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The Ryder Cup and Section 199A — Really!

To the Editor:

If I were Lee A. Sheppard, a brilliant tax writer, fashionista, and student of etiquette, I would start by pointing out that the European team lost the Ryder Cup because of its poor choice in uniforms. I would also criticize Justin Thomas and Daniel Berger for their poor judgment and behavior in doing a beer chugging and can crushing victory dance at the conclusion of day two of the competition for two reasons: It was childish behavior generally, and it proved a little premature; the Ryder Cup is a three-day competition. But since I don't have Ms. Sheppard's talents, I will skip fashion and etiquette. Instead, I will present a brief but pointed analysis on an issue in the tax bill currently before Congress as it relates to the current law 20 percent deduction for passthrough businesses under section 199A.

My message is simple: Current law should be retained in its entirety. Taking into account all the proposed changes in the pending legislation, passthrough businesses would wind up being taxed more heavily than C corporations, even if current law section 199A is retained in its entirety.

Consider how the legislation would affect C corporations and passthrough businesses that increase taxable income by $5 million increments.

C Corp	Passthrough
$5,000,000	$5,000,000
0.25[a]	0.46
$1,250,000	$2,320,000

[a]Likely rate to be enacted.

Now consider C corporations and passthrough businesses under the legislation with the caveat that it retains the current law section 199A passthrough deduction.

C Corp	Passthrough
$5,000,000	$5,000,000
0.25[a]	($1,000,000)[b]
$1,250,000	$4,000,000
	0.46
	$1,856,000[b]

[a]Likely rate to be enacted.

[b]Current law section 199A deduction.

Consider the tax on current and subsequent distributions of C corporate income as dividends.

	$5,000,000
Less corporate tax	($1,250,000)
	$3,750,000
	0.23
Percent of C corp income subject to second layer of tax	$862,500
	0.46[a]
Additional second layer of tax	$400,200

[a]Maximum rate of dividends

The comparison of C corp and passthrough under proposed legislation retaining current law section 199A.

	Maximum Tax on C Corp Taxable Income	Current Tax on Passthrough Income Retaining Section 199A Deduction
Initial C corp tax	$1,250,000	
Tax on dividends ultimately paid	$400,200	
Total ultimate tax on C corp taxable income	$1,650,000	$1,856,000

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Under the pending legislation, a passthrough entity would incur $1,865,000 of tax on a $5 million increment of income even if it has the benefit of current law section 199A. A C corporation on the same increment of income would ultimately incur $1,650,000 of tax, taking into account the tax that will eventually be paid on the distribution of profits as dividends likely to be subject to tax. A key aspect of this analysis is that the theoretical "double tax" of C corporate earnings is actually a myth.

In the United States it's common to talk about the double tax on corporate earnings. As a general proposition, it's not fake news: A corporation pays tax on its earnings[1] and the owners of corporations — that is, the shareholders — generally also pay tax on any remaining earnings that are distributed to them.

There are significant exceptions, however, to these general rules, and they determine whether corporate earnings are in fact subject to double taxation. Based on the best available data, it's estimated that no more than 9 percent of annual corporate profits are subject to tax a second time, and no more than 14 percent will eventually be taxed upon later distribution (that is, as taxable pension or retirement account distributions). That means that only around a maximum of 23 percent of U.S. corporate earnings ever face a second layer of taxation.

According to congressional testimony given by Steven M. Rosenthal, senior fellow at the Urban-Brookings Tax Policy Center, at former Senate Finance Committee Chair Orrin G. Hatch's May 17, 2016, hearing on corporate integration, the amount of U.S. corporate shares that is held in taxable accounts was only about 24.2 percent in 2015.[2] Moreover, it is also estimated that 37 percent of U.S. corporate shares were owned by pension funds or tax-exempt retirement plans, approximately 26 percent were owned by foreign persons exempt from U.S. taxation, and 12.8 percent were owned by insurance companies in segregated reserve accounts, nonprofits, government holdings, and other tax-exempt accounts (for example, college savings section 529 plans).[3]

To summarize, the amount of corporate earnings that is paid as currently taxable dividends is likely no higher than 9 percent. Taking into account subsequent distribution of dividends subject to tax, no more than 23 percent of C corporate earnings are actually subject to a second layer of tax.

Current law section 199A should be retained in its entirety. Doing so will still leave passthroughs more heavily taxed than C corporations, but removing any of the benefits of section 199A will only make the disparity worse. My apologies to Ms. Sheppard if I stole her thunder on critiquing the Ryder Cup.

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Oct. 5, 2021

[1] Exceptions to this general rule obviously exist. Within certain parameters, corporations with significant economic losses in prior (or future) years may elect to net these losses in one year against taxable income in another year. Corporations may also accrue certain deductions faster than they accrue related income and, as a timing matter, not pay current taxes as a result. Further, corporations may use a variety of general, industry-specific, and income-specific credits or deductions that can sometimes reduce (or even eliminate) taxable income in any particular year. While these important exceptions to the general rule are no less relevant than the exceptions to the rules that shareholders generally pay tax on distributed corporate earnings, they are beyond the scope of this letter.

[2] Finance Committee, "Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered" (May 17, 2016) (statement of Rosenthal); *see also* Rosenthal and Lydia S. Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," *Tax Notes*, May 16, 2016, p. 923 (describing the authors' method of deriving the 24.2 percent number in significantly greater detail). Based on changing several assumptions made by the authors, the rate could be even lower than 24.2 percent. *See, e.g.*, Rosenthal and Austin, *id.* at 927.

[3] Rosenthal and Austin, *supra* note 2, at 2-4.

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