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SUMMARY

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Section 199A of the federal tax code allows owners of pass-through businesses to deduct up to 20% of their qualified business income (QBI) from their taxable income in calculating their individual income tax liability. The deduction was established by the 2017 tax revision (P.L. 115-97) and is available from 2018 to 2025.

Calculating the deduction can be complicated. The maximum deduction is equal to 20% of an eligible business's QBI, provided the deduction does not exceed 20% of a taxpayer's taxable income, excluding long-term capital gains. The maximum deduction is subject to two limitations that phase in as taxable income increases between a lower income threshold and an upper income threshold.

If a pass-through business owner's taxable income does not exceed the deduction's lower income threshold, then the owner may claim the maximum deduction. The threshold is indexed for inflation; in 2024, it is set at $383,900 for joint filers and $191,950 for all other filers. If an owner's taxable income falls between the lower income threshold and the upper income threshold ($483,900 for joint filers and $241,950 for all other filers in 2024), both limitations could apply.

One limitation is based on whether a business is classified as a "specified service trade or business" (SSTB). The other limit takes into account an owner's share of an eligible business's W-2 wages and the unadjusted basis of its tangible, depreciable assets placed in service in the previous 10 years; this limitation is known as the wage and qualified property (WQP) limit. The maximum deduction decreases as these limits phase in. If an owner's taxable income exceeds the upper income threshold, no SSTB QBI is eligible for the deduction, and the deduction for non-SSTB QBI cannot exceed the greater of 50% of the owner's share of a business's W-2 wages, or 25% of those wages plus 2.5% of the owner's share of the business's unadjusted basis of qualified capital assets.

This report addresses what is known about the Section 199A deduction's economic effects. More specifically, it examines the deduction's impact on (1) investment and employment, (2) horizontal and vertical equity in the federal income tax, and (3) taxpayer compliance and tax administration. The report concludes with an overview of policy options for Congress as it considers whether to retain the deduction beyond 2025.

There are no studies of how the deduction has affected pass-through business investment. Available evidence suggests that the deduction may have stimulated no more than a modest rise in investment in 2018 and 2019.

Nor are there estimates of how the deduction has affected job creation among pass-through firms. It is unclear whether the deduction, combined with the temporary individual income tax cuts under the 2017 tax law, has boosted demand for labor in the noncorporate sector.

The Section 199A deduction appears to have little effect on vertical equity, as it does not appear to diminish the progressivity of the federal income tax. But the deduction does seem to reduce horizontal equity, as it can result in a lower tax burden for pass-through business owners than wage earners with the same gross income.

The deduction's complexity increases the cost of compliance for taxpayers who might benefit from it, although it is not clear to what extent. There is also uncertainty about which businesses qualify for the deduction. Some lower-income taxpayers may not claim it because of the complexity and compliance cost. Many upper-income pass-through business owners may claim the deduction, but only with the assistance of tax professionals.

The Section 199A deduction's complexity also has implications for the Internal Revenue Service (IRS). Enforcing the law and regulations regarding the deduction may be a challenge for the IRS owing to substantial reductions in its audit capacity in the past 12 or so years. This has led to significant declines in audit ratios for high-income individuals and partnerships. Without enough experienced examiners, the IRS may be incapable of deterring questionable claims for the deduction.

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Introduction

A key aim of the tax revision enacted in December 2017 (P.L. 115-97, often referred to as the Tax Cuts and Jobs Act, or TCJA) was to reduce the federal tax burden on business income. Many proponents of such a reduction were confident that it would spur businesses to hire more workers and invest more in tangible and intangible assets, boosting labor productivity. The law sought to reduce the business tax burden in two ways.

For Subchapter C corporations, the law permanently cut the top income tax rate of 35% under prior law to a single rate of 21%, a 40% decrease. Corporate profits that are distributed to owners/shareholders are subject to two levels of taxation: a corporate-level tax and then an individual-level tax on profits distributed to owners/shareholders as dividends or long-term capital gains.

To establish parity between the tax treatment of corporate and noncorporate (or pass-through) business profits, the TCJA also lowered individual income tax rates (except for the lowest rate of 10%) and created a new deduction under Internal Revenue Code Section 199A for pass-through business profits.[1] A pass-through business can take the form of a partnership, limited liability company, Subchapter S corporation, or self-employed person. Unlike corporate profits, pass-through business profits are taxed only at an owner's individual income tax rate.

The maximum deduction is equal to 20% of a pass-through firm's qualified business income (QBI).[2] For pass-through business income taxed at the highest statutory rate (37%) under current law, the deduction lowers it to 29.6% (37% x 0.8 = 29.6%), which is 25% below the top statutory rate under pre-TCJA tax law (39.6%). The TCJA's individual income tax rate cuts and the deduction are scheduled to expire at the end of 2025.

This report addresses what is known about the Section 199A deduction's economic effects. Specifically, it looks at the deduction's impact on (1) investment and employment, (2) horizontal and vertical equity in the federal income tax, (3) tax administration, and (4) taxpayer compliance. The report concludes with a discussion of some policy options for Congress if it were to consider retaining the deduction beyond 2025.

Structure of the Deduction

Section 199A permits individuals, trusts, and estates with pass-through business income to deduct up to 20% of their QBI in determining their federal income tax liability. Pass-through business

[1] For more details on the structure of the Section 199A deduction, see CRS Report R46402, *The Section 199A Deduction: How It Works and Illustrative Examples*, by Gary Guenther.

[2] Effective tax rates (ETRs) serve a crucial purpose in the analysis of the economic effects of tax provisions. They measure an individual's or corporation's tax burden, which is the percentage of taxable income that is actually taken by taxes. An ETR does this by applying to a taxpayer's statutory tax rate any tax preferences the taxpayer could claim in determining taxable income. As such, the effective rate is typically lower than the statutory rate, because tax preferences are intended to increase the welfare of designated groups or to encourage individuals or businesses to engage in certain activities. These preferences can take the form of tax credits, special deductions, exclusions, deferrals, and preferential tax rates.

Generally, an ETR can be average (AETR) or marginal (METR). In the case of businesses, the former shows the tax burden on a firm's taxable income from old and new investments, whereas the latter shows the tax burden on an additional dollar of income from new investments only. Both approaches are used in this report. Each is clearly labeled when it is used.

owners are required to report their share of profits on their individual tax returns, regardless of whether the income is distributed to them.

The deduction applies to an owner's QBI, which is the net result of combining the items of income, deduction (excluding the Section 199A deduction), loss, and gain of every eligible business he or she owns. Only income items connected to a trade or business conducted in the United States (including Puerto Rico) are eligible for the deduction.

QBI does *not* include

- wage income;
- reasonable compensation received by an S corporation shareholder for services provided to the business;
- guaranteed payments to a partner from a partnership for services provided to the business; or
- investment income unrelated to a pass-through business.

The deduction is available from 2018 to 2025 and is claimed on Form 1040 after an eligible taxpayer takes the standard deduction or the sum of her or his itemized deductions. Use of the deduction depends on a pass-through business owner's taxable income, the nature of her or his business, and the owner's share of a business's W-2 wages and the original cost (or unadjusted basis) of the business's depreciable capital assets placed in service in the previous 10 years.[3]

The **maximum deduction** is the lesser of

- 20% of an owner's QBI, or
- 20% of an owner's taxable income, excluding net capital gains.

The deduction is subject to two limitations:

- a **wage and qualified property (WQP) limitation**, which reduces the maximum deduction an owner may claim based on her or his share of a business's W-2 wages and the unadjusted basis of its qualified assets); and
- a **specified service trade or business (SSTB) limitation**, which reduces the maximum deduction an owner may claim for QBI from an SSTB. An SSTB is any trade or business primarily engaged in accounting; health; law; actuarial science; athletics; brokerage services; consulting; financial services; the performing arts; investing and investment management; or trading or dealing in securities, partnership interests, or commodities. An SSTB can also be a trade or business whose principal asset is the reputation or skill of one or more of a firm's owners or employees.

The two limitations phase in when a pass-through owner's taxable income falls between the deduction's lower income threshold ($383,900 for joint filers and $191,950 for other filers in 2024) and the deduction's upper income threshold ($483,900 for joint filers and $241,950 for other filers in 2024). For taxable income above the latter threshold, there is no deduction for SSTB QBI, and owners with non-SSTB QBI cannot claim a deduction that exceeds the larger of 50% of an owner's share of a business's W-2 wages or 25% of those wages plus 2.5% of an

[3] W-2 wages are the total wages paid by a company that are subject to withholding, elective deferrals, and deferred compensation. The unadjusted basis of depreciable, tangible assets refers to the cost of such assets when a company acquires them.

owner's share of the original cost of capital assets the business placed in service in the past 10 years.

Economic Effects of the Deduction

This section examines what is known about the use of the Section 199A deduction and its impact on investment, employment, equity, tax administration and compliance, federal revenue, and industries.

Use of the Deduction

As **Table 1** shows, claims for the Section 199A deduction have increased in number and amount in every year since 2018.[4] The average amount per claim was almost the same in 2018 and 2021, after a 12.5% decline in 2019. Available tax data from the Internal Revenue Service (IRS) do not indicate which industries have benefited the most from the deduction. The data do suggest, however, that upper-income pass-through business owners have captured much of the tax savings from the deduction. In 2021, for instance, taxpayers with adjusted gross income (AGI) above $200,000 filed 28% of the claims for the deduction, accounting for 76% of the total dollar amount.

This result is consistent with what is known about the income distribution of noncorporate business income. The Tax Policy Center's (TPC's) latest estimate of the distribution by income class of pass-through business income under current tax law indicated that the top 5% of taxpayers ranked by income received 79% of total pass-through business income in 2022.[5]

Table 1. Claims for the Section 199A Deduction Since 2018

Year	Number of claims (millions)	Total Amount ($ billions)	Average Amount per Claim ($ thousands)
2018	18.7	150.0	8.0
2019	22.2	155.2	7.0
2020	22.8	166.1	7.3
2021	25.9	205.8	7.9

Source: Internal Revenue Service, Individual Income Tax Statistics, https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income.

Investment

During the 2017 congressional debate over reforming the federal income tax, proponents of permanently lowering business income tax rates argued that reduced rates would spur many firms to invest more in capital assets than they otherwise would, especially during economic

[4] https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income. The claimed amount may be larger than the amount allowed by the IRS after it completes any audits.

[5] See https://www.taxpolicycenter.org/model-estimates/distribution-business-income-february-2023/t23-0024-distribution-business-income.

expansions.[6] The added investment would increase the firms' capital stock, boosting their productivity. Over time, rising productivity may propel increases in employment and real wages.[7]

This scenario rests on the investment effects of taxation. Taxes mainly affect investment through the user cost of capital and business cash flow. The former represents the after-tax rate of return an investment has to earn to break even. It takes into account the real interest rate, economic depreciation for the acquired assets, the marginal effect of taxes on an investment's returns, and the opportunity cost of an investment.

Technically, the Section 199A deduction is not an investment tax subsidy. A firm can benefit from the deduction if it makes no new investments in a tax year. In this case, a firm's QBI would consist of returns from past investments and other sources of income.

Nonetheless, the deduction, combined with the reduced individual income tax rates under the TCJA, has the potential to influence pass-through business investment decisions through its impact on the marginal effective tax rate (METR) for the returns on new investments and the amount of cash available to a business. An investment's METR is its pretax rate of return less its after-tax rate of return divided by the pretax rate of return for an additional dollar of revenue; it is the tax component of the user cost of capital. An METR takes into account the real interest rate, an investment's financing, an investor's desired after-tax rate of return, and applicable income tax rates and tax preferences (e.g., tax credits, exemptions, deferrals, and deductions).

For pass-through business owners in the highest individual income tax bracket under current law (37%), the maximum deduction (20% of QBI) decreases the METR on the returns from new investments from 37% to 29.6% (37% x 0.8), all other things being equal. In theory, this reduction increases the number of profitable investments a pass-through business could undertake by lowering the user cost of capital and boosting such a firm's short-term cash flow.

A 2022 paper by Kyle Pomerleau examined the deduction's impact on the incentive effect for noncorporate investment.[8] According to his calculations, the overall "effective statutory tax rate" (ESTR) for the returns on pass-through business investment was 37.1% with the Section 199A deduction and 44.5% without it; the ESTRs for corporate investment returns and wages were 42.3% and 46.1%, respectively.[9] The ESTR measures the change in tax liability for an additional amount of income, taking into account income taxes, self-employment taxes, other surtaxes, and the deductibility of tax payments. The results suggest that the deduction may boost a pass-through business's incentive to undertake new investment.

Similar results were obtained in a 2019 study by Jane Gravelle and Donald Marples. They found that the TCJA decreased the METR for corporate and noncorporate investment in a variety of assets financed both by equity alone or by a typical mix of debt and equity (see **Table 2**). [10] Current-law noncorporate METRs incorporate the combined effect of the TCJA's individual income tax rate cuts, the Section 199A deduction, and the availability (through 2022) of 100% expensing for tangible assets with a recovery period of 20 years or less (e.g., off-the-shelf software and equipment) under Section 168(k)—a depreciation allowance also known as bonus

[6] See Scott Hodge, "The Positive Economic Growth Effects of the Tax Cuts and Jobs Act," written testimony of Jane Gravelle before the Joint Economic Committee, *Tax Foundation*, September 6, 2018, pp. 2-3.

[7] See Council of Economic Advisers, *The Growth Effects of Corporate Tax Reform and Implications for Wages*, Executive Office of the President, October 2017.

[8] Kyle Pomerleau, *Section 199A and "Tax Parity,"* American Enterprise Institute, September 2022.

[9] Ibid., p. 8.

[10] CRS Report R45736, *The Economic Effects of the 2017 Tax Revision: Preliminary Observations*, by Jane G. Gravelle and Donald J. Marples, p. 17.

depreciation. Current-law corporate METRs are based on the TCJA's reduction of the corporate income tax rate to 21% and 100% bonus depreciation. The study did not address the investment effects of the Section 199A deduction.

The results in **Table 2** from the Gravelle-Marples study indicate that the TCJA has enhanced the incentive for business investment in tangible assets (e.g., equipment) but has had little effect on the incentive to invest in intangible assets (e.g., patents). The results also suggest that the deduction may have boosted the desirability of operating as a pass-through business rather than a C corporation.

Table 2. Effective Tax Rates by Type of Asset

Asset	Corporations: Pre-TCJA Law	Corporations: Current Law	Pass-through Firms: Pre-TCJA Law	Pass-through Firms: Current Law
100% Equity Financed				
Equipment	13.4%	0.0%	14.4%	0.0%
Public Utility Structures	14.2	0.0	15.2	0.0
Nonresidential Structures	30.8	18.5	32.1	26.2
Intangibles	-63.3	-63.3	-63.3	-63.3
Debt and Equity Financed				
Equipment	-0.9	-9.6	-0.6	-14.3
Public Utility Structures	-0.9	-9.6	-0.6	-14.3
Nonresidential Structures	19.2	10.7	20.2	15.7
Intangibles	-116.3	-95.4	-111.2	-109.0

Source: CRS Report R45736, *The Economic Effects of the 2017 Tax Revision: Preliminary Observations*, by Jane G. Gravelle and Donald J. Marples, Table A-1.

Notes: The calculations are based on corporate tax rates of 34.14% under pre-TCJA law (including the now-repealed Section 199 production activities deduction) and 21% under current law; pass-through tax rates of 37% under pre-TCJA law and 30% under current law (based on information from the Congressional Budget Office); a real after-tax rate of return of 7% for equity; an interest rate of 7.5%; a 2% inflation rate; and a debt financing share of 36%.

However, there are no known studies that assess the Section 199A deduction's actual investment effects. These effects are difficult to assess, in part because it is difficult to analytically separate the deduction's impact on pass-through business investment from the effects of other forces such as income tax rates, depreciation allowances, interest rates, and aggregate output. Estimating the investment effects of the deduction may require developing a model of domestic pass-through business investment and applying it to tax data to determine the sensitivity of such investment to changes in its tax price and the degree to which the deduction lowers that price.

Employment and Wages

Some have argued that "the strongest and most coherent policy rationale for the TCJA in general and for the Section 199A deduction in particular" is job creation.[11] But others contest that argument's validity. They say that there is no evidence from U.S. employment data in 2018 and 2019 to support it, and that the deduction's design does not encourage substantial job creation.

Technically, the deduction is not a job subsidy. A firm can benefit from it without creating a single job. 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 output and labor productivity. The interaction between output and productivity determines whether the firm's workforce grows in the short run.

It is not known how pass-through business owners benefiting from the Section 199A deduction have used the resulting tax savings. There are numerous possibilities, of course. For example, a firm could use the savings to increase investment, raise employee wages and salaries, or increase the owners' personal income or wealth. It is not clear whether many of the firms that have increased their investment in response to the deduction have added employees.

As some have pointed out, the deduction's design also affects its job impact. Three features in particular do little to encourage job growth. First, pass-through business owners with taxable income below the lower income threshold can benefit from the maximum deduction without creating a single job. Second, SSTB owners with taxable income above the upper income threshold cannot benefit from the deduction, regardless of how many jobs they create. Third, high-income owners of non-SSTBs investing in certain capital assets can benefit from the deduction without creating a single job.

There is no known study of the deduction's impact on pass-through business employment. A 2021 study by William Gale and Claire Haldeman that assessed the TCJA's economic effects pointed out that domestic employment growth slowed in 2018 and 2019.[12] In their view, this slowdown provided further evidence that the TCJA's immediate investment effects were not as robust as some backers of the law had expected.

Gale and Haldeman also found that wages and salaries exhibited a more complicated pattern in that period. The growth rate for real median earnings of all wage and salary employees fell by 0.2 percentage points from 2016 to 2019, but the growth rate for the employer cost index rose by 0.56 percentage points. The index measures mean wages and salaries. Gale and Haldeman argued that faster mean wage growth paired with slower median wage growth suggested that high-income workers' wages and salaries rose in that period, while lower-income workers experienced no wage growth.

Tax Administration and Taxpayer Compliance

The Section 199A deduction has implications for the cost of tax administration and taxpayer compliance.

[11] Rodney P. Mock and David G. Chamberlain, "Section 199A: Job Creator or Tax Giveaway?" Tax Notes, December 10, 2018, p. 1309.

[12] William G. Gale and Claire Haldeman, *The Tax Cuts and Jobs Act: Searching for Supply-Side Effects*, Brookings Institution Economic Studies, July 2021.

Tax Administration

The IRS is responsible for administering and enforcing federal tax laws. Its ability to do so has been hampered by reductions in the IRS's budget and workforce and increases in its workload since FY2010. From that year to FY2021, the agency's budget (in 2021 dollars) declined by 19% and its staff by 22%, while the number of returns processed annually grew by 7%.[13] In the same period, the IRS's budget (in 2021 dollars) for enforcement and operations support decreased by 22%, and its enforcement staff fell by 31%. Of particular concern for the IRS's ability to enforce changing and increasing tax laws was a 39% drop in the number of revenue agents to a level last reached in 1954; revenue agents have the knowledge and experience to audit complex returns filed by high-income individuals, partnerships, and large corporations. The IRS is trying to rebuild its staff of revenue agents with the $79 billion in mandatory funding provided by the Inflation Reduction Act (P.L. 117-169), $4 billion of which was rescinded by the Fiscal Responsibility Act of 2023 (P.L. 118-5).

Although there are no known estimates of the cost to the IRS of administering the deduction, the need to audit some claims for it may further strain the agency's enforcement budget. A possible focus of audit activity is higher-income taxpayers. In 2021, taxpayers with AGIs above $200,000 filed 28% of claims for the Section 199A deduction but accounted for 76% of the total dollar amount. Most audits are conducted through correspondence with taxpayers; the more complicated but higher-revenue-raising audits are done in person. Given the complexity of the deduction and the substantial amounts claimed by higher-income pass-through business owners, the IRS may rely more on in-person audits to enforce compliance with the deduction's regulations.

One issue likely to draw scrutiny from IRS auditors is where to draw the line between business income earned from SSTBs and non-SSTBs in related industries. While it is believed that the SSTB limitation was intended to prevent income sheltering by high-income service professionals who rely on their skills or reputations to generate demand for their services, the distinctions between SSTB and non-SSTB activities in the same or similar industries seem "artificial and murky, at best."[14]

Taxpayer Compliance

The Section 199A deduction's complexity and uncertainty regarding eligibility have implications for the cost of taxpayer compliance. This cost encompasses the time and money spent on understanding the deduction's rules, collecting the information needed to file a claim, and filing the claim. Among the key considerations in claiming the deduction are the number of eligible trades and businesses someone owns and the amount of each eligible business's W-2 wages and unadjusted basis of qualified assets allocable to the taxpayer. The recordkeeping needed to substantiate a claim for the deduction might be the biggest cost for small business owners.[15] According to an estimate by the Tax Foundation, the compliance cost for taxpayers who claimed the deduction in 2021 totaled $17.8 billion; this covered the costs of hiring tax professionals to

[13] See https://www.cbpp.org/research/federal-tax/the-need-to-rebuild-the-depleted-irs#irs_resources_are_depleted.

[14] William G. Gale et al., *Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis*, Tax Policy Center, June 13, 2018, p. 17.

[15] One example of this challenge is the difficulty some tax practitioners have had tracking the various losses (e.g., passive-activity-loss and disallowed business deduction carryforwards) that can reduce current-year QBI. For more details, see Eric Yauch, "Tracking Losses and Undue Complexity—Is 199A Even Worth It," Tax Notes, March 19, 2020.

prepare claims, as well as a monetization of the hours pass-through business owners spent preparing claims on their own.[16]

Take-up of the deduction among lower-income pass-through business owners in 2018 was lower than expected. In a report on filing for the 2018 tax year, the Treasury Inspector General for Tax Administration (TIGTA) found that 887,991 individual income tax returns that had been processed by May 2, 2019, did not claim the Section 199A deduction, even though the taxpayers seemed eligible for it based on information reported in the returns.[17] Each return included a form associated with a pass-through business (Schedule C or Schedule F) showing a profit. Moreover, all the returns reported taxable income at or below the lower income threshold for 2018: $315,000 for joint filers and $157,500 for all other filers.

IRS managers contacted by TIGTA suggested several possible explanations for the failure to claim the deduction without ranking them by probability:

- The taxpayers were unaware they were eligible to claim the deduction.
- The software they used to prepare their returns was unclear about what constitutes QBI.
- Some of their trade or business income was earned outside the United States.
- The taxpayers chose not to claim the credit because it seemed too complicated to calculate.

According to TIGTA, the findings indicated that the IRS needed to expand its efforts to educate pass-through business owners about the deduction.

A taxpayer's taxable income can affect the compliance cost. In general, pass-through business owners with taxable income at or below the lower income threshold ($383,300 for joint filers and $161,900 for other filers in 2024) for the deduction may face the lowest compliance cost. For many of them, taking the deduction may be as simple as calculating 20% of their total QBI and 20% of their taxable income less any net capital gain, and claiming the smaller of the two amounts.

Many high-income pass-through business owners likely hire tax practitioners to find ways to maximize the deduction's tax benefit. Not all planning strategies may comply with the law. Some strategies might require combining or splitting pass-through businesses to qualify for the deduction. Tax planning of this sort can be expensive. In general, large pass-through businesses are more likely than smaller ones to use tax practitioners to file a claim for the deduction. Disparities in access to effective tax planning arguably represent one way in which the Section 199A deduction unintentionally picks winners and losers among pass-through business owners.

Equity Effects

Public finance economists analyze the federal income tax's equity effects from two perspectives: vertical equity and horizontal equity. Vertical equity refers to the extent to which a taxpayer's tax burden increases as her or his income goes up. Horizontal equity refers to the extent to which taxpayers with similar incomes have similar tax burdens.

[16] Scott Hodge, *The Tax Compliance Costs of IRS Regulations*, Tax Foundation blog, August 23, 2022.

[17] U.S. Department of the Treasury, Treasury Inspector General for Tax Administration, *Results of the 2019 Filing Season*, ref. no. 2020-44-07, January 22, 2020, p. 14.

Horizontal Equity

The deduction may diminish horizontal tax equity in two ways. First, it taxes wage earners and pass-through business owners with similar income at different rates, even though there is no apparent economic justification for such disparate treatment.[18]

To illustrate this point, assume that a sole proprietor and an employee have the same taxable income ($100,000 in 2024), and that the former's income comes solely from QBI for a retail business she owns and the latter's income is from wages only. Both are single filers. Under the federal individual income tax rate schedules for 2024, the sole proprietor is eligible for the maximum Section 199A deduction, which reduces her top marginal tax rate from 22% to 17.6% (22% x 0.8). By contrast, because the employee cannot claim the deduction, her income is taxed at 22.0%. Under pre-TCJA tax law, both taxpayers would have been taxed at the same top marginal rate.

Second, the deduction arguably diminishes horizontal equity by taxing the QBI of SSTBs and non-SSTBs owned by high-income taxpayers at different rates. An SSTB owner and a non-SSTB owner with the same taxable income above the deduction's upper income threshold face different tax burdens because of the deduction. The former can claim no deduction, while the latter can claim a deduction equal to the larger of 50% of the firm's W-2 wages or 25% of those wages plus 2.5% of the original cost of the firm's capital assets placed in service in the past 10 years. This is another way in which the Section 199A deduction may unintentionally pick winners and losers among businesses.

Vertical Equity

The deduction has little effect on vertical tax equity. In theory, it reduces statutory marginal tax rates by the same factor (20%), leaving a progressive rate structure intact for pass-through business owners.

Nonetheless, available evidence indicates that high-income taxpayers might capture much of the Section 199A deduction's overall benefit. Such an outcome would be consistent with what is known about the income distribution of pass-through business profits.

According to a 2016 report by Michael Cooper et al., 69% of pass-through business income went to the top 1% of households ranked by income in 2011.[19]

A 2023 analysis by the TPC estimated that the top 1% of taxpayers received 57% of U.S. pass-through business income in 2022; business income accounted for 24% of the top 1% of taxpayers' total AGI, compared with 8.6% of AGI for all taxpayers.[20]

Impact on Federal Budget

Because the deduction reduces the tax burden on pass-through business income, its net effect on federal revenue is negative, relative to a baseline revenue projection without the deduction. The Joint Committee on Taxation recently estimated that the deduction would produce a $174.2

[18] Andrew Velarde, "Passthrough Abandonment of Horizontal Equity Means It's Game On," Tax Notes, May 18, 2018.

[19] Michael Cooper et al., "Business in the United States: Who Owns It, and How Much Tax Do They Pay?" *Tax Policy and the Economy*, vol. 30, no. 1 (2016), p. 94.

[20] Urban-Brookings Tax Policy Center, Table T23-0024: Distribution of Tax Units with Business Income by Expanded Cash Income Percentile, 2022, March 1, 2023.

billion revenue loss from FY2023 to FY2025.[21] The projection extended to FY2027, but the deduction is set to expire at the end of 2025. Focusing only on the period from FY2023 to FY2025 is likely to present a more accurate picture of the deduction's annual revenue cost.

Impact Among Industries

In a 2019 report, the Treasury Department's Office of Tax Analysis (OTA) estimated the extent to which taxpayers who reported pass-through business income on their 2016 tax returns would have benefited from the deduction if it had been available then.[22] The study was based on a sample of 780,000 taxpayers deemed representative of the taxpayers who reported pass-through business income to the IRS for 2016. OTA also identified the industries that would have benefited the most from the deduction. In a controversial step, the authors assumed that pass-through business owners would not have altered their economic behavior in 2016 if the deduction had been available.

According to the findings, 18 million businesses would have been eligible for the deduction in 2016, 11 million of which would have realized tax savings from the deduction.[23] The tax savings would have totaled $34.5 billion (2018 dollars), after allowing for the SSTB and WQP limitations. In the absence of the limitations, the tax savings would have been $63 billion. Taxpayers in the top 5% of the income distribution would have captured 72% of the total tax savings, with 47% going to taxpayers in the top 1% and 23% to taxpayers in the top 0.1%.

The study estimated that the tax savings from the deduction with the SSTB and WQP limitations would have been largest for businesses in (1) professional services, (2) real estate, (3) construction, (4) retail trade, and (5) manufacturing.[24] The tax savings without the limitations would have been largest for firms in (1) professional services, (2) real estate, (3) health, (4) finance and insurance, and (5) construction.

The impact of the limitations varied among industries. For example, the tax savings with the two limitations were 54% lower than the tax savings without the limitations for professional services, but for retail trade the difference was only 10%. This variation reflected differences among industries in (1) the percentage of firms classified as an SSTB, (2) the income distribution of pass-through business owners, and (3) the amount of depreciable, tangible assets, and number of employees.[25]

The study found that industries differed in the percentage of firms that would have benefited from the Section 199A deduction. Without the two limitations, this percentage ranged from 43.6% for mining, oil, and gas to 73.2% for professional services. Three other industries had percentages above 70%: education (72.6%), wholesale trade (71.4%), and manufacturing (71.3%). Some

[21] U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2023-2027*, JCX-59-23 (Washington, DC: GPO, December 7, 2023).

[22] Lucas Goodman et al., *Simulating the 199A Deduction for Pass-through Owners*, Treasury Department Office of Tax Analysis, Working Paper 118, May 2019. (Hereinafter referred to as Goodman et al., *Simulating the 199A Deduction for Pass-through Owners*.)

[23] Goodman et al., *Simulating the 199A Deduction for Pass-through Owners*, p. 18.

[24] It may come as a surprise that the OTA analysis found that professional services would have realized the largest tax savings (with and without limitations) from the deduction, if it had been available in 2016. The industry encompasses firms primarily engaged in law, accounting, and consulting, each one considered an SSTB. But Goodman et al. found that professional services included subgroups that were not deemed SSTBs, such as computer and specialized design services and advertising. They also noted that many SSTB owners had taxable incomes below the 2018 lower income threshold for the deduction, allowing them to claim the maximum deduction.

[25] Goodman et al., *Simulating the 199A Deduction for Pass-through Owners*, p. 17.

industries with relatively large tax savings (e.g., professional services) had many SSTBs. This happened because these industries had some subindustries with few SSTBs and most pass-through business owners in these industries had taxable incomes below the lower income threshold, allowing them to claim the maximum deduction.

Worker Classification and Independent Contractors

The Section 199A deduction applies to QBI, not wage income. As a result, it offers an incentive for wage earners to become independent contractors.

Starting in the 1980s, many larger U.S.-based companies began to restructure their businesses around "core competencies," which were activities deemed likely to produce the largest returns for stockholders. Other activities (e.g., facilities maintenance, accounting, human resources, and janitorial services) were increasingly outsourced to subcontractors. This process, known as *workplace fissuring*, allowed an employer to cut its labor costs. Some individuals who lost their jobs because of outsourcing ended up working as independent contractors providing the same or similar services to their former employers but at reduced wages and with reduced or no benefits.[26]

In the congressional debate preceding the enactment of the TCJA, some expressed concern that Section 199A deduction would trigger a surge in the number of employees becoming independent contractors to benefit from the deduction. There is no evidence of such an increase since 2018. There are several reasons why the Section 199A deduction is unlikely to spur a large expansion in the domestic pool of independent contractors.

First, the final regulations for Section 199A (TD 9487) make it difficult for a former employee working as an independent contractor and providing a service to a former employer to benefit from the deduction. According to the regulations, an independent contractor who provides the same or similar services to a former employer or a related entity is presumed to be providing services as an employee. Consequently, this person is ineligible for the Section 199A deduction. The regulations allow an independent contractor to challenge this *presumption*, but it is up to that person to prove to the IRS through records such as partnership agreements and work contracts that she or he has not worked as an employee for at least three years after her or his most recent employer stopped treating the individual as an employee for the purpose of the federal payroll tax.

Second, the tax savings from the deduction may not compensate for the disadvantages of working as an independent contractor. Typically, there are few legal protections for independent contractors regarding the minimum wage, overtime pay, sexual harassment, and workplace safety. Employers that provide benefits to employees (e.g., paid family and medical leave, unemployment insurance, workers' compensation, health insurance, and retirement benefits to full-time employees) are not required to provide them to independent contractors. And independent contractors are required to pay the entire 15.3% payroll tax, whereas employees share the tax equally with employers, each paying 7.65%.

Third, the Section 199A deduction offers employers no safe harbor for classifying workers as independent contractors. Under current law, a company is allowed to classify an employee as an independent contractor for tax purposes only if the employee's work status satisfies a 20-factor

[26] David Weil, "How To Make Employment Fair in An Age of Contracting and Temp Work" *Harvard Business Review*, March 24, 2017, https://hbr.org/2017/03/making-employment-a-fair-deal-in-the-age-of-contracting-subcontracting-and-temp-work.

test focused on the degree of control the company has over the services the employee provides and the method of payment for those services.[27]

Policy Options

The Section 199A deduction is scheduled to expire at the end of 2025. Congress may consider the advantages and disadvantages of extending it between now and then.[28] Whatever Congress decides to do may have significant implications for businesses that account for considerable shares of domestic business income and employment.[29]

The main options are to

- allow the deduction to expire at the end of 2025;
- permanently extend the deduction with no changes;
- permanently extend the deduction with changes; and
- replace the deduction with an alternative method of taxing pass-through businesses.

Allow the Deduction to Expire

This option would reinstate in 2026 the tax treatment of pass-through business income that applied in 2017. If the deduction and the TCJA's cuts in individual income tax rates are both allowed to expire, the top marginal tax rate for pass-through business profits would rise to 39.6%, from 29.6% under current law.

Permanently Extend the Deduction with No Changes

This option would retain the current Section 199A deduction without changing its structure. A key consideration with this option is its revenue cost. A 2020 TPC study estimated that a permanent extension of the deduction in its current form would reduce tax revenue by $1.7 trillion from 2026 to 2040, relative to a baseline without the deduction.[30] The TPC's analysis attributed $279 billion (or 16%) of that amount to income shifting, reflecting the deduction's incentives for wage earners and corporations to switch to pass-through status.

Permanently Extend the Deduction with Changes

This option would retain the Section 199A deduction with structural changes. Of course, the changes would depend on lawmakers' policy aims. One aim might be to make the current

[27] For details on this test, see IRS, "Understanding Employee vs. Contractor Designation," July 20, 2017, at https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation.

[28] Scott Greenberg and Nicole Kaeding, *Reforming the Pass-through Deduction*, Tax Foundation, Fiscal Fact No. 593, June 2019, pp. 22-23.

[29] According to data compiled by the Tax Foundation, in 2014, pass-through firms represented 86% of all U.S. firms and employed 57% of the U.S. private-sector workforce; in 2012, pass-through firms (as a whole) earned 48% more net income than C corporations did: $1.63 trillion compared to $1.10 trillion. See Scott Greenberg, "Pass-through Businesses: Data and Policy," *Tax Foundation*, January 17, 2017, https://taxfoundation.org/pass-through-businesses-data-and-policy/.

[30] Benjamin Page et al., *Tax Incentives for Pass-through Income*, Tax Policy Center, July 15, 2020, p. 8.

deduction more generous by raising its rate to, for example, 25% and allowing all pass-through firms to benefit from it, regardless of line of business and an owner's taxable income.

Another aim might be to lower the deduction's compliance cost. A 2019 proposal by The Tax Foundation might have that effect.[31] Under the proposal, pass-through business owners would have two choices for calculating their Section 199A deduction: (1) a "simplified deduction," or (2) a deduction based on their investment in the current tax year. The simplified deduction would allow an owner to deduct his or her QBI up to a certain amount that would be indexed for inflation (e.g., $6,000 for joint filers and $3,000 for all other filers). Those choosing the investment-based deduction would be allowed to deduct 20% of their QBI, but the QBI would be based on the adjusted basis of qualified property a business places in service during the current tax year. An owner would calculate her or his share of the total amount of this property at the end of the year and multiply the amount of that share by a fixed rate of return. The resulting dollar amount would be an owner's QBI for the year. In this option, the deduction would operate like an investment tax subsidy.

Others have suggested retaining the deduction but enhancing its job-creation potential. Among the options are (1) limiting the deduction to pass-through business owners who pay W-2 wages and (2) making all pass-through business income (including SSTB income) eligible for the deduction, regardless of an owner's AGI.

Replace the Deduction with a More Efficient Approach to Taxing Pass-through Business Profits

Congress might consider replacing the Section 199A deduction with an approach to taxing noncorporate business profits that avoids the efficiency concerns raised by the present deduction. Such a change might serve a variety of policy aims, including simplifying business taxation, raising more revenue, and promoting business activities (e.g., R&D investment) that could drive faster economic and productivity growth.

Eric Toder of the TPC has proposed two options for reforming the taxation of noncorporate business income.[32] One option would repeal the deduction and instead tax all privately held C corporations on the same terms as pass-through entities. This would mean that all business profits except those of publicly held C corporations would be taxed at the same rates as wage income. Special rules would be needed to tax the accumulated profits of C corporations required to switch to pass-through status. The profits of publicly traded C corporations would continue to be taxed at the current corporate tax rate (21%), and their owners would continue to face a second level of tax on dividends they receive and long-term gains they realize.

Toder's second option would tax wage income and pass-through business profits at the same rates but continue to tax privately held C corporation income at the corporate tax rate.[33] Privately held C corporation profits would be allocated to stockholders according to their ownership shares and taxed under the individual tax, whether or not they are distributed. Such tax treatment already applies to pass-through business profits. The income tax for publicly held C corporations would operate as a withholding tax for which shareholders would claim a credit when they file their

[31] Scott Greenberg and Nicole Kaeding, *Reforming the Pass-through Deduction*, Tax Foundation, Fiscal Fact No. 593, June 2019, pp. 22-23.

[32] Eric Toder, "Eliminate the Deduction for Qualified Business Income and Require Most Firms to Be Taxed as Pass-throughs," Tax Policy Center, *TaxVox Blog*, June 4, 2018.

[33] Ibid.

individual tax returns. A two-level income tax would still apply to the profits of publicly traded C corporations distributed to shareholders.

Toder's proposal would not equalize the tax treatment of pass-through business profits and publicly held C corporation profits. Achieving tax neutrality would require taxing income received by shareholders from publicly held C corporations on an accrual basis to prevent shareholders from accumulating tax-preferred income within corporations.

Some proposals would reform the taxation of business profits on a broader scale. For example, in 2020, Jason Furman proposed making broader changes in business taxation to raise more revenue, foster faster U.S. economic growth, and simplify tax compliance for small business owners. His proposal would

- retain a 100% Section 168(k) expensing allowance and expand it to include structures and all intangible assets, make this treatment permanent, and disallow interest deductions linked to new investment;
- increase the corporate tax rate to 28%;
- require large firms to file as a C corporation, while giving smaller firms the choice to file as a C corporation or a pass-through entity;
- repeal the Section 199A deduction;
- eliminate "corporate loopholes"; and
- enhance the R&D tax credit under Section 41 by increasing the alternative simplified credit's top rate from 14% to 20%.[34]

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[34] Prepared testimony of Jason Furman, in U.S. Congress, House Committee on Ways and Means, *The Disappearing Corporate Income Tax*, hearings, 116th Cong., 2nd sess., February 11, 2020 (Washington, DC: GPO, 2020).