

#27: Managing IRC § 199A Limitation Amounts

IRC § 199A provides owners of pass-through businesses with an income tax deduction of up to 20% of their share of qualified business income (QBI). However, the deduction is subject to three important limitations when taxable income exceeds certain threshold amounts. There is a specified service trade or business (SSTB) limitation, a W-2 wage/unadjusted basis limitation and a limitation based on taxable income.

For 2024, the SSTB and W-2 wage/unadjusted basis limitations both begin when taxable income exceeds \$191,950 for single taxpayers and \$383,900 for married taxpayers and are fully phased at \$241,950 for single taxpayers and \$483,900 for married taxpayers filing jointly. When fully phased in, the SSTB limitation completely eliminates the § 199A deduction and the W-2 wage/limitation restricts the deduction to the greater of (1) 50% of the taxpayer's share of W-2 wages, or (2) 25% of the taxpayer's share of W-2 wages plus 2.5% of the taxpayer's share of the unadjusted basis of qualified property owned by the business (UBIA). In addition, the § 199A deduction can't exceed 20% of taxable income in excess of capital gains.

Planning for the Limitation Amounts

There are five strategies for avoiding or minimizing the effect of the limitations.

- (1) Increasing W-2 wages
- (2) Decreasing W-2 wages
- (3) Increasing UBIA
- (4) Reducing taxable income below the threshold amounts
- (5) Increasing taxable income to avoid the taxable income limitation

Increasing W-2 Wages

Disregarding UBIA for the time being, if 20% of QBI exceeds 50% of W-2 wages it may be possible to increase the limitation amount by increasing wages.

Example 1. Bart and his wife, Helen, had taxable income of \$525,000 in 2024. They own a tire business. The business—

- Is structured as a sole proprietorship
- Had \$280,000 of QBI
- Has no employees
- Has no qualified property because it leases its space and equipment

Because Bart and Helen had taxable income over \$483,900 and the business is a non-service business (non-SSTB), the W-2/UBIA limitation applies in full. A sole proprietorship can't pay W-2 wages to its owners. Thus, Bart and Helen's 199A deduction is the lesser of

- 20% of QBI (\$56,000), or

- The greater of (1) 50% of W-2 wages (\$0), or (2) 25% of W-2 wages (\$0) + UBI (\$0).

Thus, Bart and Helen have a § 199A deduction of \$0.

Example 2. Assume the same facts as in Example 1 except that Bart and Helen convert the business to an S corporation. An S corporation can pay W-2 wages to its owners as well as to employees. If the business pays Helen \$100,000 in W-2 wages, the IRC § 199A deduction is the lesser of--

- 20% of QBI (.2 x \$180,000 = \$36,000), or
- 50% of W-2 wages (.5 x \$100,000) = \$50,000

Thus, the § 199A deduction is increased to \$36,000.

Note that the optimal amount of income to be paid as wages to a business owner is achieved when 50% of wages equals 20% of QBI. This would be accomplished by paying Helen 2/7 of the sum of flow-through income and wages, or \$80,000, then—

$$20\% \text{ of QBI } (.2 \times \$200,000 = \$40,000)$$

$$50\% \text{ of wages } (.5 \times \$80,000 = \$40,000)$$

If Helen is paid either more or less than this amount, the deduction will go down. Unfortunately, if the business doesn't pay Helen reasonable compensation for the work she does, the IRS will re-characterize a portion of the profits interest passing through to her as wages to prevent avoidance of self-employment tax.

It may also be possible to increase W-2 wages by converting independent contractors to employees. This may not be as easy as it sounds, however. Workers may prefer to be independent contractors because independent contractors can qualify for their own IRC § 199A deduction while employees can't. Also, the workers would have to meet IRS requirements for employee status.

Decreasing W-2 Wages

In the previous examples, 20% of QBI exceeded 50% of W-2 wages so it was advantageous to increase W-2 wages. If, 20% of QBI is less than the 50% W-2 wage/UBIA limitation, it may be advisable to reduce wages and increase QBI.

Example 3. Herb and his wife, Jane, are the sole owners of an S corporation that makes widgets. In 2024, business produced \$200,000 of profit and paid Jane a salary of \$160,000 for operating the business. The couple's taxable income is \$520,000. The business owns no depreciable property. If Herb and Jane do no planning, their § 199A deduction is the lesser of

$$20\% \text{ of QBI } (.2 \times 200,000) \dots\dots\dots \$40,000$$

Or the greater of

50% of W-2 wages (.5 x \$160,000) \$80,000, or
25% of W-2 wages + 2.5% of unadjusted basis..... \$40,000

This makes the § 199A deduction \$40,000. To increase the deduction, they decide to reduce Jane's W-2 wages by \$50,000. This increases QBI by \$50,000 to \$250,000 and increases their § 199A deduction to the lesser of

QBI (.2 x 250,000) \$50,000

Or the greater of

50% of W-2 wages (.5 x \$110,000) \$55,000, or
25% of W-2 wages + 2.5% of unadjusted basis..... \$27,500

By reducing Jane's wages by \$50,000, the § 199A deduction is increased from \$40,000 to \$50,000. This is a good result, but the deduction could be made slightly higher by paying Jane 2/7 of the sum of Jane's wages plus company profit. This amount would be $2/7 \times \$360,000 = \$102,857$, leaving \$257,143 of pass-through income ($\$360,000 - \$102,857$). Then, the § 199A deduction would be the lesser of

20% of QBI (.2 x \$257,143)..... \$51,429

Or the greater of

50% of W-2 wages (.5 x \$102,857) \$51,429, or
25% of W-2 wages + 2.5% of unadjusted basis..... \$25,714

Again, the IRS might question whether the business was paying reasonable compensation.

Increasing Unadjusted Basis

The W-2 wage/UBIA limitation amount can also be increased by either acquiring depreciable property or by owning property instead of leasing it.

Example 4. Ward and Kay own a small unincorporated business that manufactures garden tools. The business produced \$600,000 of pass-through income in 2024. Ward and Kay do all the work themselves and lease the machinery used to make the tools so they have no W-2 wages. Their taxable income is \$650,000 so the taxable income limitation doesn't come into play. If Ward and Kay do no planning, their § 199A deduction will be \$0, the lesser of

20% of QBI (.2 x \$600,000)..... \$120,000

Or the greater of

50% of wages (.5 x \$0) \$0, or
 25% of wages (\$0) + 2.5% of basis (\$0)..... \$0

Now suppose that instead of leasing, Bill and Kay decide to buy the building and machinery for \$800,000. Their § 199A deduction amount is now the lesser of

QBI (.2 x \$600,000)..... \$120,000

Or the greater of

50% of wages (.5 x \$0) \$0, or
 25% of wages (\$0) + 2.5% of basis (\$20,000)..... \$20,000

Reducing Taxable Income Below the Threshold Amounts

It may be possible to avoid, or at least diminish the effect of the SSTB and W-2 wage/UBIA limitations by decreasing taxable income. Two easy ways to reduce taxable income are making charitable contributions and making contributions to qualified plans.

Example 5. Emily, a single taxpayer, is a lawyer with a solo practice that generates \$200,000 of QBI. She pays \$150,000 in wages to her employees and has taxable income of \$250,000. The building that houses the practice is leased. Without planning, Emily’s IRC § 199A deduction would be totally phased out because the business is a service business and her taxable income exceeds \$241,950. If Emily makes a \$60,000 charitable contribution to her church, however, she can reduce her taxable income to \$190,000 and claim a § 199A deduction of \$40,000 (.2 x \$200,000).

Oil and Gas Investments. A more sophisticated strategy for reducing taxable income is making oil and gas investments. Investors can deduct 100% of their share of intangible drilling costs (IDCs) in the year they are incurred. IDCs typically produce deductions equal to 65 to 85 percent of the total investment. Thus, a \$100,000 investment could create an immediate deduction of \$65,000 to \$85,000.

Gifts of Business Interests. Taxpayers might also consider gifting shares of a business to family members. This would spread income from the business among several taxpayers, creating additional threshold amounts and making it easier to stay below the phase-in or phase-out thresholds.

Example 6. Greg and April are married taxpayers filing jointly with \$600,000 of QBI from GA Partnership and taxable income of \$500,000. The GA Partnership pays no wages. Because Greg and April have taxable income over \$483,900, the W-2 wage limitation applies in full and they receive no IRC § 199A deduction. Greg and April have two children, Ray and Lauren, both married taxpayers filing jointly, each with taxable income of \$100,000.

Greg and April gift a 15% interest in GA to Greg and a 15% interest in GA to April, shifting \$90,000 of qualified business income to each of them. Following the

transfer, Greg and April have taxable income of \$320 (\$500,000 - \$180,000) and Ray and Lauren have taxable income of \$190,000 each. Thus, all of them qualify for the full 20% deduction on GA pass-through income.

Increasing Taxable Income

Even if QBI isn't limited by the W-2 wage/UBIA limitation, it may be limited by the 20% of taxable income over capital gains limitation. If so, an owner of a non-SSTB may be able to avoid the limitation by earning additional income outside the pass-through business.

Example 7. Bill is the sole proprietor of a non-SSTB business that produces \$110,600 of pass-through income. Bill has no other income and claims the \$14,600 standard deduction, reducing his taxable income to \$96,000. Although his tentative QBI deduction is \$22,120 (.2 x \$110,600), the deduction is limited to \$19,600 (.2 x \$98,000) because of the taxable income limitation (20% of taxable income over capital gains). Bill earns an additional \$12,000 coaching at the local high school and tutoring students in math. This increases his taxable income to \$110,000 and his taxable income limitation to \$22,000 (.2 x \$110,000).

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