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

The 2017 tax revision (P.L. 115-97, also known as the Tax Cuts and Jobs Act or TCJA) created a temporary deduction for qualified pass-through business income (QBI) under Section 199A of the federal tax code. The maximum deduction is equal to *the lesser* of (1) 20% of a firm's qualified business income (QBI) in a tax year or (2) 20% of its taxable income without the Section 199A deduction and any net capital gains. The deduction is scheduled to expire at the end of 2025.

The Section 199A deduction helps establish parity between the tax burden on corporate and noncorporate profits. The TCJA also reduced the corporate tax burden by replacing a graduated rate structure with a top rate of 35% under prior law with a single rate of 21%, a 40% decrease. By contrast, the maximum Section 199A deduction lowers the top effective tax rate on pass-through business profits from 39.6% to 29.6%, a 25% decrease.

Pass-through businesses fall into three categories: sole proprietorships, subchapter S corporations, and partnerships (including limited liability companies electing to be taxed as partnerships). In each category, the items of income, loss, gain, and deduction for a business are attributed (or passed through) to the owners, and any profits are taxed as part of their individual taxable income, regardless of how the profits are distributed.

By contrast, subchapter C corporation profits are taxed twice: once at the entity level, and a second time at the owners' individual 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 entity. According to Internal Revenue Service (IRS) data, pass-through firms accounted for 96% of the 38 million business tax returns filed for the 2019 tax year; sole proprietorships filed 76% of pass-through business returns.

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. Owners of agricultural and horticultural cooperatives may also claim the deduction. Taxpayers may claim the deduction after computing their adjusted gross income (AGI).

A pass-through business owner's QBI is the net amount of income, loss, gain, and deduction for each qualified domestic trade or business he or she owns. 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.

QBI does not include wage income, 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 and payments to partners for services they perform for their business.

Use of the Deduction

Use of the deduction hinges on four considerations: (1) a pass-through business owner's taxable income, (2) the nature of the owner's business, (3) the owner's share of W-2 wages for the business, and (4) the owner's share of the unadjusted basis of tangible, depreciable property placed in service in the past 10 years.

Taxable income refers to a pass-through business owner's AGI less all deductions, except for the Section 199A deduction. Owners whose taxable income is at or below the deduction's lower income threshold ($383,900 for joint filers and $191,950 for other filers in 2024) may claim the maximum deduction for any kind of business.

For owners with taxable income above that threshold, the deduction they may claim is subject to two limitations.

One limitation is based on a business's W-2 wage base and stock of tangible capital assets and can be labeled the wage-and-qualified-property (WQP) limit. A business's W-2 wage base is the sum total of its wages subject to withholding, elective deferrals, and deferred compensation. A business's capital stock refers to the unadjusted basis of tangible, depreciable assets it placed in service in the previous 10 years.

The other limitation is based on whether or not a business qualifies as a "specified service trade or business" (SSTB). A SSTB is any trade or business involved 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. A SSTB is also any business whose principal asset is the reputation or skills of one or more of its employees and/or owners.

The two limitations on the Section 199A deduction phase in if an owner's taxable income lies between the deduction's lower income threshold and its upper income threshold ($483,900 for joint filers and $241,950 of other filers in 2024). Both thresholds are indexed for inflation. Separate formulas determine the deduction an owner may claim under each limitation. Owners with taxable income above the upper income threshold may claim no deduction for SSTB QBI; in the case of non-SSTB QBI, an owner may claim a deduction equal to the larger of 50% of an owner's share of a business's W-2 wage base or 25% of that base plus 2.5% of an owner's share of the business's capital stock.

Three Basic Outcomes

The rules for the use of the Section 199A deduction for QBI mean that eligible taxpayers face three basic outcomes, depending on their taxable income.

Outcome 1

Pass-through business owners with taxable income at or below the 2024 lower income threshold may take the maximum Section 199A deduction.

Outcome 2

Pass-through business owners with taxable income between the 2024 lower and upper income thresholds may take a reduced deduction because they are subject to the SSTB and WQP limits. In the case of taxpayers with SSTB or non-SSTB income only, the allowable deduction depends on a pass-through business owner's "applicable percentage," which is the ratio of an owner's taxable income minus the applicable lower income threshold to $100,000 for joint filers and $50,000 for other filers. This percentage is used to calculate a reduction amount, which is subtracted from a taxpayer's deduction with no limits to determine the Section 199A deduction an owner may claim. This calculation is more complicated if an owner has both SSTB and non-SSTB income.

Outcome 3

Pass-through business owners with taxable income above the 2024 upper income threshold may claim no deduction for SSTB income. They may claim a deduction for non-SSTB income that cannot exceed the larger of (1) 50% of an owner's share of a business's W-2 wage base or (2) 25% of those wages plus 2.5% of an owner's share of the business's unadjusted basis of qualified property placed in service in the previous 10 years.

Initial Filing Concerns

It is estimated that over 90% of pass-through business owners might have qualified for a full or partial Section 199A deduction in 2018, the first year the deduction was available. However, data from the 2019 filing season indicated that many eligible owners did not claim it. In a 2020 report, the Treasury Inspector General for Tax Administration (TIGTA) found that nearly 880,000 of the federal tax returns processed as of May 2, 2019, that appeared to be eligible for the deduction did not claim it. Eligibility was determined according to the net income they reported on Schedule C (for sole proprietors) or Schedule E (for partners or S corporation shareholders). The taxable income of each filer did not exceed the deduction's lower income threshold for 2018.

It is unclear from the TIGTA report why so many pass-through business owners failed to take the deduction. The report mentioned four likely explanations: (1) the owners were unaware of the deduction; (2) the software used to prepare their returns lacked clear guidelines about the determination of QBI; (3) the taxpayers earned substantial business income outside the United States, which is ineligible for the deduction; and (4) they chose not to claim the deduction because they did not understand how to calculate it. The IRS promised to invest more to increase awareness of the deduction among small business owners.

Among the continuing challenges in claiming the deduction is determining whether certain 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 business income. In many cases, a business's eligibility is likely to hinge on relevant "facts and circumstances."

Policy Issues

Congress may consider whether to extend and modify the Section 199A deduction before it expires at the end of 2025. Analysts point out that there are reasons to retain the deduction (though not necessarily in its current form) and reasons to let it expire.

Proponents of extending the deduction argue that it provides pass-through firms with a powerful incentive to invest more than they otherwise would by reducing their cost of capital for investment in a wide range of tangible and intangible assets and increasing their short-term cash flow. It is unclear to what extent any rise in pass-through business investment since 2018 can be attributed to the Section 199A deduction. It is difficult to disentangle its investment effects from the pass-through business investment effects of the TCJA's temporary individual income tax rate cuts and 100% expensing allowance for certain capital certain assets placed in service between 2018 and 2022.

Critics of the deduction acknowledge the Section 199A deduction's potential for boosting pass-through business investment, but they say there are several reasons why it should not be extended beyond 2025. In their view, the deduction is an inefficient investment incentive because a business can benefit from it without undertaking new investments. Critics also note that the deduction is non-neutral in its impact on pass-through business income, encouraging investment and growth in some industries but not all industries. In addition, critics says the deduction reduces horizontal equity in the federal income tax, creates new opportunities for small business owners to underreport their income to the IRS, and deters many eligible taxpayers from claiming it because of its complexity.

Some call for replacing the deduction with a more efficient system for taxing business income. Options include progressively taxing the profits of all pass-through businesses and privately held corporations at the same rate while keeping the current corporate income tax for publicly held corporations and implementing new measures to reduce income underreporting by pass-through businesses.

Gary Guenther, Analyst in Public Finance

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