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INSIGHT

The Debate over Extending the Section 199A Deduction for Qualified Business Income

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The 2017 tax law (P.L. 115-97, commonly known as the Tax Cuts and Jobs Act or TCJA) made significant changes to the taxation of business income. For C corporations, the act permanently reduced the corporate tax rate from a top graduated rate of 35% before 2018 to a single rate of 21%. For pass-through firms (sole proprietors, S corporations, and partnerships), which do not pay the corporate income tax, the law temporarily reduced marginal individual income tax rates and established a temporary deduction under Section 199A of the federal tax code that is equal to as much as 20% of a firm's qualified business income (QBI), subject to certain limitations. The individual income tax rate cuts and Section 199A deduction are set to expire at the end of 2025.

There is a debate in Congress over whether to extend the Section 199A deduction beyond 2025. This Insight briefly explains the deduction's design, reviews arguments for and against such an extension, and discusses what is known about the deduction's effects to date.

Overview of the Deduction

Section 199A allows individuals, estates, and trusts with pass-through business income to deduct up to 20% of their QBI in calculating their income tax liability, subject to certain limitations. The deduction is claimed against a taxpayer's adjusted gross income. QBI is a pass-through business owner's net amount from the items of income, loss, gain, and deduction from every qualified business he or she owns; it does not include wages, capital gains, dividends, and interest and annuity income unrelated to a trade or business. The maximum Section 199A deduction cannot exceed 20% of a pass-through business owner's taxable income, less capital gains and dividends.

The maximum 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 2023, no limit applies if a taxpayer's taxable income is less than $364,200 for joint filers and $182,100 for single filers. The limits phase in for incomes between $364,200 and $464,200 for joint filers, and between $182,100 and $232,100 for single filers.

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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

The Section 199A deduction first became available in 2018. Between 2018 and 2020 (the most recent year for which data are available), claims for it rose from 18.7 million to 22.8 million, and the total amount of claims rose from $149.9 billion to $166.1 billion. **Table 1** shows the deduction's distributional effects. The figures indicate that the primary beneficiaries were pass-through business owners with less than $1 million in adjusted gross income (AGI). The largest claims were filed by taxpayers with $5 million and above in AGI.

Table 1. Use of the IRC Section 199A Deduction for Qualified Business Income in 2020

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	80%	30%	$2,811
$200,000 to $1 million	18%	30%	$12,575
$1 million to $5 million	2%	20%	$82,750
$5 million and above	0.2%	19%	$161,500
Overall	—	—	**$7,222**

Source: Internal Revenue Service, *Individual Income Tax Returns: Complete Report*, Table 1.4 for each year, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-complete-report-publication-1304-basic-tables-part-1.

Arguments For and Against Extending the Deduction

Proponents of the Section 199A deduction say that it should be extended mainly because it encourages eligible firms to grow faster. The deduction lowers the tax burden on business investment, allowing pass-through firms to invest more and hire more workers than they otherwise would. According to proponents, another reason to retain the deduction is that it narrows the difference between the tax burden on corporate profits and the tax burden on pass-through business profits.

Critics of the deduction cite several reasons for letting it expire. First, they contend that there is no evidence that the deduction has spurred increased investment and job growth by pass-through firms. Second, they say that calculating the deduction can be complicated and costly for many eligible small business owners, deterring them from claiming it. Third, according to critics, the deduction is an inefficient way to promote business investment, as it applies to income from past investments as well as income from new investments, producing a windfall gain for pre-TCJA investments. Fourth, the deduction benefits some firms more than others for reasons that critics say cannot be justified on economic grounds. Finally, the deduction entails a significant revenue loss: according to the Joint Committee on Taxation, the deduction will lead to an estimated $258 billion revenue cost from FY2022 to FY2026.

Available Evidence on the Deduction's Impact

There is limited research into the Section 199A deduction's effects so far. A 2022 study by Lucas Goodman, Katherine Lim, Bruce Sacerdote, and Andrew Whitten found no evidence of a "large response" to the deduction by taxpayers and businesses in 2018, the only year covered by the study. Specifically, Goodman et al. could find no evidence that the deduction altered the share of AGI classified as QBI. They also found that there was little change in the wages paid to S corporation shareholder-employees, even though those wages did not qualify for the deduction but S corporation profits do. The researchers did find evidence that some partnerships responded to the deduction as expected by reducing guaranteed payments to partners, which do not qualify for the deduction, and replacing them with distributed profit, which is eligible. Contrary to proponents' expectations, there was no evidence that the deduction had a significant impact on the number of independent contractors and on pass-through business investment and hiring in 2018.

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