Larry's Tax Law

One Big Beautiful Bill Act, H.R. 1 - 119th Congress (2025-2026): Part IV - The Qualified Business Income Deduction / Code Section 199A

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In this fourth installment of my multi-part series on the One Big Beautiful Bill Act (the "Act"), Steve Nofziger and I discuss a provision of the Act that impacts pass-through business entities and their owners, Code Section 199A.[1]

Background

Code Section 199A, commonly referred to as the Qualified Business Income ("QBI") deduction, was enacted during President Trump's first term in office as part of the Tax Cuts and Jobs Act ("TCJA"). As you may recall, the TCJA changed the C corporation tax rate landscape that came with a top tax rate of 35% to a flat rate structure pegged at 21%. Meanwhile, pass-through entities (S corporations, partnerships and sole proprietorships), which are predominately owned by individuals, were left with a graduated tax rate structure that quickly rises to a rate of 37%.

To create more of an even playing field between pass-through entities and C corporations, the TCJA created a new deduction for pass-through entities with the enactment of Code Section 199A. This provision allows owners of certain pass-through entities a 20% deduction of "qualified business income" ("QBI").

Like many provisions of the TCJA, Code Section 199A was scheduled to sunset at the end of 2025. The Act, signed into law by President Trump on July 4, 2025, made Code Section 199A a so-called permanent provision. It also made several changes to its deduction framework.

TCJA / Existing Deduction

As originally enacted under the TCJA, Code Section 199A allows individuals, trusts and estates to deduct up to 20% of QBI received from certain pass-through trades or businesses, such as S corporations, partnerships (including LLCs taxed as partnerships) and sole proprietorships. The deduction, in effect, reduces the TCJA's top 37% marginal income tax rate for their business owners to approximately 29.6%

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(i.e., 80% of 37%), putting owners of certain pass-through entities on a more level playing field with owners of C corporations who, under the TCJA, have the benefit of the greatly reduced 21% flat tax rate.

Code Section 199A allows certain noncorporate taxpayers to deduct 20% of their QBI passing through from a qualified trade or business, plus 20% of the aggregate amount of qualified cooperative dividends, qualified real estate investment trust dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

The deductible amount of QBI from each qualified trade or business is subject to certain income limitations discussed below.

The deduction is applied to the taxpayer's taxable income, not adjusted gross income, and it cannot exceed the amount of the taxpayer's taxable income for the tax year. In the case of partnerships and S corporations, the deduction applies at the partner or shareholder level, and each partner or shareholder must take into account his or her allocable share of items of income, deduction and loss from the partnership or S corporation.

The TCJA also imposed a sliding-scale income limitation to determine the amount of QBI subject to the deduction. For taxpayers above a "threshold amount" (discussed below), this limitation is the greater of:

(1) 50% of the W-2 wages paid with respect to the qualified trade or business ("W-2 Wage Limit"), or

(2) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business, plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property" of the qualified trade or business (the "Wage and Capital Limit").

For purposes of the limitation, "qualified property" means tangible, depreciable property that is held by and available for use in the qualified trade or business at the close of the tax year, is used at any point during the tax year in the production of QBI, and the depreciable period for which has not ended before the close of the tax year. The "depreciable period" is the latter of ten (10) years from the original placed-in-service date or the last day of the last full year of the applicable recovery period under Code Section 168.

The "threshold amount" is subject to adjustment for inflation. In 2025, the threshold amount was $394,600 for married individuals filing jointly and $197,300 for other individuals.

Under the TCJA, the income limitations were also phased in on a sliding scale. For married individuals filing jointly, the phase-in occurs over the next $100,000 of taxable income above the threshold amount. For other taxpayers, the phase-in occurs over the next $50,000 above the threshold amount. Thus, under the TCJA, the 2025 limits fully applied when taxable income is over $494,600 for married individuals filing jointly, and $247,300 for other individuals.

Additionally, there is a second limitation in the application of Code Section 199A. The pass-

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through entity must be a "qualified trade or business." Such is defined as any trade or business other than a specified service business or the trade or business of performing services as an employee.

For purposes of Code Section 199A, a "specified service business" means any trade or business in the fields of:

- Health;
- Law;
- Accounting;
- Actuarial science;
- Consulting;
- Athletics;
- Financial services;
- Brokerage services;
- Businesses involving investing, investment management, trading or dealing in securities, partnership interests or commodities; and
- Businesses in which the principal asset of the business is the reputation or skill of one or more of its employees or owners.

Notably, the TCJA specifically excluded architecture and engineering services from the list of specified service businesses; therefore, engineering and architecture firms are not subject to this second limitation.

Importantly, the limitation for "specified service businesses" only applies to taxpayers with taxable income greater than the "threshold amount" described above, and it phases in using the same sliding scale dollar phase-in used for the W-2 Wage Limit and Wage and Capital Limit.

Accordingly, a partner in a law firm who, in 2025, has less than $394,600 of taxable income (married filing jointly) is not affected by this exclusion, but his or her business partner with more than $494,600 of taxable income (married filing jointly) is excluded entirely from using the deduction.

The Act

The original version of the House bill would have made a number of changes to the Code Section 199A deduction, including increasing the QBI deduction from 20% to 23% and replacing the sliding-scale income limitation with a fixed-rate reduction under which the taxpayer's deduction would have been reduced by 75 cents for each dollar of taxable income above the threshold amount. These changes were not enacted in the final version of the Act.

The changes made to Code Section 199A by the Act do not fundamentally alter the existing QBI deduction framework, but the Act does significantly change some aspects of this provision. Of note:

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- The deduction rate is maintained at 20%.
- The deduction is made permanent (that is, the sunset provision has been eliminated). Unless lawmakers act in the future to change or eliminate Code Section 199A, it is here to stay.
- The existing limitation framework for the threshold amount, sliding-scale income limitation and the limitation for specified service businesses were kept in place. However, the phase-in dollar amounts for the income limitation and specified service business limitation were increased to $150,000 (up from $100,000) for married individuals filing jointly and to $75,000 (up from $50,000) for all other taxpayers.
- The Act added a new $400 minimum deduction (Code Section 199A(i)) for taxpayers with at least $1,000 of QBI from a qualified trade or business in which the taxpayer materially participates (within the meaning of IRC section 469(h)). The $400 minimum deduction is adjusted for inflation (in increments of $5) after 2026.
- Unlike many provisions of the Act, the changes to Code Section 199A are not retroactively effective for tax years starting in 2025. Consequently, the changes to Code Section 199A are effective for tax years beginning after December 31, 2025.

The Impact of the Act With Respect to Code Section 199A

The changes made to Code Section 199A by the Act are fundamentally of a lesser scale and nature than what had been originally proposed by lawmakers. Some lawmakers, in favor of allowing it to sunset, expressed concerns about this provision, including its complexity and potential for abuse, its tax revenue cost and that it disproportionately benefits high-income earners. On the other side of the coin, advocates for extending Code Section 199A touted it being necessary to somewhat level the playing field between C corporations and pass-through entities, which make up the majority of U.S. businesses and are needed to stimulate economic growth in the country.

Keeping Code Section 199A alive does several things, including:

1. Avoiding the scheduled "sunsetting" will be a substantial benefit to owners of pass-through entities, maintaining the existing relative mathematical parity that the QBI deduction provides those owners relative to C corporation shareholders.[2] Making the deduction a permanent benefit effectively prevents the creation of a substantial tax rate disparity between operating as a C corporation and operating as a pass-through entity. Thus, the Act prevents the creation of tax rate disparity substantial enough to make owners of pass-through entities seriously consider changing the entity's tax classification to a C corporation.[3]
2. The decision to keep the existing limitation framework based on a threshold amount and sliding-scale dollar limitations is helpful to both taxpayers and practitioners in that the existing guidance and

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regulations are a known quantity. It's not necessary for the IRS to replace or update-or for taxpayers and practitioners to learn-a new limitation framework.

3. The increase in the phase-in dollar amounts for the income limitation and specified service business limitation by $50,000 for married individuals filing jointly and by $25,000 for all other taxpayers means that more taxpayers will be able to qualify for the QBI deduction. Again, this change further helps even out the playing field between C corporations and pass-through trades or businesses.

   As noted above, prior to the Act, in 2025, the threshold amount was $394,600 for married individuals filing jointly and $197,300 for other individuals and the dollar limitations (i.e., for the W-2 Wage Limit and Wage and Capital Limit and the definitional limitation for specified service businesses) fully applied when taxable income is more than $494,600 for married individuals filing jointly, and $297,300 for other individuals. With the increases to the dollar limitations, and assuming no underlying inflation adjustment to the 2025 threshold amount, the dollar limitations in 2026 will increase to $544,600 and $272,300, respectively. These changes will allow more taxpayers to utilize the QBI deduction.

   In the case of the definitional limitation for specified service businesses, using the prior example of partners in a law firm (and assuming no underlying inflation adjustment to the 2025 threshold amount), as a result of the Act's changes, in 2026, a partner in a law firm with less than $394,600 of taxable income (married filing jointly) would not be affected by this exclusion, and his or her business partner with $494,600 of taxable income (married filing jointly) would still be able to partially utilize the deduction. Only his or her business partner(s) with over $544,600 of taxable income (married filing jointly) would be excluded entirely from using the deduction.

4. The new $400 minimum deduction for taxpayers with at least $1,000 of QBI from a qualified trade or business in which the taxpayer materially participates-although not a huge benefit-will benefit some taxpayers.

5. It is worth paying attention to the laws of states that have income tax regimes to see how they respond to these changes. Many state income tax regimes have adopted the underlying federal income tax framework. After passage of the TCJA, however, some states, including Oregon, "disconnected" from federal law with respect to the Code Section 199A deduction. In Oregon, ORS 316.859 requires taxpayers to add back the amount of the federal Code Section 199A deduction for purposes of computing Oregon taxable income. Given the relatively small nature of the changes to Code Section 199A, states may continue such an approach. State law cannot be ignored.

Conclusion

Code Section 199A continues to be complex in application. It has evolved from a temporary provision aimed at leveling the playing field among C corporations that are subject to a flat 21% tax rate regime and pass-through entities that are subject to a graduated tax rate structure that tops out at 37%, to a provision that appears to have garnered a permanent place in our federal tax system.

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Stay tuned for further installments on the provisions of the One Big Beautiful Bill Act.

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[1] All references to "the Code" are to the Internal Revenue Code of 1986, as amended.

[2] As noted above, the QBI deduction effectively reduces the top 37% marginal income tax rate for business owners of pass-through entities to approximately 29.6% (i.e., 80% of 37%), to provide them a more level playing field vis a vis shareholders of C corporations.

[3] For example, in the case of an S corporation, by revoking the existing S corporation election, or, in the case of a limited liability company, by formally incorporating or filing an IRS Form 8832 to elect to be taxed as a C corporation.

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