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IN FOCUS

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Selected Issues in Tax Policy: Section 199A Deduction for Pass-Through Business Income

The 2017 tax revision (P.L. 115-97, also known as the Tax Cuts and Jobs Act or TCJA) created a temporary tax deduction for pass-through businesses under Section 199A of the federal tax code. The deduction is equal to 20% of a firm's qualified business income, subject to certain limitations. The deduction is scheduled to expire at the end of 2025. Tax proposals in the 119th Congress may include extending or modifying the Section 199A deduction. This In Focus provides an overview of the 199A deduction and briefly examines selected key policy issues.

Overview of the Deduction

How a business is taxed at the federal level depends partly on how it is organized. A firm can be organized as either a C corporation or a pass-through entity (i.e., partnership, S corporation, limited liability company, or sole proprietorship). C corporation profits are taxed once according to the corporate tax system, and then potentially a second time at the shareholder level when corporate dividend payments are made or capital gains are recognized. Pass-through business profits are, in general, not subject to the corporate tax. Instead, the income of these businesses passes through to the individual owners who pay tax according to individual income tax rates.

Under current law, the tax rate for corporate income is permanently set at a flat rate of 21% for tax years after 2017. Most corporate dividends and capital gains recognized by individual shareholders are subject to a maximum tax rate of 23.8% (accounting for 3.8% net investment income tax). In contrast, the tax rates on pass-through income range from 10% to 37% through 2025. Starting in 2026, pass-through income is scheduled to be taxed at higher pre-TCJA rates, with a maximum rate of 39.6%.

Section 199A of the Internal Revenue Code allows individuals, estates, and trusts with pass-through business income to deduct up to 20% of their qualified business income (QBI) in determining their taxable income. Owners of agricultural and horticultural cooperatives may also claim the deduction. Taxpayers do not need to itemize to claim the deduction.

To understand the basic mechanics of the 199A deduction, consider a pass-through business owner with taxable business income of $100. Prior to the TCJA, the owner would pay tax on the $100 of income. With the 199A deduction, the owner only pays tax on $80 of income (assume all income is QBI). The effect of the deduction is thus to reduce the owner's effective marginal tax rate by 20%. For example, if the owner faced a 37% tax rate, the effective tax rate would be 29.6%, computed as 37% multiplied by (1-0.20).

In practice, determining QBI and the amount of the deduction is more complicated than the simplified example just presented suggests. A pass-through business owner's QBI is the net amount from items of income, loss, gain, and deduction for each qualified domestic trade or business he or she owns. QBI does not include wage income, capital gains, dividends, and interest and annuity income unrelated to a trade or business. Taxpayers who own more than one pass-through business are required to determine the QBI for each one and combine them to determine the taxpayer's total QBI in a tax year.

The deduction is subject to two limits: (1) a "specified service trade or business" (SSTB) limit and (2) a wage and capital asset (WCA) limit. An SSTB is a personal service business such as accounting, law, and medicine. Whether the limits apply depends on a taxpayer's taxable income (without the deduction) and filing status. In 2024, no limit applies if a taxpayer's taxable income is less than $383,900 for joint filers, and $191,950 for other filers. The limits phase in for income between $383,900 and $483,900 for joint filers, and between $191,950 and $241,950 for other filers. Under the SSTB limit, an SSTB owner with taxable income above the upper income threshold may claim no deduction for the SSTB's QBI.

Under the WCA limit, a non-SSTB owner with income above the threshold may claim a deduction, but it cannot exceed the greater of 50% of the owner's share of the business's W-2 wages or 25% of those wages plus 2.5% of the owner's share of the business's tangible capital assets placed in service in the past 10 years.

Use of the Deduction

According to IRS data, the number of 199A deduction claims rose from 18.7 million in 2018, when it was first available, to 25.7 million in 2022 (the most recent year for which data are available). The total amount of claims rose from $150.0 billion to $216.1 billion over that period.

Table 1 shows a distributional summary, by adjusted gross income (AGI), of 199A claimants in 2022. The figures indicate that pass-through business owners with less than $1 million in AGI accounted for 97.7% of claimants. The shares of the total $150.0 billion in deductions claimed were more evenly distributed across incomes. **Table 1** indicates that the average claim amount increased with income, with those earning less than $200,000 deducting $2,909 on average, and those with an AGI of $5 million and above deducting $741,436 on average.

Table 1. Use of 199A Deduction in 2022 by AGI

Adjusted Gross Income (AGI)	Share of Section 199A Claims	Share of the Amount of Section 199A Claims	Average Amount per Section 199A Claim
Up to $200,000	76.2%	26.3%	$2,909
$200,000 to $1 million	21.5%	29.7%	$11,642
$1 million to $5 million	2.1%	20.7%	$85,074
$5 million and above	0.3%	23.3%	$741,436
Overall	100%	100%	$8,423

Source: Internal Revenue Service, *Individual Income Tax Returns: Complete Report*, Table 1.4, 2022.

Tax Parity

The Section 199A deduction promotes parity between the tax burden on corporate and noncorporate profits. The TCJA reduced the maximum corporate tax of 35% to 21%. Prior to the TJCA, pass-through income was subject to a maximum marginal tax rate of 39.6%, which, left unchanged, would have resulted in a sizeable difference between the 21% corporate tax rate and the tax rates applicable to pass-throughs. However, the TCJA lowered the maximum individual marginal tax rate to 37%, which, combined with the 199A deduction, results in a maximum marginal tax rate of 29.6%.

The TCJA also made broader changes to the tax code that reduced taxes on both forms of business. **Table 2** presents estimated marginal effective tax rates by business form under the pre-TCJA tax law (2017) and the first year the TCJA was in effect (2018). The marginal effective rates presented in **Table 2** capture major features of the tax code impacting business investment, including the statutory corporate and pass-through business tax rates, the production activities deduction (2017), the 199A deduction, and depreciation.

Table 2. Marginal Effective Tax Rates

Business Form	2017 Law	2018 Law	2018 Law (no 199A)
Pass-through	21.1%	14.3%	17.9%
C corporate	16.7%	9.4%	9.4%

Source: CRS estimates, see CRS Report R48277, *CRS Model Estimates of Marginal Effective Tax Rates on Investment Under Current Law*, by Mark P. Keightley and Jane G. Gravelle for more information.

Comparing tax rates under 2017 law to 2018 law shows that the TCJA lowered the tax burden on new pass-through investment from 21.1% to 14.3% and on new corporate investment from 16.7% to 9.4%, maintaining approximately the same tax differential across business forms that existed prior to the TCJA. **Table 2** also shows that had the 199A deduction not been included in the TCJA, the marginal rate on new pass-through investment would have been 17.9% compared to the 9.4% rate on corporate investment.

Investment, Employment, and Wages

Proponents of the 199A deduction argue that it encourages increased investment by pass-throughs, which, in turn, is accompanied by increased hiring and wage growth. Research on the 199A deduction's economic impact is limited. In one of the only empirical studies on the deduction, economists Lucas Goodman, Katherine Lim, Bruce Sacerdote, and Andrew Whitten found "little evidence of changes in real economic activity as measured by physical investment, wages to non-owners, or employment." The lack of an investment or employment response may be partly attributable to the deduction's design.

The 199A deduction is not a direct investment subsidy. A firm may benefit from the deduction without increasing its investment. The deduction, however, may encourage investment because it reduces the effective tax rate on new investment. At the same time, the deduction also reduces the effective rate on past investments, which by definition cannot be influenced by the 199A deduction. The reduced tax on past investment produces a windfall tax benefit on prior investment.

Similarly, the deduction is not technically an employment or wage subsidy. A firm can benefit from it without hiring more workers or raising wages. Consequently, its impact on domestic labor demand is likely transmitted through the deduction's investment effects. Increased investment expands a firm's capital stock, allowing for increased labor productivity, which, in turn, can result in increased hiring and wage growth.

Revenue Effects

The Joint Committee on Taxation (JCT) is the official tax revenue estimator for Congress. In December 2017, shortly before the enactment of the TCJA, the JCT estimated that the 199A deduction would reduce federal tax revenues by approximately $53 billion annually. According to more recent JCT estimates made in December 2023, the deduction is expected to reduce federal tax revenues by $57.6 billion in 2024 and $60.9 billion in 2025. Most recently, the JCT estimated the revenue effects of permanently extending the 199A deduction to be $684.2 billion from FY2025 through FY2034.

Looking Forward

The 199A deduction is set to expire after 2025, and no legislation to extend the deduction has been introduced in the 118th Congress. Interest in the deduction's future may increase in the 119th Congress, and its future may depend on decisions regarding other expiring provisions—e.g., the reduced individual tax rates or bonus depreciation—and decisions about the corporate rate, which is not set to expire but that Congress could choose to alter depending on policy goals and budget constraints.

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