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IN FOCUS

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# Estimated Effects on Effective Tax Rates and Revenues of Increasing the 199A Deduction for Pass-Through Businesses

Under Section 199A of the Internal Revenue Code (IRC), owners of pass-through businesses are eligible to claim a deduction of up to 20% of a firm's qualified business income, subject to certain limitations. The deduction was added to the tax code from 2018 to 2025 by the 2018 reconciliation law (P.L. 115-97). The 2025 reconciliation law (P.L. 119-21) made the deduction permanent and widened eligibility limits. According to the Joint Committee on Taxation's (JCT's) most recent estimates, the extension and changes to the deduction made by the 2025 reconciliation law are expected to reduce federal tax revenues by $736.5 billion from FY2025 to FY2034.

This In Focus provides an overview of the 199A deduction, briefly examines selected key policy issues of the deduction generally, and presents estimated effects on effective tax rates and revenues of increasing the deduction to 25%. Increasing the deduction's rate from 20% was considered during the debate over the 2025 reconciliation law. The chair of the House Ways and Means Committee reportedly expressed interest in increasing the deduction to 25%.

## Overview of the Deduction

How a business is taxed at the federal level depends partly on how it is organized. A firm can be organized as either a C corporation or a pass-through entity (i.e., partnership, S corporation, limited liability company, or sole proprietorship). C corporation profits are taxed once according to the corporate tax system, and then potentially a second time at the shareholder level when corporate dividend payments are made or capital gains are recognized. Pass-through business profits are, in general, not subject to the corporate tax. Instead, the income of these businesses passes through to the individual owners who pay tax according to individual income tax rates.

Under current law, the tax rate for corporate income is permanently set at a flat rate of 21% for tax years after 2017. Most corporate dividends and capital gains recognized by individual shareholders are subject to a maximum tax rate of 23.8% (this includes the 3.8% net investment income tax). In contrast, the tax rates on pass-through income range from 10% to 37%.

IRC Section 199A allows individuals, estates, and trusts with pass-through business income to deduct up to 20% of their qualified business income (QBI) in determining their taxable income. Owners of agricultural and horticultural cooperatives may also claim the deduction. Taxpayers do not need to itemize to claim the deduction.

To understand the basic mechanics of the 199A deduction, consider a pass-through business owner with taxable business income of $100. Prior to P.L. 115-97, the owner would pay tax on the $100 of income. With the 199A deduction, the owner pays tax on only $80 of income (assumes all income is QBI). The effect of the deduction is thus to reduce the owner's effective marginal tax rate by 20%. For example, if the owner faced a 37% tax rate, the effective tax rate would be 29.6%, computed as 37% multiplied by $(1 - 0.20)$.

In practice, determining QBI and the amount of the deduction is more complicated than this simplified example suggests. A pass-through business owner's QBI is the net amount from items of income, loss, gain, and deduction for each qualified domestic trade or business he or she owns. QBI does not include wage income, capital gains, dividends, interest, and annuity income unrelated to a trade or business. Taxpayers who own more than one pass-through business are required to determine the QBI for each and combine them to determine the taxpayer's total QBI in a tax year.

The 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, or medicine. Whether the limits apply depends on a taxpayer's taxable income (without the deduction) and filing status. In 2026, no limit applies if a taxpayer's taxable income is less than $403,500 for joint filers and $201,750 for other filers. The limits phase in for income between $403,500 and $553,500 for joint filers, and between $201,750 and $276,750 for other filers. 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

According to IRS data, the number of 199A deduction claims rose from 18.7 million in 2018, when it was first available, to 26.6 million in 2023 (the most recent year for which data are available). The total amount of claims rose from $150.0 billion to $214.6 billion over that period.

**Table 1** shows a distributional summary, by adjusted gross income (AGI), of 199A claimants in 2023. The figures indicate that pass-through business owners with less than $1 million in AGI accounted for 97.7% of claimants. The shares of the total $214.6 billion in deductions claimed were more evenly distributed across incomes. **Table 1**

indicates that the average claim amount increased with income, with those earning less than $200,000 deducting $2,790 on average, and those with an AGI of $5 million and above deducting $724,162 on average.

**Table 1. Use of 199A Deduction in 2023 by AGI**

| 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 | 74.7% | 25.8% | $2,790 |
| $200,000 to $1 million | 23.0% | 31.3% | $10,977 |
| $1 million to $5 million | 2.1% | 21.0% | $82,544 |
| $5 million and above | 0.2% | 22.0% | $724,162 |
| **Overall** | 100% | 100% | $8,079 |

**Source:** Internal Revenue Service, *Individual Income Tax Returns: Complete Report*, Table 1.4, 2023.

## Investment, Employment, and Wages

Proponents of the 199A deduction argue that it encourages increased investment by pass-throughs, which, in turn, is accompanied by increased hiring and wage growth. Research on the 199A deduction's economic impact is limited. In one of the only empirical studies on the deduction, researchers found "little evidence of changes in real economic activity as measured by physical investment, wages to non-owners, or employment." A lack of an investment or employment response may be partly attributable to the deduction's design.

The 199A deduction is not a direct investment subsidy. A firm may benefit from the deduction without increasing its investment. The deduction, however, may encourage investment because it reduces the effective tax rate on new investment. At the same time, the deduction also reduces the effective rate on past investments, which produces a windfall tax benefit on prior investment.

Similarly, the deduction is not technically an employment or wage subsidy. A firm can benefit from it without hiring more workers or raising wages. 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 labor productivity, which, in turn, can result in increased hiring and wage growth.

## Tax Parity

The Section 199A deduction promotes parity between the tax burden on corporate and noncorporate profits. P.L. 115-97 reduced the maximum corporate tax of 35% to 21%. Prior to P.L. 115-97, pass-through income was subject to a maximum marginal tax rate of 39.6%, which, left unchanged, would have resulted in a sizeable difference between the 21% corporate tax rate and the tax rates applicable to pass-throughs. However, P.L. 115-97 lowered the maximum individual marginal tax rate to 37%, which, combined with the 199A deduction, results in a maximum statutory marginal tax rate of 29.6%.

**Table 2** presents CRS estimates of marginal effective tax rates on investment by business form under 2026 current law and under an enhanced 199A deduction (25%). The marginal effective rates presented in **Table 2** capture major features of the tax code impacting business investment, including the statutory corporate and pass-through business tax rates, R&D tax credit, 199A deduction, depreciation rules, and, for C corporations, individual-level taxes.

**Table 2. Marginal Effective Tax Rates on Investment**

| Business Form | Current Law | 25% 199A | No 199A |
|---|---|---|---|
| Pass-through | 17.0% | 16.1% | 20.9% |
| C corporation | 9.5% | 9.5% | 9.5% |
| **Difference (percentage points)** | 7.5 | 6.6 | 11.4 |

**Source:** CRS estimates; see CRS Report R48277, *CRS Model Estimates of Marginal Effective Tax Rates on Investment Under Current Law*, by Mark P. Keightley and Jane G. Gravelle, for more information.

Increasing the 199A deduction from 20% to 25% is estimated to reduce the effective tax on new pass-through investment from 17.0% to 16.1%, and therefore would reduce the tax differential across business forms by 0.9 percentage points (or 12%). **Table 2** also shows that if there were no 199A deduction, the estimated marginal tax rate on new pass-through investment would be 20.9% compared to the 9.5% rate on corporate investment.

## Potential Revenue Effects

CRS uses two open-source microsimulation tax models to estimate the revenue effects of changes to federal tax law: the Budget Lab at Yale's (TBL's) Tax-Simulator and the Policy Simulation Library's (PSL's) Tax-Calculator.

Using the TBL model, CRS estimates a potential revenue loss of $199 billion over 2026-2035 from increasing the deduction to 25%, and a revenue loss of $69.3 billion over 2026-2035 using the PSL model. The difference in model estimates highlights a known difficulty in modeling changes to the deduction: Its value depends on business-level inputs that are not directly reported in the data source that both models use and therefore must be imputed. See CRS Report R49052, *A Comparison of Two Open-Source Tax Microsimulation Models*, by Mark P. Keightley and Brendan McDermott, for more on the TBL and PSL models.

The TBL and PSL model estimates are intended to inform congressional deliberations and would likely differ from those produced by the JCT. The JCT is the official tax revenue estimator for Congress.

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