Congress of the United States

JOINT COMMITTEE ON TAXATION
1625 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621
http://www.jct.gov

APR 13 2012

Honorable Dave Camp, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth HOB
Washington, D.C. 20515

Honorable Sander M. Levin, Ranking Member
Committee on Ways and Means
U.S. House of Representatives
1106 Longworth HOB
Washington, D.C. 20515

Dear Chairman Camp and Ranking Member Levin:

During the committee markup on March 28, 2012, of H.R. 9, the "Small Business Tax Cut Act," Mr. Levin asked if the staff of the Joint Committee on Taxation could provide the committee with some information regarding the distribution of tax benefits under H.R. 9 by income of the taxpayer. This letter is in response to that request.

Under this proposal, as reported by the committee, qualified domestic business income is income of a qualified small business generated through the conduct of a trade or business within the United States. Qualified business income does not include gain from the sale or exchange of a capital asset or property used in the trade or business (as defined in section 1231(b)), royalties, rents, dividends, interest, annuities, or any income that constitutes wages (as defined in section 3401). A qualified small business is defined as one with fewer than 500 full-time equivalent employees for either calendar year 2010 or 2011 (or calendar year 2012 for businesses not in existence on December 31, 2011).

The deduction generally is equal to 20 percent of the lesser of: (1) qualified domestic business income, or (2) taxable income. However, the deduction is limited to 50 percent of certain wages of the qualified small business properly allocable to qualified domestic business income. The deduction is limited to 50 percent of the greater of (1) W-2 wages paid by the taxpayer to non-owner employees, or (2) the sum of W-2 wages paid by the taxpayer to (a) employees who are non-owner family members of direct owners and (b) employees who are 10-percent-or-less direct owners. For purpose of computing this wage limitation, a partnership may elect to treat as W-2 wages the distributive share of qualified domestic business income of service-providing, less-than-10-percent partners of a partnership ("deemed W-2 wages"). Qualified domestic business income of a partnership must be reduced by any such deemed W-2 wages.

Any gross receipts taken into account under this proposal in computing qualified domestic business income may not be taken into account under section 199 for the taxable year. This exclusion prevents the income benefiting from this proposal from also benefitting from the domestic manufacturing deduction under section 199.

A taxpayer may elect not to take into account under this proposal any item of domestic business gross receipts. Under this election, for example, the taxpayer may treat an item of domestic business gross receipts as not taken into account under the proposal so that the item may be taken into account for purposes of section 199.

In analyzing this proposal, it is assumed that affected businesses will respond to the incentive to maximize the deduction by reclassifying income as wages to persons whose wages or deemed W-2 wages increase the deduction limitation amount. However, the ability to respond in this way is assumed to be constrained by the extent to which managing owners can exercise such control. Firms with many owners and/or large firms with many employees are less likely to be able to respond. In addition, transactions costs and a desire to avoid IRS scrutiny are assumed to impose additional limits on responsiveness.

The proposal is effective only for the taxpayer's first taxable year beginning after December 31, 2011.

The enclosed table presents the distribution of the estimated liability effect of the proposal for individual taxpayers who receive business income that is reported on their individual tax return. The liability effect of the proposal is included as if it all occurred within one calendar year, even though a small portion will occur in 2013 for taxpayers who receive income from entities whose fiscal year ends within calendar 2013. The liability that is distributed is in 2012 dollars, as are the levels of AGI against which it is distributed. The number of taxpayers affected is based on estimated 2012 levels for each type of entity. The estimate is based on comparing counts of taxpayers in 2007 and projected counts of taxpayers in 2012 who have positive AGI and who have positive business income from businesses in the relevant entity types.

The distribution of the liability, and of the counts of taxpayers, is based on patterns from 2007 business and individual data. This is because of the unique nature of the dataset required to provide an accurate distribution of the effect of the 20 percent deduction. In order to provide this distribution, we must track entity-level income and deductions from passthrough entities such as S corporations or partnerships to the recipients of their income. The dataset that we have available to provide this tracking combines a statistical sample of 2007 individual tax returns with tax returns from all of the business entities from which those individual tax returns receive income. For each business entity, given the information available from its 2007 business income, we compute the amount of deduction in a manner consistent with the revenue estimate. We then impute the amount of that deduction that would be passed through to each income recipient from that business. Finally, given the recipient's other tax return information, we compute how much their liability will change given the deductions they receive. Note that the total amount of liability that is distributed differs from the revenue estimate, since it includes only income received directly by individuals, and does not include income subject to corporate income taxation.

We do not have any evidence on how the distribution of passthrough income to recipients by AGI class has changed from 2007 to 2012. Thus, we are using the 2007 patterns of income and of counts of recipients. But as noted above, the AGI classifier shown in the table is in 2012 dollars, and the counts of taxpayers are reported at projected 2012 levels.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

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Enclosure

Honorable David Camp
Honorable Sander M. Levin
U.S. House of Representatives

cc: Honorable Wally Herger, Honorable Sam Johnson, Honorable Kevin Brady, Honorable Paul Ryan, Honorable Devin Nunes, Honorable Pat Tiberi, Honorable Geoff Davis, Honorable Dave G. Reichert, Honorable Charles W. Boustany, Jr., Honorable Tom Reed, Honorable Peter J. Roskam, Honorable Jim Gerlach, Honorable Tom Price, Honorable Vern Buchanan, Honorable Adrian Smith, Honorable Aaron Schock, Honorable Lynn Jenkins, Honorable Erik Paulsen, Honorable Rick Berg, Honorable Diane Black, Honorable Charles B. Rangel, Honorable Fortney Pete Stark, Honorable Jim McDermott, Honorable John Lewis, Honorable Richard E. Neal, Honorable Xavier Becerra, Honorable Lloyd Doggett, Honorable Mike Thompson, Honorable John B. Larson, Honorable Earl Blumenauer, Honorable Ron Kind, Honorable Bill Pascrell Jr., Honorable Shelley Berkley, and Honorable Joseph Crowley

TWENTY-PERCENT BUSINESS DEDUCTION WITH DETAIL BY ENTITY TYPE
DISTRIBUTION OF TAX LIABILITY EFFECT FROM 2012 PROPOSAL AGAINST INCOME PATTERNS FROM 2007 BUSINESS AND INDIVIDUAL DATA [1]

	Tax Change from All Business Income Reported on Individual Tax Returns			Tax Change from Sole (NonFarm) Proprietorship Deductions			Tax Change from Farm Proprietorship Deductions			Tax Change from S Corporation Deductions			Tax Change from Partnership Deductions		
AGI	Taxpayers (thousands)	Amount (millions)	Share of tax change by AGI Class	Taxpayers (thousands)	Amount (millions)	Share of tax change by AGI Class	Taxpayers (thousands)	Amount (millions)	Share of tax change by AGI Class	Taxpayers (thousands)	Amount (millions)	Share of tax change by AGI Class	Taxpayers (thousands)	Amount (millions)	Share of tax change by AGI Class
ZERO TO $10,000...............	156	-18	0.0%	141	-8	0.1%	4	0	0.0%	4	-1	0.0%	8	-1	0.0%
$10,000 TO $20,000...............	1,087	-278	0.7%	1,044	-135	1.5%	26	-4	1.1%	11	-7	0.0%	28	-8	0.1%
$20,000 TO $30,000...............	1,219	-459	1.1%	1,147	-220	2.5%	35	-6	1.6%	24	-18	0.1%	47	-19	0.3%
$30,000 TO $40,000...............	1,332	-574	1.4%	1,223	-260	2.9%	57	-15	4.3%	37	-44	0.2%	52	-26	0.5%
$40,000 TO $50,000...............	1,233	-730	1.8%	1,098	-313	3.5%	50	-16	4.5%	62	-105	0.4%	56	-38	0.7%
$50,000 TO $75,000...............	2,625	-1,984	5.0%	2,277	-806	9.0%	109	-49	13.9%	184	-375	1.5%	133	-112	2.0%
$75,000 TO $100,000...............	1,990	-2,123	5.3%	1,675	-766	8.6%	68	-40	11.4%	196	-634	2.5%	105	-175	3.2%
$100,000 TO $200,000..........	3,156	-8,076	20.2%	2,410	-2,485	27.9%	85	-111	31.7%	540	-3,572	14.1%	231	-691	12.5%
$200,000 TO $250,000.........	492	-3,207	8.0%	319	-842	9.5%	8	-18	5.0%	125	-1,755	6.9%	60	-389	7.0%
$250,000 TO $500,000.........	756	-9,130	22.8%	402	-1,843	20.7%	12	-59	16.8%	234	-6,149	24.3%	131	-1,437	26 0%
$500,000 TO $1,000,000......	254	-6,133	15.3%	95	-792	8.9%	3	-24	6.8%	90	-4,993	19.8%	71	-1,375	24 9%
$1,000,000 AND OVER........	125	-7,350	18.3%	29	-442	5.0%	1	-10	2.8%	53	-7,619	30.1%	41	-1,258	22.8%
TOTAL, ALL RETURNS....	**14,426**	**-40,064**	**100.0%**	**11,860**	**-8,912**	**100.0%**	**459**	**-350**	**100.0%**	**1,558**	**-25,273**	**100.0%**	**961**	**-5,529**	**100.0%**

Joint Committee on Taxation

NOTE: Total number of taxpayers for all business income differs from the sum of the totals for each entity type, since some taxpayers may receive deductions from multiple entity types.

AGI Levels in 2012 Dollars. Counts of taxpayers are the estimated number of taxpayers in 2012, for all taxpayers with positive AGI and with positive income in each entity type

[1] Individual Distribution Effect, Not Including any Effect from Corporate (Non S Corporate) Deductions, Sole (Nonfarm) Proprietorship, Farm Proprietorship, S Corporation, and Partnership income flowing to individuals.