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INSIGHT

# The Debate Over Extending the Section 199A Deduction

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The tax law passed by Congress in 2017 (P.L. 115-97; also known as the Tax Cuts and Jobs Act or TCJA) made significant changes in the taxation of corporate and noncorporate business income. Two key changes were a permanent cut in the corporate tax rate from a top rate of 35% to a single rate of 21%, and a temporary deduction for qualified pass-through business income under Internal Revenue Code Section 199A. One consequence of these changes was a shift in the tax incentives for businesses to operate as a C corporation (whose profits are taxed twice) or a pass-through entity (whose profits are taxed once).

The Section 199A deduction is due to expire at the end of 2025. There is a debate over whether to extend the deduction and if so, with or without changes. This Insight explains how the deduction is calculated, examines the arguments for and against the current deduction, and identifies legislation in the 117th Congress that would alter the deduction's future status.

## Calculation of the Deduction

The Section 199A deduction is intended to reduce the tax burden on pass-through business profits. The maximum deduction is equal to the lesser of (1) 20% of a taxpayer's qualified business income (QBI) plus 20% of any qualified income a taxpayer receives from real estate investment trusts and publicly traded partnerships; or (2) 20% of his or her taxable income, excluding long-term capital gains. QBI comprises a qualified business's items of income, gain, loss, and deduction. Wage income does not qualify for the deduction. A taxpayer allowed to claim the maximum deduction realizes a 20% reduction in his or her marginal tax rate. For example, a pass-through business owner taxed at the top individual rate of 37% would lower that rate to 29.6% for business net income [37% x (1-0.2)] by claiming the maximum deduction.

The most beneficial scenario for the Section 199A deduction involves a pass-through business owner with taxable income that does not exceed the deduction's low-income threshold amount ($164,900 for single filers and $329,800 for joint filers in 2021), which is indexed for inflation.

Calculating the deduction becomes more complicated if taxable income exceeds the low-income threshold amount. In that case, two limitations phase in for taxable income between that amount and the deduction's



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upper-income threshold amount ($214,900 for single filers and $429,800 for joint filers in 2021), which is also indexed for inflation. One limitation is based on whether a business is considered a "specified service trade or business (SSTB)," which is defined as a professional service firm in designated fields (e.g., accounting, law, health care) or a firm whose primary asset is the skills or reputation of its owners or employees. The second limitation is based on a pass-through business's W-2 payments and the unadjusted basis of its tangible, depreciable assets (e.g., buildings and equipment).

If a pass-through business owner's taxable income exceeds the upper-income threshold amount, two outcomes are possible: an SSTB owner can no longer claim a Section 199A deduction, and a non-SSTB owner is limited to a deduction that equals the greater of 50% of the owner's share of total W-2 wages, or 25% of those wages plus 2.5% of the owner's share of the unadjusted basis of the firm's depreciable, tangible assets. A high-income non-SSTB owner with no employees and no tangible, depreciable assets cannot benefit from the deduction.

# Pros and Cons

Proponents of the Section 199A deduction argue that it should be retained to support small businesses. They claim that the deduction promotes job growth and higher investment among pass-through firms by increasing their cash flow and lowering their cost of capital for a range of investments. Proponents also say that the deduction mainly benefits small pass-through firms because the maximum deduction can be captured only by owners whose taxable income does not exceed $164,900 for single filers and $329,800 for joint filers in 2021. In 2018, according to IRS data, taxpayers with adjusted gross income below $200,000 filed 80.2% of all claims for the deduction, accounting for 31.9% of their total value.

Critics of the Section 199A deduction argue that it should be allowed to expire and not be extended, or should be extended only with significant changes to enhance the deduction's potential benefit. One issue is the deduction's uneven benefits. Critics contend that the deduction effectively picks winners and losers among pass-through businesses by denying it to SSTB owners with relatively high incomes.

Another issue is the deduction's impact on pass-through business profits. Because it applies equally to returns from previous investments and returns from new investments, critics say, the deduction serves as an inefficient policy tool for economic stimulus.

Critics also note that the deduction poses significant challenges for taxpayer compliance and tax administration. Some eligible taxpayers may not claim the deduction because they find calculating it too complicated, while some others may file questionable claims for the deduction. Enforcing the deduction's regulations is the responsibility of the IRS, whose enforcement resources have declined substantially in real terms since FY2010.

# Legislation in the 117th Congress

At least four bills have been introduced in the 117th Congress that would modify the Section 199A deduction. Three of them (H.R. 1381, S. 126, and S. 480) would permanently extend the existing deduction, with no changes.

The fourth bill (S. 2387) would also permanently extend the credit, but with the following changes:

- make the deduction amount equal to the lesser of (1) 20% of a taxpayer's QBI; (2) 20% of his or her taxable income less capital gains; or (3) 20% of a threshold amount of $400,000 (or $80,000);
- phase out the deduction for taxpayers with taxable income between $400,000 and $500,000;

- eliminate the distinction between SSTBs and non-SSTBs, making all lines of business eligible for the deduction on equal terms; and
- deny the deduction to married persons filing separately, estates, and trusts.

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