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Section 199A Deduction for Pass-through Business Income: An Overview

The 2017 tax revision (P.L. 115-97) added, under Section 199A of the federal tax code, a new deduction for pass-through business income. In its simplest form, the deduction is equal to 20% of a firm's qualified business income (QBI) in a tax year. However, the calculation becomes more complicated when an owner's income exceeds certain amounts and a business has employees and depreciable, tangible assets.

Congress created the deduction, in part, to establish parity between the taxation of corporate and noncorporate business income from 2018 to 2025; the deduction is set to expire on December 31, 2025. P.L. 115-97 reduced the corporate income tax from a graduated rate structure with a top rate of 35% to a single rate of 21%, a 40% decrease. By contrast, the Section 199A deduction lowers the effective tax rate on pass-through business profits by 20% at all individual tax rates.

Pass-through businesses fall into one of three categories: a sole proprietorship, a subchapter S corporation, or a partnership (including a limited liability company electing to be taxed as a partnership). In each case, the items of income, loss, gain, and deduction for the business are attributed (or passed through) to the owners, and any profits are taxed as part of their individual taxable income. By contrast, the profits of a subchapter C corporation are taxed twice: once at the entity level, and a second time at the owners' level when the profits are distributed to them as dividends and realized long-term capital gains.

Most U.S. businesses are organized as a pass-through business. According to data from the Internal Revenue Service (IRS), pass-through firms accounted for 94% of the 36.2 million business tax returns filed for the 2016 tax year. Sole proprietorships filed 75% of pass-through business returns and 70% of all returns.

Summary of Current Law

Section 199A allows individuals, estates, and trusts with pass-through business income to deduct up to 20% of their QBI in determining their taxable income through 2025. Owners of agricultural and horticultural cooperatives may also claim the deduction. Taxpayers claim the deduction after computing their adjusted gross income (AGI).

A pass-through business owner's QBI is the net amount of items of income, loss, gain, and deduction for each qualified domestic trade or business he or she owns. If a taxpayer owns more than one business, then QBI must be determined separately for each one and added together to determine the taxpayer's total QBI in a tax year.

QBI does not include capital gains, dividends, and interest and annuity income unrelated to a trade or business. It also does not apply to compensation paid to S corporation shareholders or partners for services they perform for their business, or to their employees.

In general, the deduction for QBI in a tax year for taxpayers with relatively low taxable income is equal to the *smaller of*

- 20% of a taxpayer's QBI, or
- 20% of their taxable income computed without the Section 199A deduction and reduced by any net capital gain and qualified cooperative dividends.

Taxpayers with qualified cooperative dividends make a similar computation. Any deduction they claim is added to any deduction they may claim if they have QBI.

For pass-through business owners with relatively high taxable income, the deduction is either unavailable because of the kind of business they own, or is the *smaller of*

- 20% of a taxpayer's QBI from all businesses, or
- a W-2 wages/qualified property (WQP) limit, which is the *larger of*
    - 50% of a taxpayer's share of total W-2 wages for a business, or
    - the sum of 25% of those wages plus 2.5% of their share of the unadjusted basis of all qualified property used in the business.

Use of the Deduction

Use of the deduction hinges on four considerations: (1) the taxable income of a taxpayer with QBI, (2) the nature of the trade or business generating the QBI, (3) the taxpayer's share of W-2 wages for the QBI, and (4) the taxpayer's share of the unadjusted basis of tangible, depreciable property used to generate the QBI. (See below for a few examples of how these criteria interact in determining a taxpayer's Section 199A deduction.)

Taxable income denotes a pass-through business owner's AGI less all deductions, except the Section 199A deduction. All trades and businesses are eligible for the deduction when a taxpayer's taxable income is less than or equal to a specified level. Above that amount, the deduction is subject to two limits. One is the WQP limit, and the other is a limit based on whether or not a business is considered a "specified service trade or business" (SSTB).

In the case of the WQP limit, W-2 wages are the total wages attributable to a taxpayer's QBI during a tax year subject to withholding, elective deferrals, and deferred compensation. The unadjusted basis of tangible, depreciable assets used in a business refers to the acquisition cost of such property attributable to a taxpayer's QBI.

A SSTB is any trade or business involved in the performance of services in health care, law, accounting, actuarial science, the performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, commodities, or partnership interests. Businesses whose principal asset is the reputation or skills of one or more of their employees and/or owners are also regarded as SSTBs.

Section 1202, which provides a capital gains tax exclusion for qualified small business stock, has a similar list of ineligible businesses. Among those lines of business are architecture and engineering firms. By contrast, those businesses qualify for the Section 199A deduction.

The limitations on the use of the deduction are phased in for joint filers when their taxable income in 2020 falls between $326,600 and $426,600, and for all other filers when their taxable income is between $163,300 and $213,300. Beyond the upper income limit, no SSTB income qualifies for the deduction, and the deduction for other firms cannot exceed the WQP limit. These income thresholds are indexed for inflation.

There are three basic outcomes for using the Section 199A deduction.

Outcome 1

Taxpayers with QBI who have taxable income in 2020 at or below the lower income threshold of $163,300 for single and head-of-household (HOH) filers, and $326,600 for joint filers, may be able to take the maximum Section 199A deduction, which is equal to 20% of their QBI.

Outcome 2

The second outcome happens when a taxpayer's taxable income exceeds $213,300 for single and HOH filers, and $426,600 for joint filers in 2020. In this case, no deduction is available for SSTB income. For other QBI, the deduction is subject to the WQP limit. In this case, the deduction is the smaller of 20% of a taxpayer's QBI for such a business, or an amount equal to the larger of (1) 50% of a taxpayer's share of W-2 wages for a qualified business or (2) 25% of those wages plus 2.5% of their share of the unadjusted basis of qualified property used in the business.

Outcome 3

This is arguably the most complicated of the three outcomes, as it involves a phase-in of the SSTB and WQP limits. It applies to taxpayers with QBI from SSTBs and non-SSTBs, and taxable income in 2020 between the income thresholds of $163,300 and $213,300 for single and HOH filers, and $326,600 and $426,600 for joint filers. For these taxpayers, the calculation of the deduction takes into account an owner's "applicable percentage," which is the ratio of a taxpayer's taxable income less the applicable lower income threshold, to $50,000 for single and HOH filers or $100,000 for joint filers. This percentage is used to adjust a taxpayer's QBI for SSTB income, and then to calculate a reduction amount, which is subtracted from a taxpayer's deduction with no WQP limit to determine the Section 199A deduction.

Selected Filing Issues

According to one estimate, over 90% of pass-through business owners were likely to have qualified for a full or partial Section 199A deduction in the 2018 tax year. But data from the 2019 filing season indicate that many owners who were eligible for the deduction did not claim it. According to a 2020 report on the 2019 filing season by the Treasury Inspector General for Tax Administration (TIGTA), nearly 880,000 tax returns processed as of May 2, 2019, did not claim the deduction, even though the taxpayers appeared to be eligible for it, based on profits they reported on Schedule C (for sole proprietors) or Schedule E (for partners or S corporation shareholders). In each case, taxable income did not exceed the applicable lower income threshold for 2018.

It is unclear why so many pass-through business owners did not claim the deduction when they qualified for it. TIGTA cited these possible explanations: (1) the taxpayers were unaware they could claim the deduction; (2) the software used to prepare their returns was unclear about what constituted QBI; (3) the taxpayers earned substantial business income outside the United States; or (4) they chose not to claim the deduction because it seemed too complicated to calculate.

Among the challenges in claiming the deduction is determining whether business activities qualify for the deduction. The final regulations (T.D. 9847) for Section 199A, issued by the IRS in January 2019, provided guidelines for identifying qualifying businesses. In many cases, the question of a firm's eligibility is likely to hinge on relevant "facts and circumstances."

Policy Issues

There are benefits and costs associated with the Section 199A deduction. Proponents argue that it encourages increased business investment in a wide range of assets by reducing the cost of capital for that purpose and increasing the cash flow of firms that can claim the deduction. Owing to the deduction and the temporary cut in individual income tax rates, the 2017 tax revision strengthened the incentive to invest arising from the tax code.

Critics of the deduction recognize its potential benefits for business investment, but they point to several other effects as reasons to revise or repeal it. In their view, the deduction is not neutral in its impact on the taxation of pass-through firms; reduces the progressivity of the federal income tax; creates new opportunities for gaming the tax code; and imposes significant compliance costs on taxpayers.

Gary Guenther, Analyst in Public Finance

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