 30 percent, while pass-through entities face an effective tax rate of approximately 25 percent.[5] (This analysis does not include state corporate tax rates that can increase the effective marginal tax rate.) In a similar analysis, the Congressional Budget Office found that C corporations in 2014 paid an effective rate of 31 percent, while pass-throughs paid an average rate of 27 percent. Thus, because pass-throughs are not burdened by the double tax, currently their marginal rates are effectively between 4 and 5 percentage points lower than those for corporate-rate taxpayers. As a result, pass-throughs could be subjected to a somewhat higher tax rate than C corporations and still be effectively on parity with the effective tax rate for C corporations.

Interaction with Progressive Individual Tax Rates

In addition, under current law, pass-throughs receive the benefit of the lower individual tax rates (relative to the rate for corporations) that apply at lower income levels.[6] Thus, some amount of income is taxed at rates much lower than the current C corporation rate of 35 percent. If pass-through entities are provided with a lower rate on qualifying income, policymakers could choose to maintain pass-throughs' access to the lower individual rates.

For example, if the maximum pass-through rate were 28 percent, pass-throughs could be taxed at the lower rates of 10, 15, and 25 percent on income below $190,151—the threshold for entry into the current 33 percent bracket. Allowing pass-throughs access to these lower rates would reduce the effective rate of taxation.[7] Alternatively, pass-throughs could be subjected to one flat rate on all their business income, in a manner analogous to how various tax-reform proposals would treat C corporations.

For purposes of this options paper, as previously stated, BPC assumes that corporations would be subject to one flat rate of 25 percent. Therefore, policymakers should consider whether applying one flat rate could result in some small pass-through entities facing a tax increase. For example, a pass-through owner who had taxable income of $100,000 would face an effective tax rate of approximately 21 percent if filing as an individual and approximately 19 percent if filing a joint return. Both are below 25 or 28 percent under current law. Thus, the application of one flat rate would result in a tax increase, even before the impact of any base broadening.

“Claw Back” of High-Income Pass-Throughs

If policymakers are concerned about the revenue loss or distributional consequences associated with permitting pass-through entities to maintain access to the lower rates, policymakers could include a “claw-back” option for high-income pass-throughs.[8] A claw-back provision would recapture the benefit of the lower rates for pass-throughs with income over a certain threshold. Such a policy could be implemented in a way that protects smaller pass-through entities from tax increases that would result from the loss of access to the lower rates. For example, the phase-out could be implemented in a way that does not increase the effective tax rate for pass-throughs with taxable income below the top pass-through rate. At the same time, this policy would reduce the overall revenue loss from the new top pass-through rate by limiting the benefit of the lower rates for high-income pass-throughs.

Question 2: What Business Activity Should Qualify for The Pass-Through Rate?

Options for Determining What Business Activity Qualifies for Lower Pass-Through Business Rates

When creating a separate tax rate structure for pass-throughs, policymakers must also identify what type of activity is eligible for the separate rate structure. Conceptually, policymakers may wish to permit only certain types of income directly related to the business activity of the pass-through business to benefit from the separate rate structure. In particular, they may want to limit the access to the lower rates to only what policymakers would consider *non-labor income*, which would result in the lower rate applying only to income that is generally analogous to the types of income that would benefit from a reduction in the corporate tax rate.

As noted, policymakers may wish to treat certain types of activity, regardless of whether it’s related to a pass-through or a C corporation business, the same when the individuals engaging in that activity would typically be taxed under the individual side of the tax code. For example, the provision of certain services can be done through both pass-through and C corporation businesses. Policymakers may wish to ensure that the individuals providing such services are taxed in the same manner. These types of activity include, among others, legal and accounting services where individuals provide the same types of service in both pass-through and C corporation businesses, but in the context of the pass-through businesses, the individuals may also be the owners of the business. If these types of activity were eligible for the pass-through tax rates, the income of the pass-through owners would qualify for the same pass-through rates.[9]

Policymakers, therefore, could limit access to the separate pass-through regime by excluding certain types of activity from qualifying. For example, they could exclude income arising from the provision of personal services from qualifying for the lower pass-through rates. Such personal services are already defined in the tax code as any activity performed in the fields of health, law, engineering, architecture, accounting, actuarial science, architecture, performing arts, or consulting.[10]

Also, policymakers could limit the type of income that qualifies by prohibiting passive income, from investments or other sources, from qualifying for the pass-through tax rates.[11] Income from such sources as royalties, rents, dividends, and interest would therefore be excluded from qualifying. Such a limitation would focus the benefits of the pass-through tax rates on active income.

Alternatively, policymakers could specify what types of income qualify, with all other income not qualifying for the pass-through rates. For example, policymakers could determine that only certain manufacturing income would qualify. They could limit the benefits of the pass-through structure to only activity that currently qualifies under the Section 199 deduction for manufacturing.[12] There is considerable precedent as to what types of activity qualify for Section 199, thereby making the administration of the separate rate easier. In contrast, however, there are several different types of business activities that would not qualify for Section 199, such as retail businesses that are generally considered "small businesses."

Policymakers could develop additional definitions to Section 199, such as for retail establishments. The Census Bureau maintains a definition of what qualifies as retail sales for the purpose of reporting on economic indicators.[13]

Question 3: What Share of Qualifying Income Should Benefit from The Pass-Through Rates?

Options for Determining What Share of Qualifying Income Benefits from the Lower Pass-Through Rates

In addition to determining what types of income can qualify for the separate pass-through rate, policymakers can also make determinations as to the amount of such income that can qualify. Determining how much income can qualify is predicated on policymakers' goals for how the separate rate would impact taxpayer behavior. For example, if policymakers have a goal of encouraging pass-through owners to invest more in their company, then rules would be designed to encourage that activity. However, if they wish to reduce administrative complexity, they might permit all the qualifying income to benefit from the pass-through tax rate.

In addition, a certain amount of the income earned by the business owner is likely compensation for work performed by the owner, as opposed to a return on the owner's capital. Therefore, some share of the income may be better qualified as analogous to wages or salary and therefore taxed at the regular individual tax rates. Under current law, notions of "reasonable compensation" apply for S corporations. In this circumstance, the owner is required to receive a reasonable amount of compensation to ensure that income that is more accurately considered labor income is taxed at individual rates and therefore subject to payroll taxes. That same concept can be applied in a separate rate structure for pass-throughs.

From a design standpoint, policymakers can approach this question by distinguishing between income and assets. An income-based approach may be less complicated to administer but also less likely to create incentives to reinvest in the business. An asset-based approach would more directly tie to incentives for the owner to increase their capital investment in the business, but it would also be more complicated to account and administer.

Income-Based Approach

An income-based approach is less complex, and potentially, one structure could be applied to all types of pass-through entities. Under this approach, the pre-tax profit of the entity that is attributable to the owner based on their share of ownership in the entity would be eligible for the pass-through tax rates. Thus, if an S corporation has four owners each with an equal share in the company and the pre-tax income of the entity is $1 million, then each owner would be able to qualify an amount up to $250,000 for the pass-through tax rates.

Policymakers could further limit the amount of income that qualifies by limiting the share of qualifying income to a ratio equivalent to income reinvested in the business by the owner or by imposing other explicit ratio limitations to be discussed below.

Policymakers could limit the benefit of the pass-through tax rates in circumstances where the business is in a loss position by prohibiting the owners from applying their share of those losses to other, non-qualifying income. In such a circumstance, the losses could be carried forward as a net operating loss applied against future positive qualifying income.

Asset-Based Approach

Using an asset-based approach to determine the share of income qualifying for the pass-through rate, the income associated with the return on contributions of capital by the owner of the pass-through entity would determine the amount of income that qualifies. Income associated with the return on labor or services provided by the owner of the pass-through could continue to be taxed at the regular individual rates.

Each of the types of pass-through entities—for example, S-Corp, partnerships, LLC, sole properties—have existing rules and structures that can be used as the basis for measuring the amount of return on capital invested by the owner in the business. One asset-based policy that is common to all forms of pass-throughs requires that any capital—in the form of property, equipment, equity, etc.—contributed to the business by an owner be valued according to fair market value at the time of the contribution. Any built-in gain at the time of the contribution would therefore be included in the valuation.

S Corporations

S corporations present a special case for determining the share of income qualifying for pass-through rates when using an asset-based approach for valuation. In an S corporation structure, the owners receive stock in the company. This stock forms the basis of the owner's share of the corporation. Stock is received in exchange for contributions of capital, including property. The owner's basis (i.e., the value at the time of contribution) in the stock changes over time based on earnings, distributions, and depreciation. One policy option would be to use the value of the owner's stock (i.e., outside basis) in the S corporation as the metric for tracking the amount of, and return on, capital contributed and owned by the individual owner.[14] Such an approach would likely require some businesses that currently do not closely track the value of their stocks to begin doing so. It may also require companies to clearly establish basis value at the time of the new tax structure.

This structure could be applied on a prospective basis only and require the owner to have identified and documented the value of their basis before being able to qualify income for the separate rate structure. Policymakers could also require that the owner's basis in the pass-through be positive before any income could qualify for the pass-through rate. Thus, capital invested to return the owner's basis to a positive basis would not be included in the calculation as to how much of the owner's income is eligible for the pass-through rate.

The net change in basis at the end of a specified period would determine the amount of income received by the owner that qualifies for the pass-through rate. This rate would be applied to the share of the individual's ownership in the S corporation. In order to smooth out volatility, the change could be averaged over more than one year. For example, assume that after year one the owner's basis increased by 20 percent, at the end of year two the owner's basis declined by 10 percent, and at the end of year three the owner's basis increased by 8 percent. Over the three-year period, the owner's basis increased by an average of 6 percent. Thus, the owner could qualify 6 percent of any income for the pass-through rate.[15]

The change in basis could be calculated more simply. The owner's initial basis in year one is $1 million. In year two, the owner contributes $200,000 in new capital. In year two, the owner's share of the depreciation is $50,000. The net change in capital (new capital less depreciation) is $150,000. So, the percentage applicable for that year would be 15 percent (150,000/1 million x 100 = 15 percent).

This 15 percent would be used to determine the share of the owner's income from the pass-through that would be subject to the pass-through rate. Assuming the pass-through owner keeps access to the lower individual rates (as discussed in the prior section) this ratio would apply only to the share of income above the threshold for the top pass-through rate. For example, assuming the pass-through rate is 28 percent, the 15 percent ratio would be applied to any income received in excess of $190,151, the entry point of the 33 percent bracket for single filers. In this tax structure, if the owner's basis in the company declines year over year, the owner could not qualify any income for the pass-through rate.

Further, policymakers could limit this tax structure only to owners who have contributed capital to the corporation regardless of the owner's status as an active or inactive participant. Thus, passive owners who do not contribute capital to the business would not be eligible for the pass-through rate. In the case of ownership in an S corporation where the owner's share was a gift, policymakers could apply existing carryover rules under current gift rules. This would effectively reduce or eliminate any basis in the S corporation the recipient of the gift could claim. If policymakers took this approach, it would create a strong incentive for the new owner to invest new capital into the business in order to obtain the basis used to qualify income for the pass-through rate.

Partnerships and LLCs

Unlike S corporations, partnerships already have a formal structure for tracking the partner's ownership interest and capital contributions to the partnership—the partner's capital account. This account tracks the partner's capital contributions to the partnership, profits and losses earned by the partnership, and any distributions paid to the partner. Thus, the partnership capital account can serve as a reasonable measure of the amount of capital invested by the partner and the return to that investment.

The percentage change in the partner's capital account from one tax year to the next or calculated as an average of a set period could serve as the percentage of the partner's distribution that qualifies for the pass-through rate. Any remaining distribution would be taxed at individual rates.

Question 4: What Policies Should Be Included to Prevent Abuse and Simplify Administration of the Reformed Code?

Options for Preventing Abuse and Simplifying Administration

A significant disparity between the top individual rate and the pass-through rate will create strong incentives for owners to try to qualify as much income as possible for the pass-through rate. Therefore, in addition to the options discussed above, policymakers may want to include certain explicit limitations on taxpayers' ability to qualify income for the pass-through rate. They may also wish to adopt these policies as guards against abuse with the understanding that these policies may be stronger protection against abuse than the current rules—such as reasonable compensation rules—that have led to concerns about abuse of pass-through structures. Among other ideas, this can be accomplished by:

- Minimum or safe-harbor ratios of how much income could qualify for the pass-through rate;
- Caps on the annual return to capital for each year; or
- Maximum ratio for how much income could qualify for the pass-through rate.

Safe-Harbor Ratio

A minimum or a safe-harbor ratio could be established to determine how much income could qualify for the pass-through rate. For example, 90 percent of the income received by the owner could be taxed at the individual rate, and 10 percent of the income received by the owner could be taxed at the pass-through rate. The owner could opt instead to perform the calculations described in the previous section if that would provide a more beneficial tax result. By setting a default ratio that would deem at least some percentage of the income as eligible for the pass-through tax rate, the owner is guaranteed at least some recognition of return on "sweat equity" if there is no other capital investment made in the business. In addition, it would ensure that in a situation in which the value of the owner's share in the business declines, the owner can still qualify some income for the pass-through rate. A safe harbor also provides administrative simplicity for businesses, therefore obviating the need for the taxpayer to conduct the calculations.

Cap on Annual Return

Incorporating a cap on the percentage increase as it is calculated and applied in order to determine what share of income qualifies for the pass-through rate would serve as a limitation in situations where large percentage increases result from relatively large gains off a small base. The proposal could rely on existing provisions in the code, such as the long-term applicable federal rate (AFR). Today, the AFR ranges from X percent for short-term to Y percent for long-term investments. A formula to establish AFR plus a percentage (X) could be created.[16] Determining how much income qualifies for the pass-through rate would be the lower of the percentage calculated according to the asset-based approach described above, or AFR plus X.

Maximum Cap

An alternative or compliment to the minimum-ratio or safe-harbor concept would be to set a maximum, or cap, on the overall share of income that could qualify for the pass-through rate. For example, the maximum ratio could be set at 50/50, thereby establishing that a maximum of 50 percent of the income received by the owner could be taxed at the pass-through rate. If policymakers apply a maximum cap, they would need to consider whether the cap might be more generous than typical practice for S corporations when satisfying reasonable compensation requirements.

In addition, if policymakers provide more than one approach to the taxation of pass-through entities, they may wish to limit a business's ability to pick and choose what approach to adopt. Companies could be required to elect into one option and have such an election be permanent. Alternatively, policymakers could limit the number of times an entity could switch between options over any specified period of time.

Options for Extending Tax Concepts to Other Income

Finally, decision-makers will confront secondary issues that need to be addressed when deciding how to structure the new pass-through system. Among other items, this would include how to apply payroll taxes, carried interest, standard deductions for small businesses, and a myriad of related issues.

Application of Payroll Taxes

The proposed structures described above could be extended to determine what income is subject to FICA/SECA taxes. The proposal could apply FICA/SECA to all income subject to tax at individual tax rates (subject to the tax maximum for old age, survivor, and disability insurance, or "OASDI"). For S corporations in particular, this would expand the amount of income subject to payroll taxes. However, such a policy would largely address any concerns about abuse of the S corporation structure as a means to avoid SECA taxes. It would also significantly reduce the tax pressure on reasonable-compensation rules.

Application to Carried Interest

The underlying theory behind the asset-based option is that returns to capital should be taxed at business rates, not individual tax rates. The same theory can apply to carried interest. Thus, policymakers could extend the asset-based option and carried-interest profits. Some analysts have suggested that if the carry were subject to individual tax rates, the investors would be able to claim a deduction for the equivalent of wages paid to the service provider.[17]

Standard Deduction

For small pass-through businesses that already pay lower rates because they have low amounts of taxable income, base-broadening could result in a tax increase even if access to the lower rates is maintained. Therefore, policymakers should consider adding a "standard deduction" for pass-through businesses. Such a deduction could be designed to ensure that these pass-throughs do not experience a sharp and unintended tax increase. This deduction could be phased down as the amount of income that qualifies for the pass-through rate increases.

Other Issues

Integrating corporate tax reform with pass-through entities means tackling the various related policy issues that reflect the complexity of the current system and the challenges decision-makers must confront to protect the integrity of the system. As an example, the proposal could incorporate some existing S corporation tax-policy proposals, such as the existing rules that automatically terminate an S corporation when it has excessive passive income. Other changes could include making the time period for electing S corporation status line up with the deadline for filing S corporation taxes for that tax year; there could also be provisions that allow for an easier transition from C corporation to S corporation.

Similarly, the application of a new structure could impact partnerships. Various conforming changes could be made to partnership rules to ensure proper inclusion of capital contributions into the partner's capital account. Among such changes:

- Repeal provisions permitting guaranteed payments and liquidation distributions. Under this structure, such contributions would be included in the partner's capital account and included in the calculation to determine the segregation of income between individual and corporate tax rates.
- Extend current requirements for mandatory basis adjustments upon the transfer of any partnership interests within the partnership or the distribution of property to a partner.
- Ensure proper tracking of any built-in gain in property contributed by a partner to the partnership.
- Ensure that partnership interests provided as a gift to a partner are excluded from the partner's capital account.
- In order to prevent the unintended termination of the partnership when capital in the partnership is transferred, the proposal could repeal the existing rule that would terminate partnerships when 50 percent or more of the capital in the partnership is sold or is exchanged in any 12-month period.

Conclusion

Tax reform is inherently difficult: It is not only intricate, with myriad potential interactions, but it also affects virtually every American. Accordingly, it requires policymakers to weigh an array of potentially competing priorities and goals.

The paramount mission for policymakers should be to develop a business tax code that is seen as fair and equitable in its treatment of businesses both large and small, and to provide the incentives for individuals to become entrepreneurs who will, in turn, create jobs and economic growth. This approach is vital with respect to reforming the tax treatment of pass-through entities. Policymakers must resolve concerns about raising taxes on pass-through businesses while also ensuring that any new rules or structures do not become an avenue of abuse. The options presented in this paper reflect the breadth of issues, challenges, and potential paths forward that policymakers should consider when wrestling with this crucial and complex undertaking.

Endnotes

[1] IRS, Statistics of Income, Business Tax Statistics. Available at: https://www.irs.gov/uac/tax-stats.
[2] This paper assumes a flat corporate rate of 25 percent applied to the first dollar of taxable income.
[3] $1.2 trillion assumes each percentage-point reduction in the corporate rate results in approximately $120 billion in revenue loss over the ten-year budget window.
[4] The increase in taxes on pass-through businesses that would occur if tax reform broadened the tax base on pass-through businesses without any accompanying reduction in tax rates would make pass-through businesses less competitive vis-à-vis C corporations in situations where the pass-through business competes directly with the C corporation.
[5] Economic Report of the President, February 2015, 230. Available at: https://www.gpo.gov/fdsys/pkg/ERP-2015/pdf/ERP-2015.pdf.
[6] For example, an individual filer is subject to a tax rate of 10 percent on the first $9,275 in income, a tax rate of 15 percent on income over that but not exceeding $37,650, a rate of 25 percent on income over that but not exceeding $91,150, and so on with progressively higher income brackets and rates. See: IRS, "IRS Tax Brackets & Deduction Amounts for Tax Year 2016: Federal Tax Rates, Personal Exemptions, and Standard Deductions," 2016. Available at: https://www.irs.com/articles/2016-federal-tax-rates-personal-exemptions-and-standard-deductions.
[7] For example, assume a pass-through with $250,000 in qualifying income. The effective tax rate on that income would be approximately 25.2 percent: (10%*$9,275)+(15%*($37,650-$9,276))+(25%*($91,150-$37,651))+(28%*($250,000-$91,151)).
[8] A similar concept applies in current law with regard to the corporate rate. Although often glossed over, the current corporate tax rate is progressive with a rate of 15 percent on the first $50,000 in taxable income, 25 percent on the next $25,000 in taxable income, and 34 percent on income between $75,000 and $10 million. As a corporation's taxable income rises, it loses the benefits of the 15 and 25 percent rates (beginning when a corporation has taxable income over $100,000) and the 34 percent rate (beginning when a corporation has taxable income over $15 million). See: Joint Committee on Taxation, Overview of the Federal Tax System as in Effect for 2016, JCX-43_15, May 10, 2016. Available at: https://www.jct.gov/publications.html?func=startdown&id=4912.
[9] An extreme option would be to require all companies providing such services to be taxed as corporations, such as by subjecting them to taxation as personal service corporations as defined in IRC 269A.
[10] Internal Revenue Code 448(d)(2)(A).
[11] Policymakers could define such income as income covered by Internal Revenue Code 1362(d)(3).
[12] Section 199 (or the domestic-production deduction) provides a deduction against qualified business income that is intended to provide tax relief equivalent to a 3 percent reduction in the taxpayer's effective tax rate.
[13] U.S. Census, Monthly & Annual Retail Trade, March 2017. Available at: https://www.census.gov/retail/index.html.
[14] Generally, the inside basis of an S corporation is a measure of the value of the property held by the business entity. The outside basis is a measure of the value of the owner's S corporation stock.
[15] Over the first two years in which the pass-through entity participates in this structure, the calculation would be performed only for the years actually recorded. For example, year one the percentage would be measured relative to the owner's starting basis. In year two, the change would be measured averaging years one and two.
[16] The applicable federal rate (AFR) is an interest rate determined by the IRS for income-tax purposes. There are three AFRs: short-term, mid-term, and long-term. See: Internal Revenue Code 1274(d).
[17] Donald Marron, *Goldilocks Meets Private Equity: Taxing Carried Interest Just Right*, Tax Policy Center, Urban Institute and Brookings Institution, October 6, 2016. Available at: http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000956-Goldilocks-Meets-Private-Equity-Taxing-Carried-Interest-Just-Right.pdf.

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