

# **Economic activity supported by the Section 199A deduction**

Prepared on behalf of the S Corporation Association

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## Executive summary

Pass-through businesses, which include sole proprietorships, partnerships, and S corporations, are generally not subject to entity-level income tax. The entity's income, deductions, credits, and losses are generally passed through to the individual tax returns of the business owners, where they are taxed at the individual's income tax rate. The top individual income tax rate is currently 37%.

Section 199A of the Internal Revenue Code provides a 20% deduction for pass-through income, subject to limitations.<sup>i</sup> The Section 199A deduction was enacted as part of the Tax Cut and Jobs Act (TCJA) in December 2017. The Section 199A deduction went into effect in 2018 and is scheduled to expire at the end of 2025.<sup>ii</sup>

This report estimates the US economic activity – jobs, employee compensation, and gross domestic product (GDP) – supported by the Section 199A deduction in 2024. Specifically, this analysis provides a snapshot of the economic activity supported at businesses directly benefitting from the 199A deduction, as well as the economic activity connected to this economic activity (i.e., related supply chain activity and consumer spending).<sup>iii</sup>

### Key results

- ▶ **The total US economic activity supported by the Section 199A deduction in 2024 is estimated to be 2.6 million workers earning \$161 billion and generating \$325 billion of GDP.** The total economic activity supported by the Section 199A deduction – the economic footprint – consists of the economic activity at pass-through businesses directly supported by the deduction, as well as the related supplier activity and consumer spending.
  - Pass-through business activity directly supported by the Section 199A deduction. The Section 199A deduction is estimated to directly support 1.1 million workers at pass-through businesses. These workers are estimated to earn \$65 billion in employee compensation and generate \$132 billion of GDP in the United States in 2024. The average employee compensation per worker supported by the Section 199A deduction is estimated to be \$58,000 in 2024. Employee compensation is a component of GDP.
  - Related supplier activity. Pass-through businesses purchase goods and services from suppliers, supporting additional activity at their suppliers. The supplier activity related to the pass-through business activity directly supported by the Section 199A deduction is estimated to employ more than 590,000 workers throughout the US economy. These workers are estimated to earn \$43 billion in employee

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<sup>i</sup> Owners of certain agricultural or horticultural cooperatives, publicly traded partnerships (PTPs), and real estate investment trusts (REITs) are also eligible for this deduction.

<sup>ii</sup> For more details see, EY Tax Alert, “Final Section 199A regulations and other guidance provide welcome guidance, leave questions unanswered and raise new issues”, January 2019 <https://taxnews.ey.com/news/2019-0218-final-section-199a-regulations-and-other-guidance-provide-welcome-guidance-leave-questions-unanswered-and-raise-new-issues>.

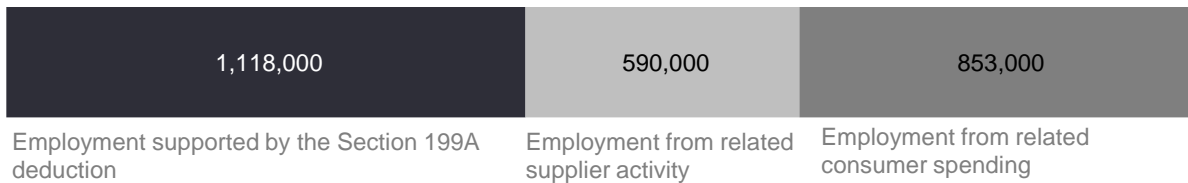
<sup>iii</sup> Formally, the amount of economic activity supported by the 199A deduction estimated in this report is a partial equilibrium analysis. This contrasts to a general equilibrium analysis that would simulate how markets respond to the repeal of the 199A deduction (e.g., shifting of economic activity between sectors).

compensation and generate \$87 billion of GDP in the United States. The average employee compensation of workers supported through this related supplier activity is estimated to be \$73,000.

- Related consumer spending. Workers directly supported at pass-through businesses and supported through the related supplier activity earn employee compensation. This employee compensation supports consumer spending by these workers and economic activity at the businesses where these workers spend their earnings (e.g., at grocery stores and restaurants). The economic activity supported by this related consumer spending is estimated to employ more than 853,000 workers throughout the US economy. These workers are estimated to earn nearly \$53 billion in employee compensation and generate more than \$106 billion of GDP in 2024. The average employee compensation of workers supported by this related consumer spending is estimated to be \$62,000.

**Figure ES-1. Total economic activity supported by, and related to, the Section 199A deduction, 2024**

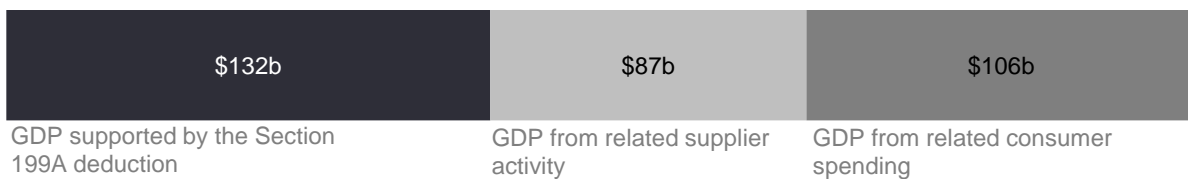
**2.6 million jobs**



**\$161 billion of employee compensation**



**\$325 billion of GDP**



Note: Employee compensation includes employee cash compensation and benefits. Employee compensation is a component of GDP. Figures are rounded.  
Source: EY analysis.

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# Economic activity supported by the Section 199A deduction

## I. Introduction

Pass-through businesses, which include sole proprietorships, partnerships, and S corporations, are generally not subject to entity-level income tax. The entity's income, deductions, credits, and losses are generally passed through to the individual tax returns of the business owners, where they are taxed at the individual's income tax rate. The top individual income tax rate is currently 37%.

Section 199A of the Internal Revenue Code provides a 20% deduction for pass-through income, subject to limitations.<sup>1</sup> The Section 199A deduction was enacted as part of the Tax Cut and Jobs Act (TCJA) in December 2017. The Section 199A deduction went into effect in 2018 and is scheduled to expire at the end of 2025.<sup>2</sup>

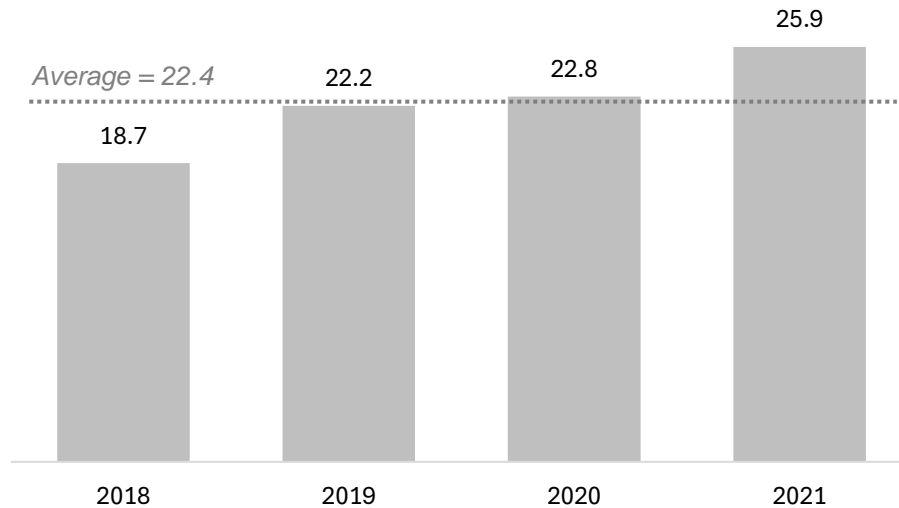
This report estimates the US economic activity – jobs, employee compensation, and gross domestic product (GDP) – supported by the Section 199A deduction in 2024. Specifically, this analysis provides a snapshot of the economic activity supported at businesses directly benefitting from the 199A deduction, as well as the economic activity connected to this directly supported economic activity (i.e., related supply chain activity and consumer spending).<sup>3</sup>

### Section 199A deduction

The Section 199A deduction allows pass-through business owners to deduct up to 20% of certain Qualified Business Income (QBI).<sup>4</sup> The computation of QBI, as well as other items needed to calculate the deduction are determined at the operating business level, but the deduction is taken by the owner of a sole-proprietorship, partner of a partnership or shareholder of an S corporation (hereinafter referred to as the “**business owner**”). The maximum amount of the deduction is limited by a taxpayer's taxable income excluding capital gains. The deduction is also not available to taxpayers above certain income thresholds with businesses operating in service-intensive businesses including in the health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and investing and investment management industries.

As displayed in Figure 1, the number of tax returns claiming the Section 199A deduction grew from 18.7 million in 2018 to 29.5 million in 2021. This is an increase of over 38% or nearly 9% per year on average. The average Section 199A deduction was nearly \$8,000 in 2021 and remained relatively stable after 2018.

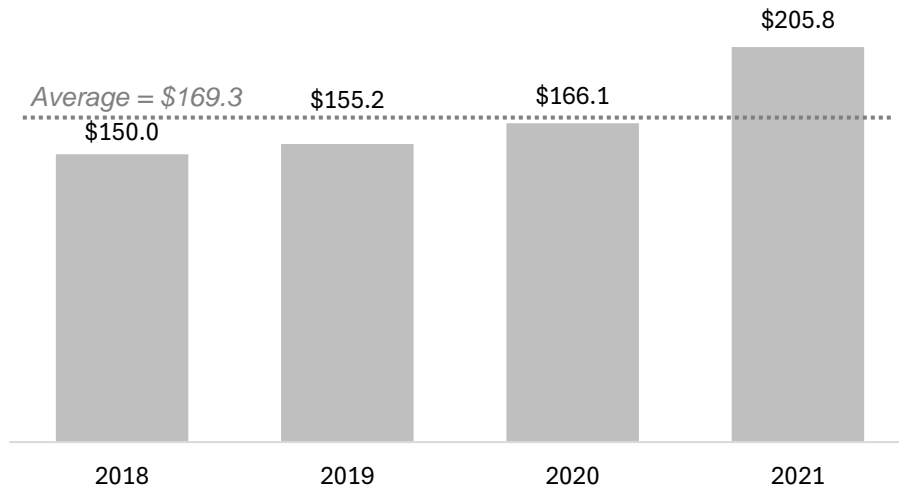
**Figure 1. Tax returns claiming the Section 199A deduction**  
*Millions of tax returns*



Note: Figures are rounded.  
 Source: Internal Revenue Service (IRS) Statistics of Income Data.

As displayed in Figure 2, the Section 199A deduction claimed by taxpayers increased from \$150 billion in 2018 to \$206 billion in 2021, an increase of 37% or over 8% annually. The deduction increased by nearly 24% in 2021 as the economy emerged from the COVID-19 pandemic.

**Figure 2. Amount of Section 199A deduction**  
*\$ billions*



Note: Figures are rounded.  
 Source: IRS Statistics of Income Data.

The Joint Committee on Taxation (JCT) estimates that extending the Section 199A deduction would cost \$684 billion over the 2025-2034 budget window.<sup>5</sup>

## II. Economic activity supported by the Section 199A deduction

This analysis provides a snapshot of the economic activity supported at businesses directly benefitting from the 199A deduction, as well as the economic activity connected to this directly supported economic activity (i.e., related supply chain activity and consumer spending). Results are presented for employment, employee compensation, and GDP:

- ▶ **Employment.** Employment is measured as the total headcount of workers. For example, a company with three full-time workers and a company with two full-time workers and one part-time worker would both be measured as having three workers.
- ▶ **Employee compensation.** Employee compensation includes employee cash compensation (wages) and benefits. Employee compensation is a component of GDP.
- ▶ **GDP.** GDP measures a sector's contribution to the production of all final goods and services produced in the United States.

The economic activity supported by the Section 199A deduction is estimated as follows. First, the cost of capital is estimated with and without the Section 199A deduction.<sup>6</sup> An elasticity of investment with respect to the cost of capital, which reflects the responsiveness of investment to its tax treatment from economic research, is then applied to the change in the cost of capital (i.e., with and without the Section 199A deduction). This results in an estimate of investment directly supported by the Section 199A deduction. In addition to the cost of capital, the change in the after-tax return of labor for the self-employed is estimated with and without the Section 199A deduction.<sup>7</sup> These effects are combined with the change in investment and translated into estimates of the jobs, employee compensation, and GDP directly supported by the Section 199A deduction at businesses benefitting from the Section 199A deduction.

Finally, the Impacts for Planning (IMPLAN) input-output model of the US economy is used to estimate the supplier purchases and consumer spending related to the economic activity directly supported by the Section 199A deduction.<sup>8</sup> All estimates are relative to the size of the US economy in 2024. See Appendix A for more information on the IMPLAN input-output model of the US economy.

### Total economic activity supported by Section 199A deduction

The total economic activity supported by the Section 199A deduction is measured as the sum of direct, indirect (supplier-related), and induced (consumption-related) activity:

- ▶ The **direct effect** is the economic activity supported at businesses where tax liability decreases as a result of the 199A deduction.
- ▶ The **supply chain effect** is the economic activity supported at suppliers of goods and services for the economic activity supported at businesses benefitting from the 199A deduction. Purchases of these goods and services lead to additional rounds of economic activity as suppliers purchase operating inputs from their own suppliers.
- ▶ The **related consumer spending effect** occurs when employee compensation is supported at business benefitting from the 199A deduction and their suppliers, which in



turn affects consumer spending that supports economic activity at other businesses (e.g., grocery stores and restaurants). The earnings spent on food at a restaurant, for example, support jobs at the restaurant as well as at farms, transportation companies, and other businesses involved in the restaurant’s supply chain.

As displayed in Table 1, the US total economic activity supported by the Section 199A deduction in 2024 is estimated to be 2.6 million workers earning \$161 billion in employee compensation and generating \$325 billion of GDP.

**Table 1. Total economic activity supported by, and related to, the Section 199A deduction, 2024**  
*Thousands of jobs; billions of dollars*

	<b>Directly supported economic activity</b>	<b>Related supplier activity</b>	<b>Related consumer spending</b>	<b>Total</b>
Employment	1,118	590	853	2,561
Employee compensation	\$65	\$43	\$53	\$161
GDP	\$132	\$87	\$106	\$325

Note: Employee compensation includes all labor income (i.e., employee cash compensation and benefits). Employee compensation is a component of GDP. Figures are rounded.  
Source: EY analysis.

Pass-through business activity directly supported by the Section 199A deduction

The Section 199A deduction is estimated to directly support 1.1 million workers at pass-through businesses. These workers are estimated to earn \$65 billion in employee compensation and generate \$132 billion of GDP in the United States in 2024. The average employee compensation per worker supported by the Section 199A deduction is estimated to be \$58,000 in 2024. Employee compensation is a component of GDP.

Related supplier activity

Pass-through businesses purchase goods and services from suppliers, supporting additional activity at their suppliers. As displayed in Figure 3, the supplier activity related to the pass-through business activity directly supported by the Section 199A deduction is estimated to employ more than 590,000 workers throughout the US economy. These workers earn \$43 billion in employee compensation and generate \$87 billion of GDP. The average employee compensation of workers supported via this related supplier activity is \$73,000.

The largest supplier-related industries supporting economic activity related to the Section 199A deduction were: business services (210,000 jobs; 36% of total), finance, insurance, and real estate (79,000 jobs; 13% of total), personal services (77,000 jobs, 13% of the total), transportation and warehousing (68,000 jobs; 12% of total), and manufacturing (50,000 jobs, 9% of total). These five supplier-related industries comprised roughly 82% of the total supplier-related employment from the Section 199A deduction.

The remaining supplier-related employment includes: wholesale trade (29,000; 5% of total), agriculture, forestry, fishing, and hunting (23,000 jobs; 4% of total), retail trade (23,000 jobs; 4%

of total), information (14,000 jobs; 2% of total), and all other industries (17,000; 3% of total).

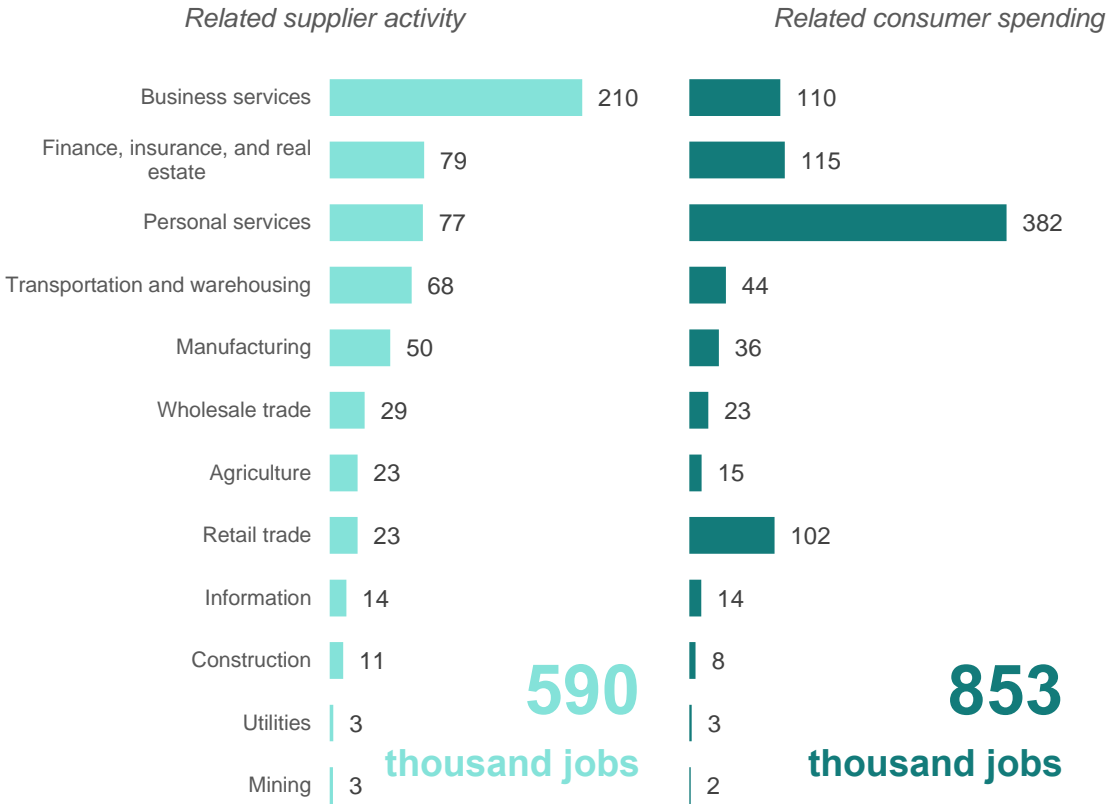
### Related consumer spending

Workers directly supported at pass-through businesses and supported via the related supplier activity earn employee compensation. This employee compensation supports consumer spending by these workers and economic activity at the businesses where these workers spend their earnings (e.g., at grocery stores and restaurants). As displayed in Figure 3, the economic activity supported by this related consumer spending is estimated to employ more than 853,000 workers throughout the US economy. These workers are estimated to earn nearly \$53 billion in employee compensation and generate more than \$106 billion of GDP in 2024. The average employee compensation of workers supported by this related consumer spending is estimated to be \$62,000.

The largest segments were estimated to be: personal services (382,000 jobs; 45% of total), finance, insurance, and real estate (115,000 jobs; 13% of total), professional, management, and business services (110,000 jobs; 13% of total), retail trade (102,000 jobs; 12% of total), and transportation and warehousing (44,000 jobs; 5% of total). These five industries comprise 88% of this related consumer spending effects.

The remaining employment related to the consumer spending of workers supported by the Section 199A deduction and the consumer spending of related supplier activity includes: manufacturing (36,000 jobs; 4% of total), wholesale trade (23,000 jobs; 3% of total), agriculture, forestry, fishing, and hunting (15,000 jobs; 2% of total), information (14,000 jobs; 2% of total), and all other industries (12,000 jobs; 1% of total).

**Figure 3. Economic activity related to the Section 199A deduction, 2024**  
*Thousands*



Note: The related supplier activity and related consumer spending only accounts for the portion of business directly supported by the Section 199A deduction. Industry definitions are based on the North American Industry Classification System (NAICS). Figures are rounded.  
 Source: EY analysis

### III. State distribution of economic activity

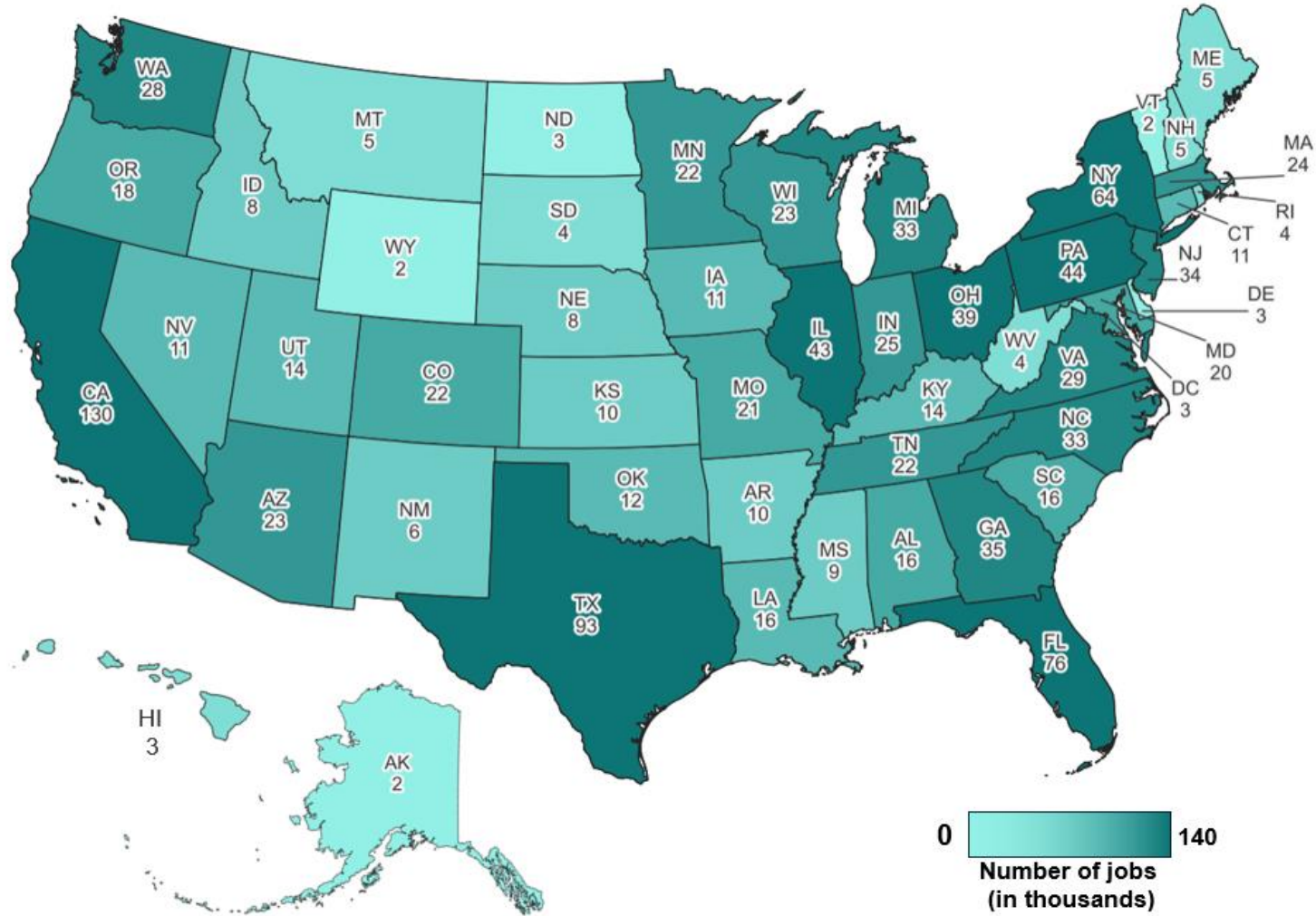
The distribution of US jobs, employee compensation, and GDP by state (plus the District of Columbia) at pass-through businesses directly supported by the Section 199A deduction is displayed in Table 2. The states estimated to have the largest number of jobs at pass-through businesses supported by the Section 199A deduction are: California (130,000 jobs), Texas (93,000 jobs), Florida (76,000 jobs), New York (64,000 jobs), and Pennsylvania (44,000 jobs).

**Table 2. Direct economic activity supported by the Section 199A deduction by state, 2024**  
*Thousands of jobs; millions of dollars*

	Jobs	Employee comp.	GDP		Jobs	Employee comp.	GDP
<b>United States</b>	<b>1,118</b>	<b>\$65,100</b>	<b>\$132,370</b>	Missouri	21	\$1,260	\$2,530
Alabama	16	\$910	\$1,890	Montana	5	\$240	\$510
Alaska	2	\$120	\$260	Nebraska	8	\$430	\$880
Arizona	23	\$1,320	\$2,700	Nevada	11	\$620	\$1,300
Arkansas	10	\$560	\$1,170	New Hampshire	5	\$300	\$590
California	130	\$7,500	\$15,500	New Jersey	34	\$2,070	\$4,130
Colorado	22	\$1,250	\$2,590	New Mexico	6	\$310	\$630
Connecticut	11	\$670	\$1,310	New York	64	\$3,830	\$7,880
Delaware	3	\$190	\$380	North Carolina	33	\$1,870	\$3,810
District of Columbia	3	\$170	\$320	North Dakota	3	\$190	\$410
Florida	76	\$4,360	\$9,020	Ohio	39	\$2,320	\$4,560
Georgia	35	\$2,050	\$4,200	Oklahoma	12	\$710	\$1,410
Hawaii	3	\$170	\$350	Oregon	18	\$920	\$2,020
Idaho	8	\$440	\$920	Pennsylvania	44	\$2,630	\$5,210
Illinois	43	\$2,680	\$5,270	Rhode Island	4	\$210	\$410
Indiana	25	\$1,450	\$2,880	South Carolina	16	\$900	\$1,810
Iowa	11	\$640	\$1,310	South Dakota	4	\$220	\$440
Kansas	10	\$600	\$1,210	Tennessee	22	\$1,270	\$2,530
Kentucky	14	\$800	\$1,600	Texas	93	\$5,480	\$11,200
Louisiana	16	\$900	\$1,860	Utah	14	\$830	\$1,700
Maine	5	\$280	\$600	Vermont	2	\$130	\$260
Maryland	20	\$1,210	\$2,390	Virginia	29	\$1,690	\$3,310
Massachusetts	24	\$1,420	\$2,850	Washington	28	\$1,530	\$3,260
Michigan	33	\$1,930	\$3,890	West Virginia	4	\$230	\$470
Minnesota	22	\$1,350	\$2,710	Wisconsin	23	\$1,360	\$2,690
Mississippi	9	\$470	\$970	Wyoming	2	\$120	\$270

Note: Employee compensation includes all labor income (i.e., employee cash compensation and benefits). Employee compensation is a component of GDP. Figures are rounded.  
Source: EY analysis.

**Figure 4. Direct employment supported by the Section 199A deduction by state, 2024**  
*Thousands of jobs*



Note: Figures are rounded.  
Source: EY analysis.

## Total economic contribution

The total US jobs, employee compensation, and GDP supported by, and related to, the Section 199A deduction by state (plus the District of Columbia) are displayed in Table 3. The states estimated to have the largest amount of increased economic activity are: California (311,000 jobs), Texas (221,000 jobs), Florida (185,000 jobs), New York (149,000 jobs), and Illinois (102,000 jobs).

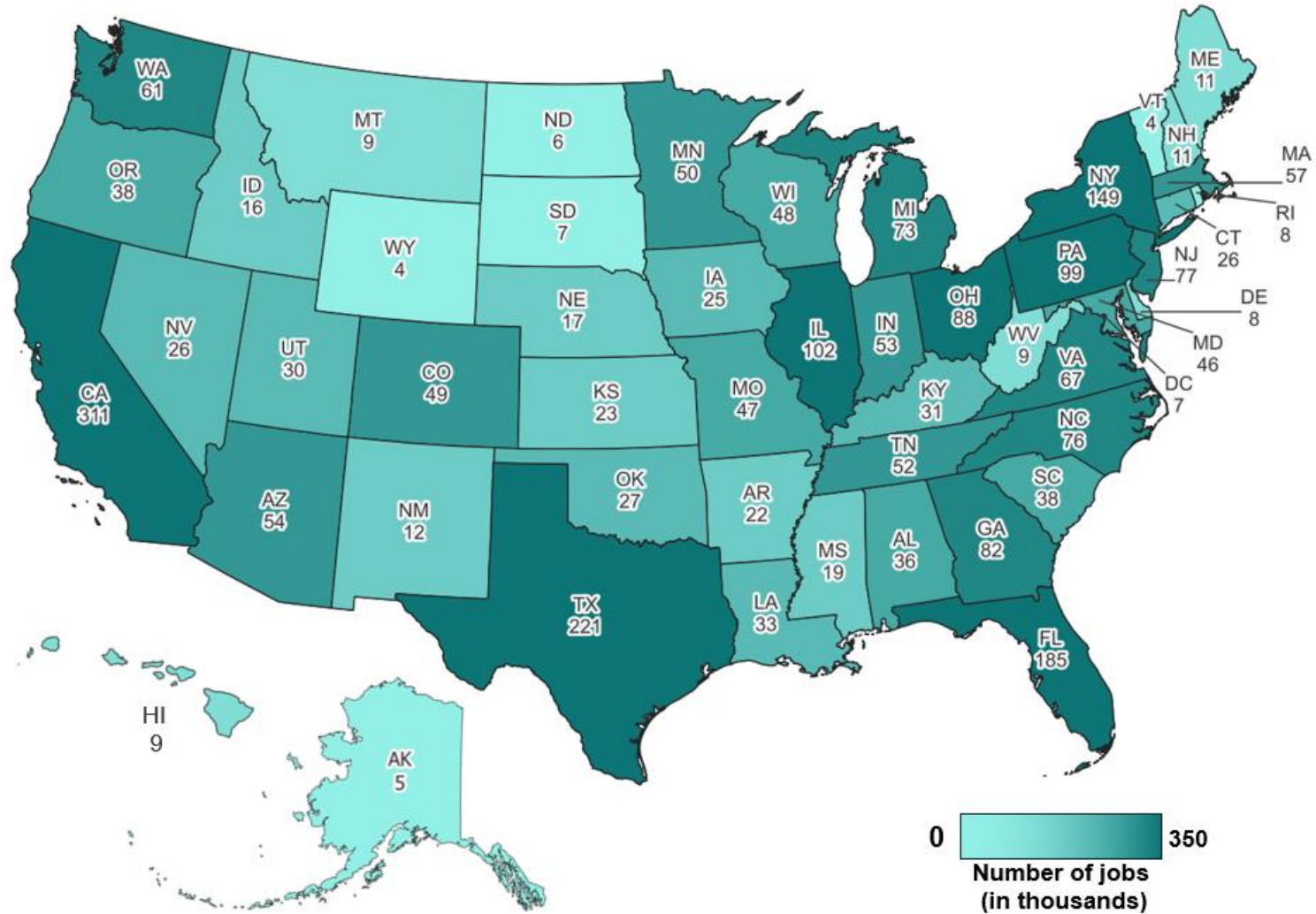
**Table 3. Total economic activity supported by, and related to, the Section 199A deduction by state, 2024**  
*Jobs; millions of dollars*

	Jobs	Employee comp.	GDP		Jobs	Employee comp.	GDP
<b>United States</b>	<b>2,561</b>	<b>\$161,000</b>	<b>\$325,390</b>	Missouri	47	\$3,040	\$6,070
Alabama	36	\$2,180	\$4,440	Montana	9	\$480	\$1,050
Alaska	5	\$300	\$650	Nebraska	17	\$1,030	\$2,060
Arizona	54	\$3,320	\$6,790	Nevada	26	\$1,470	\$3,120
Arkansas	22	\$1,320	\$2,690	New Hampshire	11	\$680	\$1,340
California	311	\$19,460	\$40,160	New Jersey	77	\$5,000	\$9,880
Colorado	49	\$3,060	\$6,340	New Mexico	12	\$750	\$1,510
Connecticut	26	\$1,700	\$3,310	New York	149	\$9,670	\$19,750
Delaware	8	\$490	\$1,000	North Carolina	76	\$4,750	\$9,560
District of Columbia	7	\$490	\$980	North Dakota	6	\$390	\$890
Florida	185	\$10,930	\$22,130	Ohio	88	\$5,720	\$11,200
Georgia	82	\$5,170	\$10,510	Oklahoma	27	\$1,700	\$3,400
Hawaii	9	\$470	\$1,020	Oregon	38	\$2,090	\$4,530
Idaho	16	\$920	\$1,900	Pennsylvania	99	\$6,400	\$12,540
Illinois	102	\$6,820	\$13,280	Rhode Island	8	\$490	\$950
Indiana	53	\$3,330	\$6,580	South Carolina	38	\$2,240	\$4,470
Iowa	25	\$1,580	\$3,180	South Dakota	7	\$440	\$890
Kansas	23	\$1,450	\$2,900	Tennessee	52	\$3,270	\$6,340
Kentucky	31	\$1,900	\$3,770	Texas	221	\$14,070	\$28,970
Louisiana	33	\$1,990	\$4,290	Utah	30	\$1,900	\$3,900
Maine	11	\$610	\$1,310	Vermont	4	\$260	\$540
Maryland	46	\$2,890	\$5,700	Virginia	67	\$4,380	\$8,480
Massachusetts	57	\$3,750	\$7,460	Washington	61	\$3,720	\$7,870
Michigan	73	\$4,630	\$9,140	West Virginia	9	\$560	\$1,190
Minnesota	50	\$3,290	\$6,480	Wisconsin	48	\$3,080	\$6,040
Mississippi	19	\$1,090	\$2,230	Wyoming	4	\$260	\$630

Note: Employee compensation includes all labor income (i.e., employee cash compensation and benefits). Employee compensation is a component of GDP. Figures are rounded.

Source: EY analysis.

**Figure 5. Total employment supported by, and related to, the Section 199A deduction by state, 2024**  
*Thousands of jobs*



Note: Figures are rounded.  
 Source: EY analysis.

## IV. Caveats and limitations

Any modeling effort is only an approximate depiction of the economic forces it seeks to represent, and the economic models developed for this analysis are no exception. Although various limitations and caveats might be listed, several are particularly noteworthy:

- ▶ **Estimates are limited by available public information.** The analysis relies on information reported by federal government agencies (primarily the Congressional Budget Office, US Census Bureau, US Bureau of Economic Analysis, and US Bureau of Labor Statistics), and other publicly available sources (i.e., IMPLAN model). The analysis did not attempt to verify or validate this information using sources other than those described in the report.
- ▶ **The estimates are for a snapshot of the economic contribution in 2024.** The input-output modeling approach used in this analysis shows the 2024 economic contribution of the Section 199A deduction based on the type of economic activity it directly supports and that activity's relationships with industries and households in the US economy. The analysis is at a single point in time (i.e., 2024). The results do not reflect or attempt to estimate an expansion, contraction, or any other changes, or related impacts, of the economic activity.
- ▶ **Estimates do not reflect the economic impact of the Section 199A deduction.** This analysis does not attempt to estimate or indicate the economic impact of the Section 199A deduction on the US economy. Rather, the analysis presents estimates of the economic contribution or economic footprint of the Section 199A deduction. By providing information on the overall scope of the economic activity supported, measured and defined in several different ways, this report attempts to shed light on the reach of the Section 199A deduction within the US economy. As compared to economic impact analyses, in input-output modeling there is generally no consideration of what the economic activity being examined would otherwise be engaged in. Nor is there generally any consideration of whether the economic activity being examined is an efficient use of resources. There is also no fixed relationship between the results of an economic contribution analysis and an economic impact analysis; the relationship can change, for example, depending on the current unemployment and labor force participation rates. As such, an economic contribution analysis should not be confused with an economic impact analysis.<sup>9</sup>
- ▶ **Without adjustments input-output analyses can produce overestimates.** In input-output modeling, economic activity directly supported by the Section 199A deduction could be a supplier (or a supplier of a supplier) to economic activity directly supported by the Section 199A deduction. Additionally, consumer re-spending of income could be at businesses where there is economic activity directly supported by the Section 199A deduction. This analysis includes an adjustment to remove this double counting. Specifically, this analysis reduces the economic activity included in the supplier and consumer spending related estimates, by industry, proportional to the direct employment share in each industry. This reduces the total amount of economic activity (i.e., jobs, employee compensation, and GDP) supported via related supplier activity and consumer spending.
- ▶ **Modeling the economic contribution of business activity supported by the Section 199A deduction relies on government industry classifications.** This report relates the activities of businesses supported by the Section 199A deduction to the operating profiles of



various industries as defined by the North American Industry Classification System (NAICS) to most effectively estimate the economic contribution of businesses supported by the deduction. Workers at these businesses are assumed to receive the average employee compensation of workers in their respective industries and to require the level of operating input purchases characteristic of the industries into which they have been categorized. This analysis relies on estimates of the domestically purchased inputs from the IMPLAN economic model, which are estimated using aggregate trade flow data and may vary by industry.

## Appendix A. Input-output model of the US economy

This analysis uses a cost of capital model and an input-output model of the US economy to estimate the economic contribution of the Section 199A deduction. Specifically, this analysis estimates (1) the decrease in the cost of capital associated with the Section 199A deduction; (2) the change in investment by applying an investment elasticity from the economic literature to the change in the cost of capital; and (3) uses the change in investment as the direct effect of the policy.<sup>10</sup> This associated change in the capital stock of the industry is used to estimate the change in scale of affected industries and, accordingly, the associated direct effect on jobs, GDP, and employee compensation. An adjustment is made to account for the change in the after-tax return of labor for the self-employed with and without the Section 199A deduction. The related supplier and consumer spending effects are then estimated through use of the IMPLAN model, which is described below.

The economic multipliers used for this analysis were estimated using the 2022 IMPLAN input-output model. IMPLAN is used by more than 500 universities and government agencies and includes the interaction of more than 500 industry sectors, thus identifying the interaction of specific industries affected by the Section 199A deduction. Direct investment effects were used as an input to estimate the overall economic activity supported by the Section 199A deduction. The 2022 data were grown to 2024 values.

The multipliers in the IMPLAN model are based on the Leontief production function, which estimates the total economic requirements for every unit of direct output in a given industry based on detailed inter-industry relationships documented in the input-output model. The input-output framework connects commodity supply from one industry to commodity demand by another. The multipliers estimated using this approach capture all of the upstream economic activity (or backward linkages) related to an industry's production by attaching technical coefficients to expenditures. These output coefficients (dollars of demand) are then translated into dollars of value added and labor income and number of employees based on industry averages.

## Endnotes

<sup>1</sup> Owners of certain agricultural or horticultural cooperatives, publicly traded partnerships (PTPs), and real estate investment trusts (REITs) are also eligible for this deduction.

<sup>2</sup> For more details see, EY Tax Alert, "Final Section 199A regulations and other guidance provide welcome guidance, leave questions unanswered and raise new issues", January 2019 <https://taxnews.ey.com/news/2019-0218-final-section-199a-regulations-and-other-guidance-provide-welcome-guidance-leave-questions-unanswered-and-raise-new-issues>.

<sup>3</sup> Formally, the amount of economic activity supported by the 199A deduction estimated in this report is a partial equilibrium analysis. This contrasts to a general equilibrium analysis that would simulate how markets respond to the repeal of the 199A deduction.

<sup>4</sup> Specifically, Section 199A generally allows non-corporate taxpayers to deduct the combined qualified business income (CQBI) amount. Subject to certain limitations and netting rules, the CQBI amount is the sum of (i) 20% of qualified business income from each "qualified trade or business" (QTB) conducted by a partnership, S corporation, and/or sole proprietorship, (ii) 20% of qualified REIT dividends, and (iii) 20% of qualified publicly traded partnership income. The taxpayer's deduction cannot be greater than 20% of the taxpayer's taxable income, less net capital gain. For higher-income individuals, Section 199A limits amount of deductible qualified business income from a trade or business based on the W-2 wages paid by the trade or business, and, in certain cases, the unadjusted basis immediately after acquisition of qualified property used in the trade or business (the wage and property limitation). It also excludes "specified service trades or businesses" from the definition of a QTB. For more details see, EY Tax Alert, "Final Section 199A regulations and other guidance provide welcome guidance, leave questions unanswered and raise new issues", January 2019 <https://taxnews.ey.com/news/2019-0218-final-section-199a-regulations-and-other-guidance-provide-welcome-guidance-leave-questions-unanswered-and-raise-new-issues>; and Internal Revenue Service, *Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs*, irs.gov, July 2024 <https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs>.

<sup>5</sup> See Congressional Budget Office, *Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues*, May 2024.

<sup>6</sup> In general, businesses and investors will make new investments as long as they earn a pre-tax return that exceeds what is required to cover taxes and compensate them for the use of their capital. This pre-tax return is referred to as the cost of capital. A business would not make an investment that earns less than this pre-tax return because such an investment would be economically unprofitable. Taxes are an important component of the cost of capital. Taxes raise a business' cost of capital because the business has to earn enough to cover taxes and still pay a competitive return to its investors. Higher taxes discourage investment by raising the cost of capital. The Section 199A deduction decreases tax liability and, in turn, the cost of capital.

Formally, the cost of capital is the real before-tax rate of return that a barely profitable new investment needs to earn to both cover taxes over its life and provide investors their required after-tax rate of return. The change in taxation on a new, barely profitable investment is a key margin on which to measure the impact of a policy change. For example, an investment that is profitable prior to a policy change and becomes less so, but still profitable, would likely occur with or without the policy change and, consequently, whether or not it occurs is largely unaffected by the policy change. A barely profitable investment, however, could become unprofitable with a policy change and, consequently, whether or not it occurs can be affected by the policy change.

The Congressional Budget Office (CBO), Congressional Research Service, Joint Committee on Taxation (JCT), and US Department of the Treasury frequently use the cost of capital framework to quantify the impact of tax policy on investment incentives. The cost of capital framework accounts for the major features of the federal income tax system (e.g., tax depreciation, tax rates, investor-level taxes). See, for example, Tracy Foertsch, "U.S. Cost of Capital Model Methodology", US Department of the Treasury Office of Tax Analysis Technical Paper 10, (May 2022). <https://home.treasury.gov/system/files/131/TP-10.pdf>.

Economic research typically measures the responsiveness of investment to its tax cost or cost of capital using a measure called an elasticity. It is calculated as the percent change in investment associated with a 1% change in the cost of capital or tax cost. This analysis uses an elasticity of 0.835, based on a review of an extensive body of empirical research. That is, for every 1% increase in the cost of capital, investment would be 0.835% lower. The elasticity estimate used in the analysis is obtained from Djankov, Simeon, et al., (2010), "The effect of corporate taxes on investment and entrepreneurship." *American Economic Journal: Macroeconomics*, 2.3 (July): 31-64. <http://dx.doi.org/10.1257/mac.2.3.31>. The consensus range for this elasticity is 0.5 to 1.0. See, for example, Kevin Hassett and R. Glenn Hubbard, (2002), "Tax Policy and Business Investment," Edited by Alan Auerbach and Marty Feldstein. *Handbook of Public Economics, Volume 3*: 1293-1343. [https://doi.org/10.1016/S1573-4420\(02\)80024-6](https://doi.org/10.1016/S1573-4420(02)80024-6); and Ruud de Mooij and Sjef Ederveen, (2008), "Corporate tax elasticities: a reader's guide to empirical findings," *Oxford Review of Economic Policy*, 24(4) (Winter), 680-697. <http://dx.doi.org/grn033>.

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<sup>7</sup> Pass-through income can reflect either returns to capital or labor. It is difficult to determine how much of pass-through profits represent returns to capital invested by the business owner or returns from the owners' labor. For example, if an entrepreneur starts a new manufacturing business as a pass-through and earns a profit, it is difficult to estimate how much of the business profit is attributable to the investment in machines and facilities (capital) versus the expertise and skills of the entrepreneur (labor). Some research suggests that approximately 75% of pass-through income can be considered as labor income. See, for example, Matthew Smith, Danny Yagan, Owen M. Zidar and Eric Zwick, "Capitalists in the Twenty-First Century", NBER Working Paper 25442, June 2019. <https://www.nber.org/papers/w25442>. The analysis estimates the labor share of proprietors' income using the ratio of total compensation paid to employees (wages, salaries, and supplemental benefits) to gross domestic income (GDI) excluding proprietors' income. This ratio is applied to proprietors' income and the result is considered the labor share. This follows CBO's methodology specified by CBO. For more details see, CBO, "How CBO Projects Income," July 2013.

The analysis adjusts for this by estimating the change in labor supplied for self-employed due to the Section 199A deduction. This reflects both an income effect and a substitution effect. The income effect refers to the change in the quantity of labor supplied resulting from a change in a worker's income; typically, as income rises, workers may choose to work less because they can maintain their desired standard of living with fewer hours worked. The substitution effect occurs when a change in wages alters the relative price of leisure and labor, leading workers to substitute labor for leisure (or vice versa); specifically, when wages increase, leisure becomes more expensive in terms of forgone earnings, prompting individuals to work more and consume less leisure.

For the Section 199A deduction, the income effect would reduce the supply of labor for the self-employed as they could work less to earn the same amount. However, the substitution effect would increase the supply of labor for the self-employed as they can earn more from their labor. The analysis uses an income elasticity of -0.1 and a substitution elasticity of 0.2. These elasticities are from Joint Committee on Taxation, "Macroeconomic Analysis Of H.R. 7024, The 'Tax Relief For American Families And Workers Act of 2024,' As Ordered Reported By The Committee on Ways And Means," JCX-6-24, January 19, 2024. <https://www.jct.gov/publications/2024/jcx-6-24/>.

<sup>8</sup> The economic multipliers used for this analysis were estimated using the 2022 IMPLAN input-output model. IMPLAN is used by more than 500 universities and government agencies and includes the interaction of more than 500 industry sectors, thus identifying the interaction of specific industries affected by the Section 199A deduction. The multipliers in the IMPLAN model are based on the Leontief production function, which estimates the total economic requirements for every unit of direct output in a given industry based on detailed inter-industry relationships documented in the input-output model. The input-output framework connects commodity supply from one industry to commodity demand by another. The multipliers estimated using this approach capture all of the upstream economic activity (or backward linkages) related to an industry's production by attaching technical coefficients to expenditures. These output coefficients (dollars of demand) are then translated into dollars of value added and labor income and number of employees based on industry averages. Results were adjusted to remove potential double counting.

<sup>9</sup> A key point is that an economic impact analysis typically attempts to estimate impacts that net out shifts in economic activity across industries and sectors as the economy moves from its initial equilibrium to its new equilibrium. In contrast, an economic contribution analysis shows the gross amount of economic activity tied to an industry or sector directly, and through its suppliers and related consumer spending. The EY Quantitative Economics and Statistics (QUEST) practice has other modeling frameworks it uses to account for the shifts in economic activity and estimate net impacts.

<sup>10</sup> The elasticity estimate used in the analysis is obtained from: Djankov, Simeon, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer, (2010), "The Effect of Corporate Taxes on Investment and Entrepreneurship." *American Economic Journal: Macroeconomics*, 2(3) (July): 31-64. <https://doi.org/10.1257/mac.2.3.31>