TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

TAX INCENTIVES FOR PASS-THROUGH INCOME

Benjamin Page, Jeffrey Rohaly, Thornton Matheson, and Aravind Boddupalli
July 15, 2020

ABSTRACT
This chartbook explores the implications of the tax-advantaged treatment of pass-through income enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA). Section 199A of the TCJA allows a deduction from taxable income of 20 percent of certain pass-through income. We look specifically at the incentives that deduction created for taxpayers to shift the form of entity through which they choose to receive income. We then analyze the revenue and distributional effects of permanently extending that deduction, which is currently scheduled to expire after 2025. We demonstrate that such an extension could have a significant impact on the form of income chosen by taxpayers among wages, corporate earnings, or pass-through income. Moreover, such income shifting could have a substantial effect on the revenue cost of extension and could affect the distribution of the tax benefits of the deduction.

Introduction

Many businesses in the United States are organized as "pass-through" entities rather than as traditional corporations. Those businesses do not pay the corporate income tax; rather, they pass income and deductions (profits and losses) through to owners, who report the income and pay tax on it through their individual tax returns. Pass-through businesses include sole proprietorships, partnerships, and S corporations.

Pass-through income flows through to owners, where most is subject to ordinary income tax rates and some is taxed at the lower capital gains rate. Only some is subject to payroll taxes (called Self-Employed Contributions Act [SECA] taxes for self-employed people).

Corporate income, in contrast, is subject to two levels of taxation: profits are taxed at the corporate level, then dividends and realized capital gains are taxed again at the shareholder level (though these rates may be lower than those on ordinary income).

The Tax Cuts and Jobs Act of 2017 (TCJA) reduced tax rates on certain qualifying income of pass-through businesses by providing a new deduction of up to 20 percent of qualified business income (QBI). The TCJA also reduced tax rates on corporations and individuals. Changing the relative tax rates among pass-through businesses, corporations, and individuals creates incentives to shift the form in which income is received. For example, if pass-through income faces lower tax rates than ordinary income, workers have a tax incentive to reclassify wage or salary income as pass-through income. Similarly, when pass-through income faces lower tax rates than the combined individual and corporate rates on corporate income, firms have a tax incentive to organize as pass-through businesses rather than corporations.

The QBI deduction is scheduled to expire (along with many other provisions of the TCJA affecting individual income taxes) at the end of 2025. In this chartbook, we analyze how permanently extending the QBI deduction (but not any of the other expiring provisions) would cause people to shift income among pass-through, corporate, and wage and salary forms as well as how those shifts would affect revenues.

To estimate how much people might shift from wage and salary to pass-through income, we reviewed evidence from a range of empirical studies. Based on this evidence, we concluded that for every additional 1 percentage point increase in the difference between the marginal tax rate on pass-through and wage income, 0.4 percent of income would shift from the higher- to the lower-taxed form if the tax difference were permanent and shifting faced no restrictions. For two main reasons, we used a lower elasticity of 0.2 in our estimates of the effect of extending the current law pass-through deduction. First, we concluded that some of the income that had shifted from wages and salaries to pass-through in response to the deduction would not return to wages and salaries when the deduction expires after 2025, because at that point both forms of income will face the same tax rate. That persistence of the shift to pass-through form in the current-law baseline reduces the effect of extending the deduction in comparison to that baseline. Second, the law defining the portion of pass-through income that is QBI includes "guardrails," or limitations on shifting, that we conclude would reduce the amount of shifting. Our estimates also assume that the full amount of shifting from wage and salary to pass-through income would phase in over three years as workers revise their compensation arrangements.

Similarly, based on empirical studies, we determine that for every additional 1 percentage point increase in the difference between the corporate tax rate (including dividend and capital gains taxes paid by shareholders) and the pass-through rate, 0.7 percent of the corporate tax base would shift to pass-through income. Moreover, we estimate the share of pass-through income that is eligible for treatment as QBI. Taxpayers with less than a certain level of adjusted taxable income ($157,000 for singles and $315,000 for couples) can claim the QBI deduction for all their pass-through income regardless of how it is generated. Above that threshold, pass-through income qualifies for the deduction based on the type of business that generates it and the business's labor and capital structure. Income earned by an entity that is a "specified service trade or business" (SSTB) as defined by the statute (one that provides medical or legal services, for example) is ineligible for the deduction for taxpayers with income above the adjusted taxable income thresholds. Based on Internal Revenue Service data, we estimate that the share of pass-through income earned by SSTBs varies depending on whether the income is derived from a sole proprietorship, a partnership, or an S corporation (figure 1).

Based on those estimates, as well as estimates of the effect of the capital and labor structure restrictions and the amount of pass-through income earned by households below the adjusted taxable income thresholds, we estimate the amount of pass-through income that would qualify for the pass-through deduction in 2026 if it were permanently extended (figure 2).

Based on the qualifying income and the difference between tax rates on corporate and qualified pass-through income, we estimate the total amount of income that would shift between corporate and pass-through forms if the pass-through deduction were extended beyond 2025. Similarly, based on the difference between the rate on pass-through income and that on wages and salaries, we estimate the total amount of income that would shift from wages to pass-through income (figure 3).[1]

Using the Tax Policy Center's microsimulation model, we then estimate the distribution of total pass-through income and QBI (figure 4) and the distribution of the tax benefits of extending the QBI deduction beyond 2025 (figure 5).

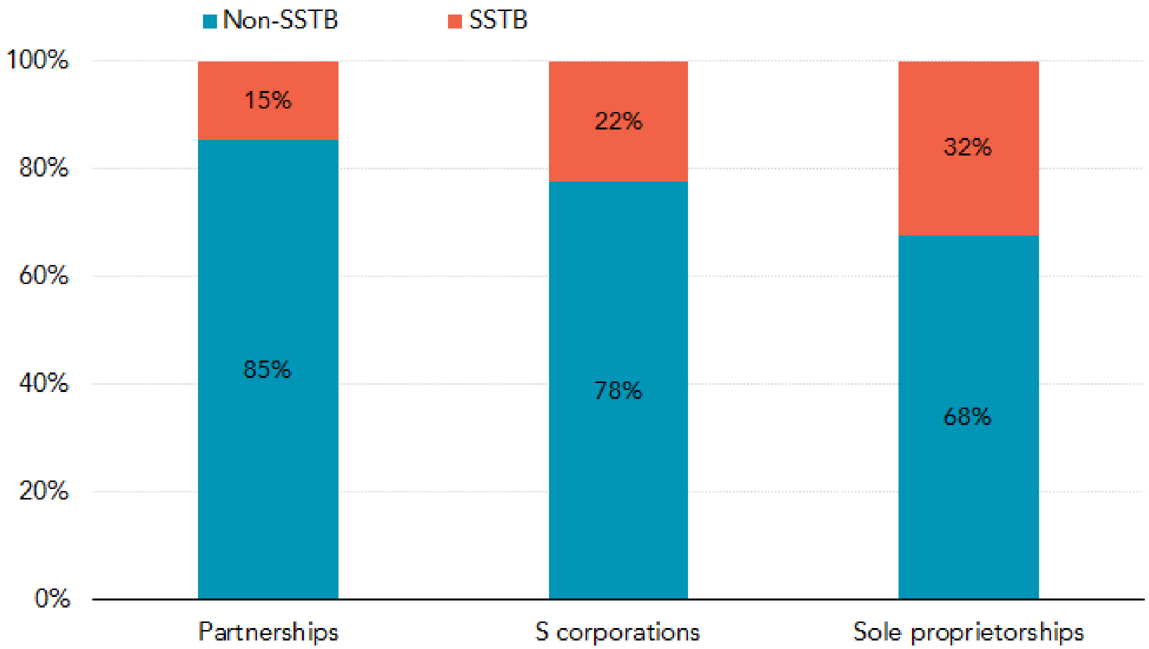
Lastly, we estimate the revenue loss from extending the deduction and the amount of that loss attributable to income shifting (figure 6). Underlying data for most figures can be found in the appendix (tables 1 through 4).

[1] This analysis was conducted prepared before the decline in economic activity caused by the COVID-19 epidemic. Our data reflect economic conditions as projected by the Congressional Budget Office in January 2019.

FIGURE 1

Share of Pass-Through Income Earned by Specified Service Trades or Businesses (SSTBs)

Share of total pass-through income by entity type, 2017



Sources: Internal Revenue Service, Statistics of Income, Nonfarm Sole Proprietorship Statistics (table 1, 2017), Partnership Statistics (table 2, 2017), and S Corporation Statistics (table 6.2, 2015); TPC calculations.
Notes: S corporation data are for 2015. SSTBs are those involving the performance of services in health, law, accounting, performing arts, consulting, athletics, financial services, and other fields where the principal asset is the reputation or skill of one or more employees or owners.

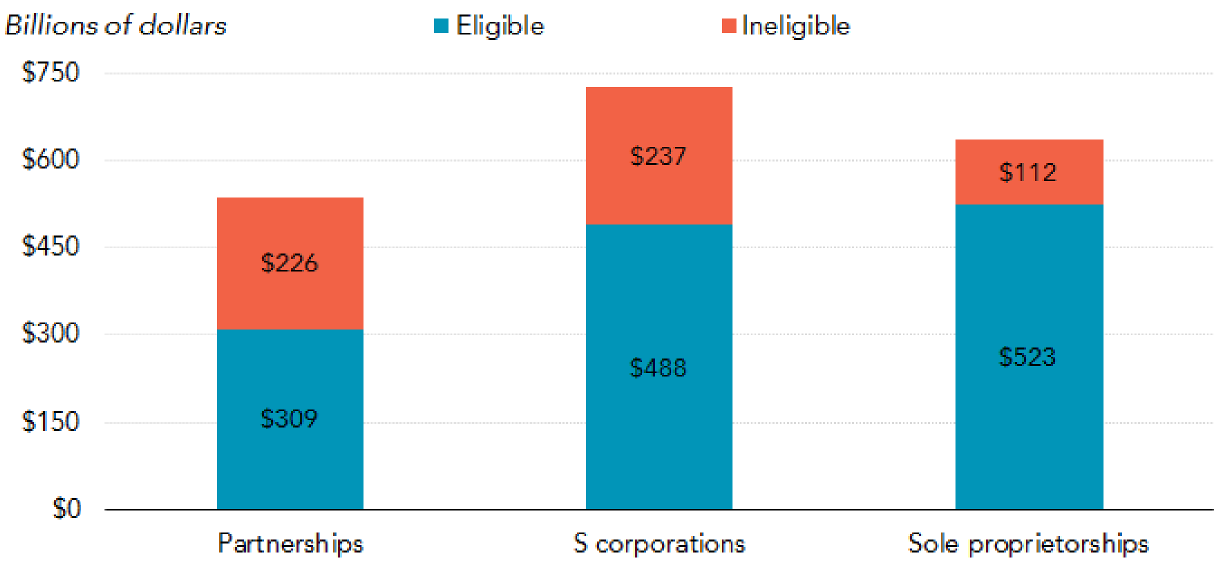
What share of pass-through business income is ineligible for the qualified business income deduction if earned by high-income taxpayers?

- "Specified Service Trade or Business" (SSTB) income is ineligible for the pass-through deduction if it is earned by a taxpayer earning above the adjusted taxable income threshold ($157,000 for single people and $315,000 for couples). SSTBs include include medical, legal, and accounting services as well as most services that derive value largely from human capital.
- Roughly one-sixth of partnership income, one-fifth of S corporation income, and one-third of sole proprietorship income are from SSTBs.

FIGURE 2

Pass-Through Income Eligible for the Qualified Business Income Deduction

Amount of total net positive pass-through income by entity type, 2026



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for 2026 as of March 17, 2020, with the qualified business income deduction permanently extended. We calculate pass-through income eligible for the deduction by imposing the restrictions on specified service trades or businesses and the limitations based on wages paid and capital owned by the businesses. Estimates shown do not incorporate the effects of income shifting and do not include the effect of the limitation based on taxable income less net capital gain.

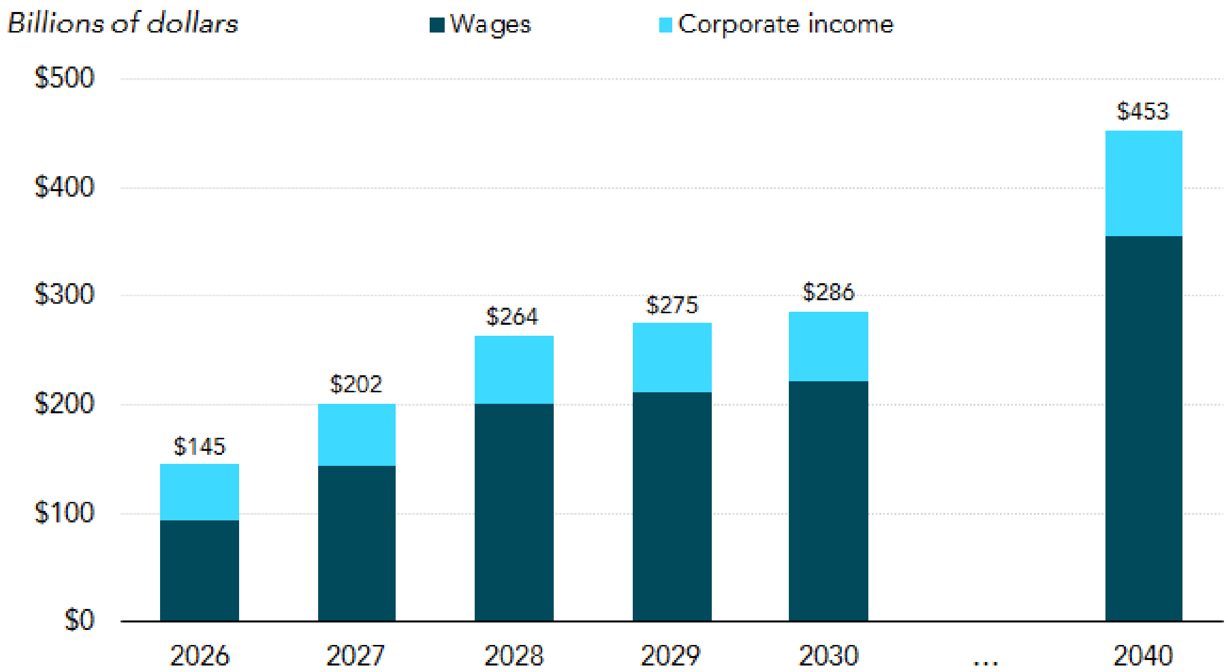
What amount of pass-through business income would qualify for the qualified business income deduction in 2026 if the deduction were permanently extended?

- The deduction for pass-through income above the adjusted taxable income threshold that is not disqualified as SSTB income is restricted to the lesser of (1) 20 percent of qualified inome or (2) the greater of 50 percent of wages or 25 percent of wages plus 2.5 percent of depreciable capital.
- Accounting for all the restrictions, out of a total of about $1.9 trillion in pass-through income in 2026, about $1.3 trillion (or 70 percent) would be eligible for the deduction if it were extended beyond 2025.

FIGURE 3

Income Shifting to Pass-Through Businesses

Amount of wages and corporate income shifted, 2026 through 2040



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for each year as of March 17, 2020, with the qualified business income deduction permanently extended. We assume a wage shifting elasticity with respect to the net of tax rate equal to -0.2, with 50 percent of the full effects phased in during the first year, 75 percent in the second year, and 100 percent in the third year; we assume a corporate income shifting elasticity of -0.7.

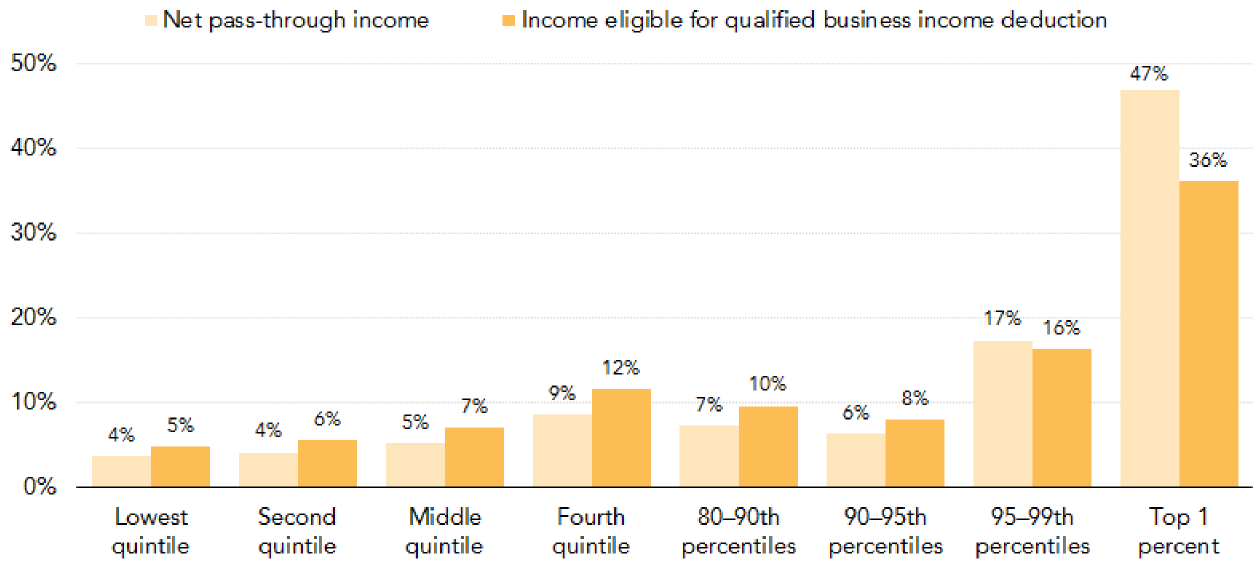
How much income would be shifted to pass-through income if the qualified business income deduction were permanently extended?

- If the deduction were permanently extended but other expiring provisions of TCJA were not, $145 billion of income would shift to pass-through income in 2026, rising to $453 billion by 2040.
- Most of the shifting would come from wages and salaries, but a substantial amount of corporate income would shift as well.
- We estimate the amount of income shifting from wages would rise over the first few years because it would take some time for employees to revise compensation agreements.

FIGURE 4

Distribution of Total Pass-Through Income and Qualified Business Income

Share of net pass-through income and eligible income, by income level, 2026



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for 2026 as of March 17, 2020, with the qualified business income deduction permanently extended. Income eligible for deduction represents the combined eligible income amount grossed up by dividing by the 20 percent rate. This amount is calculated after (a) applying the exclusion for a specified service trade or business; (b) netting of losses; and (c) applying the wage and capital limitation. Does not include the effect of the limitation based on taxable income less net capital gain.

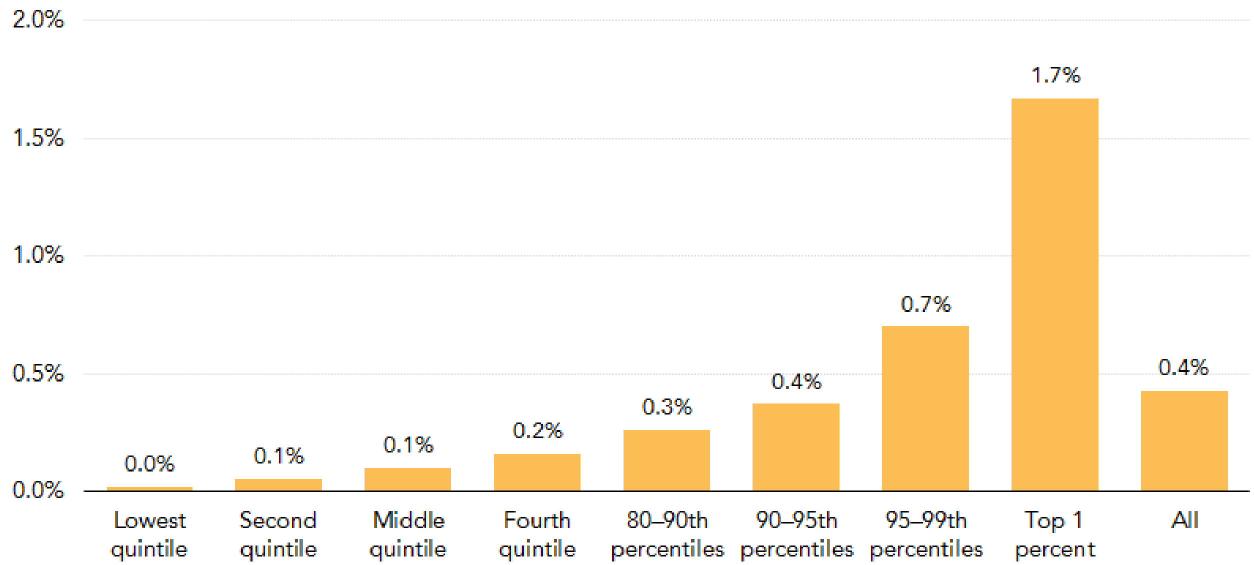
Who earns pass-through income?

- We estimate that in 2026 the distribution of pass-through income will be heavily concentrated among high-income households, with almost half of total net pass-through income going to the top 1 percent.
- However, because the restriction on specified service trades or businesses and the wage and capital requirements primarily affect only high-income households, their share of qualified business income eligible for the deduction is lower than their share of all pass-through income.

FIGURE 5

Distribution of Tax Benefits from the Qualified Business Income Deduction

Benefit as a share of after-tax income, by income level, 2026



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for 2026 as of March 17, 2020, with the qualified business income deduction permanently extended. We assume a wage shifting elasticity with respect to the net of tax rate equal to -0.2, with 50 percent of the full effects phased in during the first year, 75 percent in the second year, and 100 percent in the third year; we assume a corporate income shifting elasticity of -0.7. These estimates do not incorporate effects on payroll tax payments.

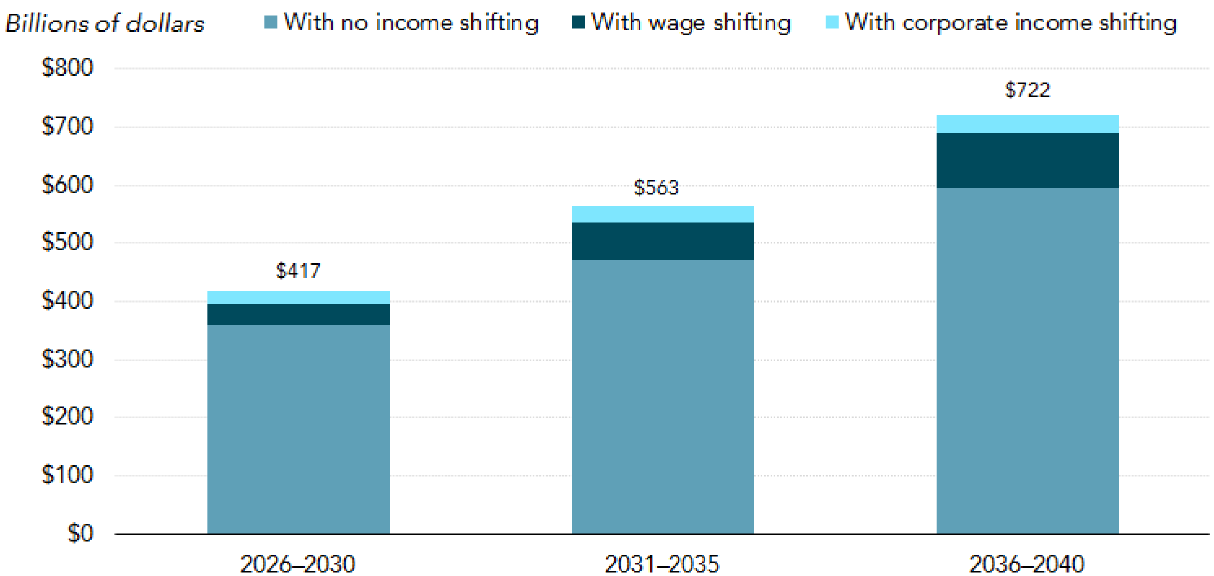
Who would benefit from making the qualified business income deduction permanent?

- The tax benefits of the deduction would increase overall after-tax income by about 0.4 percent, on average, in 2026.
- The tax benefits (as a share of after-tax income) rise with income.
- Households with lower incomes receive very little benefit from the deduction, on average.

FIGURE 6

Reduction in Tax Revenue from Permanently Extending the Qualified Business Income Deduction

With and without income shifting to pass-through businesses, fiscal years 2026 through 2040



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for each year as of March 17, 2020, with the qualified business income deduction permanently extended. We assume a wage shifting elasticity with respect to the net of tax rate equal to -0.2, with 50 percent of the full effects phased in during the first year, 75 percent in the second year, and 100 percent in the third year; we assume a corporate income shifting elasticity of -0.7. These estimates do not incorporate effects on payroll tax revenues.

How much would it cost to make the qualified business income deduction permanent?

- Permanent extension of the pass-through deduction would reduce revenues by a total of $417 billion over the 2026-2030 period. The cost would rise to $1.3 trillion over the ten-year period from 2031 to 2040.
- Income shifting would account for $58 billion of that amount through 2030 and $221 billion over the next 10 years.

TABLE 1

Income Shifting to Pass-Through Businesses

Billions of dollars, calendar years 2026 through 2040

Year	Wages	Corporate income	Total
2026	$92.6	$52.1	$144.7
2027	$144.1	$57.5	$201.6
2028	$200.3	$63.8	$264.1
2029	$211.4	$63.5	$274.9
2030	$220.8	$65.5	$286.3
2031	$231.6	$71.1	$302.7
2032	$243.0	$72.9	$315.8
2033	$254.8	$75.9	$330.8
2034	$267.3	$78.6	$345.9
2035	$280.4	$81.6	$362.0
2036	$294.1	$84.6	$378.7
2037	$308.5	$87.8	$396.3
2038	$323.6	$91.0	$414.6
2039	$339.4	$94.2	$433.7
2040	$356.0	$97.3	$453.3

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for each year as of March 17, 2020, with the qualified business income deduction permanently extended. We assume a wage shifting elasticity with respect to the net of tax rate equal to -0.2, with 50 percent of the full effects phased in during the first year, 75 percent in the second year, and 100 percent in the third year; we assume a corporate income shifting elasticity of -0.7.

TABLE 2

Distribution of Pass-Through Income

Billions of dollars, by income level, calendar year 2026

Expanded cash income percentile	Net income	Net loss	Income potentially eligible for the qualified business income deduction	Amount of qualified business income deduction
Lowest quintile	$76.9	$8.3	$76.9	$1.5
Second quintile	$86.6	$17.4	$86.6	$5.8
Middle quintile	$112.8	$31.3	$112.8	$14.5
Fourth quintile	$183.8	$51.0	$183.8	$28.6
80–90th percentiles	$154.4	$29.7	$152.8	$26.2
90–95th percentiles	$134.4	$19.8	$127.5	$21.9
95–99th percentiles	$366.1	$25.4	$259.3	$46.2
Top 1 percent	$984.5	$73.1	$572.9	$106.4
All	$2,115.6	$360.7	$1,588.8	$251.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for 2026 as of March 17, 2020, with the qualified business income deduction permanently extended. Income eligible for deduction represents the combined eligible income amount grossed up by dividing by the 20 percent rate. This amount is calculated after (a) applying the exclusion for a specified service trade or business; (b) netting of losses; and (c) applying the wage and capital limitation. Does not include the effect of the limitation based on taxable income less net capital gain.

TABLE 3

Distribution of Tax Benefits from the Qualified Business Income Deduction

By income level, calendar year 2026

Expanded cash income percentile	Share of total tax benefits (%)	Change in after-tax income (% points)
Lowest quintile	0.2%	0.02%
Second quintile	1.0%	0.05%
Middle quintile	3.4%	0.10%
Fourth quintile	7.9%	0.16%
80–90th percentiles	8.5%	0.26%
90–95th percentiles	8.0%	0.37%
95–99th percentiles	19.8%	0.70%
Top 1 percent	51.1%	1.67%
All	100.0%	0.43%

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for 2026 as of March 17, 2020, with the qualified business income deduction permanently extended. We assume a wage shifting elasticity with respect to the net of tax rate equal to -0.2, with 50 percent of the full effects phased in during the first year, 75 percent in the second year, and 100 percent in the third year; we assume a corporate income shifting elasticity of -0.7.

TABLE 4

Reduction in Tax Revenue from Permanently Extending the Qualified Business Income Deduction

Billions of dollars, fiscal years 2026 through 2040

Year	With no income shifting to pass-throughs	With wage shifting	With wage shifting and corporate income shifting
2026	$46.1	$49.0	$51.5
2027	$73.9	$79.9	$84.0
2028	$77.0	$85.7	$90.2
2029	$79.5	$89.4	$94.0
2030	$82.0	$92.5	$97.1
2026–2030	$358.6	$396.6	$416.8
2031–2040	$1,063.8	$1,227.1	$1,284.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
Notes: Baseline is the law currently in place for each year as of March 17, 2020, with the qualified business income deduction permanently extended. We assume a wage shifting elasticity with respect to the net of tax rate equal to -0.2, with 50 percent of the full effects phased in during the first year, 75 percent in the second year, and 100 percent in the third year; we assume a corporate income shifting elasticity of -0.7.

REFERENCES

Urban-Brookings Tax Policy Center. Sec199A Deduction for Qualified Business Income (QBI) (July 2020).

———. July 2020. T20-0221 - Make Sec199A Deduction for Qualified Business Income (QBI) Permanent: Impact on Tax Revenue, 2021-30 by Fiscal Year and Total for FY2031-40.

———. July 2020. T20-0222 - Make Sec199A Deduction for Qualified Business Income (QBI) Permanent: Distribution of Federal Tax Change by Expanded Cash Income Level, 2026.

———. July 2020. T20-0223 - Make Sec199A Deduction for Qualified Business Income (QBI) Permanent: Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2026.

———. July 2020. T20-0224 - Make Sec199A Deduction for Qualified Business Income (QBI) Permanent: Distribution of Federal Tax Change by Expanded Cash Income Level, 2030.

———. July 2020. T20-0225 - Make Sec199A Deduction for Qualified Business Income (QBI) Permanent: Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2030.

———. July 2020. T20-0226 - Tax Benefit of the Sec199A Deduction for Qualified Business Income (QBI); Baseline: Current Law, Distribution of Federal Tax Change by Expanded Cash Income Level, 2019.

———. July 2020. T20-0227 - Tax Benefit of the Sec199A Deduction for Qualified Business Income (QBI); Baseline: Current Law, Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2019.

———. July 2020. T20-0228 - Tax Benefit of the Sec199A Deduction for Qualified Business Income (QBI); Baseline: Current Law Plus Permanent Extension of QBI Deduction, Distribution of Federal Tax Change by Expanded Cash Income Level, 2026.

———. July 2020. T20-0229 - Tax Benefit of the Sec199A Deduction for Qualified Business Income (QBI); Baseline: Current Law Plus Permanent Extension of QBI Deduction, Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2026.

———. July 2020. T20-0230 - Tax Benefit of the Sec199A Deduction for Qualified Business Income (QBI); Baseline: Current Law Plus Permanent Extension of QBI Deduction, Distribution of Federal Tax Change by Expanded Cash Income Level, 2030.

———. July 2020. T20-0231 - Tax Benefit of the Sec199A Deduction for Qualified Business Income (QBI); Baseline: Current Law Plus Permanent Extension of QBI Deduction, Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2030.

ABOUT THE AUTHORS

Benjamin R. Page is a senior fellow at the Urban-Brookings Tax Policy Center. He leads the center's efforts to estimate the macroeconomic effects of tax policy and incorporate those effects into analyses of tax proposals (a process often referred to as dynamic analysis). Before joining Urban, he was closely involved in dynamic analysis at the Congressional Budget Office (CBO), including macroeconomic analysis of presidential budgetary proposals, the long-term outlook for the federal budget, and the effects of stimulus policies. From 2013 to 2016, he was unit chief of the fiscal policy studies unit of the macroeconomic analysis division of the CBO. He received an AB in economics from Stanford University and a PhD in economics from the Massachusetts Institute of Technology.

Jeffrey Rohaly is a principal research associate at the Urban-Brookings Tax Policy Center. He develops and maintains the center's microsimulation model of the federal tax system.

Thornton Matheson is a senior fellow at the Urban-Brookings Tax Policy Center. She currently works on environmental and corporate tax policies. She previously worked as a senior economist in the Tax Policy division of the International Monetary Fund's Fiscal Affairs Department and as a financial economist for the US Department of the Treasury's Office of Tax Analysis. She is best known for her studies on financial transaction taxes, which are published in the February 2012 issue of *International Tax and Public Finance* and the December 2014 issue of *Finanzarchiv*. She holds a PhD in economics from the University of Maryland, College Park, an MA in international relations from the Johns Hopkins School of Advanced International Studies, and a BA in literature from Yale University.

Aravind Boddupalli is a research analyst in the Urban-Brookings Tax Policy Center, where he contributes to projects regarding federal, state, and local tax and budget issues. Boddupalli graduated summa cum laude from the University of Minnesota with a BA in economics and political science.

This report was funded by the Peter G. Peterson Foundation. We are grateful to them and to all our funders, who make it possible for the Urban-Brookings Tax Policy Center to advance its mission.

The Tax Policy Center is a joint venture of the
Urban Institute and Brookings Institution.

For more information, visit taxpolicycenter.org
or email info@taxpolicycenter.org