

#26: IRC § 199A Overview

On December 22, 2017 President Trump signed into law the Tax Cuts and Jobs Act (TCJA). One of the key provisions in the Act is a 20% deduction for qualified business income (QBI) under new Code Section 199A. The deduction has broad application, benefiting the owners of sole proprietorships, partnerships, LLCs, S corporations and rental real estate and is available to trusts and estates as well as to individuals. When the 20% deduction applies in full, it reduces the top tax rate on pass-through income from a maximum of 37% to a maximum of 29.6%. Code § 199A is effective for tax years after 2017 and, unless lawmakers act sooner, it sunsets on December 31, 2025.

The 20% deduction applies only for income tax purposes and doesn't reduce the net investment income tax, Medicare tax or the self-employment tax.⁸⁸ The deduction isn't allowed in computing adjusted gross income (AGI), but rather is applied against *taxable* income.⁸⁹

Calculation of the Deduction

The statute begins with a relatively straightforward computation of the deduction.⁹⁰ For most taxpayers the deduction is the lesser of—

- (1) The “combined qualified business income” (QBI) of the taxpayer, or
- (2) 20% of the excess of the taxpayer's taxable income over net capital gain.

Example 1. Cindy, a single taxpayer, is the sole proprietor of a small appliance store with \$155,000 of income in 2024 from the business and no other income. Cindy claims the \$14,600 standard deduction for single taxpayers giving her \$140,400 of taxable income. Cindy's tentative § 199A deduction is \$31,000 (\$155,000 x 20%). However, her deduction can't exceed 20% of taxable income over net capital gains. 20% of Betty's taxable income is \$140,400 x 20% = \$28,080, so her § 199A deduction is reduced from \$31,000 to \$28,080.

Additional Limitations on the Amount of the Deduction

In addition to the 20% of taxable income limitation, there are two additional limitations, a W-2 wage/unadjusted basis limitation and a limitation on specified service trades or businesses (SSTBs).

W-2 Wage/Unadjusted Basis Limitation

Under this limitation, QBI from the trade or business can't exceed the greater of

⁸⁸ IRC § 199A(f)(3).

⁸⁹ New IRC § 62(a), as added, by Act Sec. 11011(b).

⁹⁰ IRC § 199A.

- (1) 50% of the taxpayer's allocable share of the wages paid by the business with respect to QBI, or
- (2) 25% of the taxpayer's allocable share of wages plus 2.5% of the unadjusted basis of qualified property owned by the business.⁹¹

The W-2 wage/unadjusted basis limitation begins to be phased in when taxable income reaches \$383,900 in 2024 for married taxpayers filing jointly and \$191,950 for all other eligible taxpayers. In 2024, the phase-in is complete for married taxpayers filing jointly at \$483,900 and for all other taxpayers at \$241,950

Example 2. Joe and Brenda own a restaurant that produces \$500,000 of taxable income each year. In 2024, they have another \$44,000 of ordinary income and claim the standard deduction of \$29,200. Ward and Joyce purchased the restaurant building for \$600,000 and they paid \$120,000 of W-2 wages in 2024. Because their taxable income exceeds \$483,900, the W-2/unadjusted basis limitation applies in full. The QBI deduction for Joe and Brenda is—

The lesser of

- 20% of pass-through income ($\$500,000 \times 20\% = \$100,000$)

Or the greater of

- 50% of W-2 wages ($\$120,000 \times 50\% = \$60,000$), or
- 25% of W-2 wages ($\$30,000$) + 2.5% of the unadjusted basis in the restaurant building ($\$15,000$) = $\$45,000$

Thus, the deduction is the lesser of \$100,000 or $\$60,000 = \$60,000$.

This \$60,000 deduction is substantially less than 20% of the couple's taxable income ($.2 \times \$514,800 = \$102,960$) so the taxable income limitation doesn't apply.

In the case of a partnership or S corporation, IRC § 199A is applied at the partner or shareholder level. Each partner or shareholder takes into account that person's allocable share of each qualified item of gain, W-2 wages and unadjusted basis.

Specified Service Trade or Business (SSTB) Limitation

Under the general rule, the § 199A deduction doesn't apply to SSTBs.⁹² These businesses include businesses performing services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more owners or employees.

⁹¹ IRC § 199A(b).

⁹² IRC § 199A(d)(2).

Also included are businesses performing services in the fields of investment management, trading, or dealing in securities.⁹³

However, taxpayers in these businesses can still claim a full 20% deduction if their income is below certain threshold levels. For 2024, the threshold level for married taxpayers filing jointly, is \$383,900 and for all other taxpayers, \$191,950. As income rises above these levels, the deduction is gradually phased out. For married taxpayers filing jointly, the phase-out is complete at income of \$483,900 and for all other taxpayers at income of \$241,950.

Definitions

To calculate the amount of the deduction, it is necessary to understand the key terms.

QBI

The term QBI is generally the pass-through income of a qualified trade or business of the taxpayer after payment of wages and business expenses. Among the items of income it doesn't include are—

- (1) Capital gains and losses, including amounts treated as capital gains or losses under IRC § 1231;
- (2) Guaranteed payments;
- (3) Salary paid to the business owner;
- (4) Dividends or dividend equivalents;
- (5) Any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income;
- (6) Any interest income other than interest income properly allocable to a trade or business.⁹⁴

W-2 Wages

The term W-2 wages includes—

- (1) Wages paid to an employee;
- (2) Elective deferrals;
- (3) Deferred compensation; and
- (4) Designated Roth IRA contributions.

These amounts only count, however, if they are properly allocable to QBI. They are also excluded if they aren't properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return. Elective deferrals include elective contributions made to SIMPLE IRAs, 401(k) plans, SARSEPs, and 403(b) plans.⁹⁵

A partner's share of W-2 wages is determined in the same manner as the partner's share of wage expense. W-2 wages don't include payments to independent contractors or management fees.

⁹³ IRC § 199A(d)(2)(A).

⁹⁴ IRC §§ 199A(c)(3) and 199A(c)(4).

⁹⁵ IRC § 199A(b)(4).

Note that S corporations can pay W-2 wages to the business owners, but partnerships, LLCs and sole proprietorships can't. Note also that the statute favors business owners and self-employed individuals over wage earners. To obtain a deduction, employees must either become independent contractors or own or invest in a business.

Qualified Property

The 2.5% of unadjusted basis component of the W-2 wages/unadjusted basis limitation applies to depreciable property used at any time during the tax year for the production of QBI.

The basis of qualifying property is the basis of the property immediately after it was acquired. The depreciable period starts on the date the property is first placed in service and ends on the *later* of—

- (1) 10 years after the beginning date, or
- (2) The last day of the last full year of the applicable recovery period.

This means that property can qualify even if it has reached the end of its applicable recovery period if it was placed in service within the past 10 years. If a taxpayer makes additions to or improvements in qualified property that is already in service, the addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service.⁹⁶

Planning Considerations

IRC § 199A presents numerous planning issues. The first consideration is managing the limitation amounts. This may involve (1) increasing or decreasing W-2 wages, (2) increasing adjusted basis, and (3) increasing ordinary income to avoid the 20% of gross income limitation.

Other potential planning issues include the following—

- (1) Choosing between a pass-through entity and a C corporation following enactment of the TCJA;
- (2) Creating multiple trusts to increase limitation exclusion amounts;
- (3) Using incomplete gift, non-grantor trusts;
- (4) Employee vs. independent contractor status;
- (5) Increasing or decreasing QBI;
- (6) Tax planning for sales of crops—deciding whether to sell to a cooperative or to a non-cooperative buyer; and
- (7) Aggregation of trades or businesses.

Clients should consult with their tax advisor for advice on their specific situation.

⁹⁶ Prop. Reg. § 1.199A-2(c)(1)(ii).