The Senate's NIIT Proposal Is a Tax Increase, Not Loophole Closure

By Andrew WilfordJuly 11, 2022

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As legislators continue to negotiate to find the areas of the now-defunct Build Back Better package that can garner the support of 50 senators, this complicated process of wrangling is doing little to filter out the worst policies. One such is a deceptively-framed proposal to increase taxes on small business owners.

The Net Investment Income Tax (NIIT) is a 3.8 percent tax on investment income such as capital gains, dividends, or interest. Imposed as part of the Affordable Care Act (ACA), the tax was intended to fall upon “passive” income, or income earned from a venture in which the beneficiary has little active role.

Under a Senate proposal, the scope of the NIIT would be expanded to include income earned by pass-through businesses, generally small businesses, over $400,000 a year. Pass-through businesses are businesses structured so that the income from the business “passes through” to its owner and is taxed through the individual, rather than corporate, tax code.

The fact that the NIIT does not already apply to such businesses is no “oversight” or “loophole,” a word that is thrown around far too frequently to describe any situation in which a tax does not apply to a taxpayer. The fact that wage earners do not have to file corporate tax returns on their wages is no “loophole” — they’re just not who the corporate tax code applies to.

The same is true for pass-through businesses and the NIIT. Pass-through business owners are definitionally active participants in their businesses, and the income they earn from their business is taxed through the individual income tax code just like any wage earner’s. The ACA did not include pass-through income under the scope of the NIIT because it was not part of the income that the new tax was intended to cover.

Adding insult to injury, expansion of the NIIT to pass-through businesses would also mean that those business owners would have to pay the 3.8 percent NIIT again should they earn income from selling their businesses. That’s a real kick while you’re down for small business owners forced to sell by difficult economic circumstances or excessive taxation.

Taxation of pass-through businesses is a thorny subject, one that has only grown thornier in the wake of the Tax Cuts and Jobs Act (TCJA) and its reforms to pass-through taxation. But while the status quo is not without its flaws, Democrats’ proposals up to this point have focused entirely on raising taxes on small businesses, not ironing out any of these kinks.

For example, the last time Democrats proposed this change as part of the broader Build Back Better package, they also proposed to set income thresholds to claim the 20 percent deduction on income taxes for pass-through income that was intended to create parity between corporate and pass-through taxation. In their eyes, of course, higher taxes on everyone is parity of a sort.

But this also meant that pass-through business owners would face top pass-through income tax rates exceeding 50 percent after taking into account federal and state income taxes as well as the NIIT. Confiscation of over half the income of small business owners is no way to foster economic recovery and growth.

As Democrats go back to the well-worn tactic of framing every tax increase as “closing a loophole,” reporters and other members of the media should take care not to credulously parrot this line. Expansion of the NIIT to pass-through businesses is just yet another tax increase on small businesses.

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