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The Section 199A Deduction: How It Works and Illustrative Examples

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SUMMARY

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The Section 199A Deduction: How It Works and Illustrative Examples

Congress made numerous changes to the federal tax code for individuals and corporate and noncorporate businesses in December 2017, as part of P.L. 115-97 (referred to in this report as the 2017 tax revision but also known as the Tax Cuts and Jobs Act). At the core of the law was a permanent cut in the corporate income tax rate from a top rate of 35% to a flat rate of 21%.

During the congressional debate over the 2017 tax revision, pass-through business owners sought tax relief comparable to any reduction in corporate tax rates. Heeding this request, Congress added a new deduction under Section 199A of the federal tax code. The deduction allows pass-through business owners to deduct up to 20% of their qualified business income (QBI) in determining their personal tax liability. This reduces effective tax rates for pass-through business profits by up to 20%. Like most of the changes in the individual income tax in P.L. 115-97, the new Section 199A deduction is temporary: it is available from 2018 to 2025.

In general, Section 199A allows individuals, trusts, and estates with pass-through business income to deduct up to 20% of their QBI from their taxable income. (Owners of certain agricultural or horticultural cooperatives, real estate investment trusts, and publicly traded partnerships are also eligible for the deduction, but they are not covered in this report.) A pass-through business owner's QBI is the net amount of items of income, loss, gain, and deduction for each qualified domestic trade or business he or she owns. If a taxpayer owns more than one business, then QBI must be determined separately for each one and added together to determine the taxpayer's total QBI in a tax year.

The **maximum deduction** is the lesser of

- 20% of an owner's QBI, or
- 20% of taxable income, excluding any net capital gains.

Two other limitations may apply, reducing the amount of the deduction:

- **Wage and qualified property limitation** (WQP), which reduces the maximum deduction an owner may claim according to the owner's share of a business's W-2 wages and the unadjusted basis (or original cost) of its qualified assets); and
- **Specified Service Trade or Business (SSTB) limitation**, which reduces the maximum deduction an owner may claim for qualified income from SSTBs. An SSTB is any trade or business that is involved in the performance of services in the fields of accounting, health, law, actuarial science, athletics, brokerage services, consulting, financial services, or the performing arts; or involved in the performance of services in investing and investment management, trading, or dealing in securities, partnership interests, or commodities; or whose principal asset is the reputation or skill of one or more of a firm's owners or employees.

The SSTB and WQP limitations phase in, reducing the maximum deduction, when the owner's income exceeds a lower income threshold. Their full impact is realized when taxable income exceeds an upper income threshold.

This report illustrates how the deduction amount is calculated in various scenarios that illustrate the mechanics of the WQP limitations and the SSTB limitation, and the interaction of these limits when applicable.

Contents

Structure of the Section 199A Deduction 1
Who Qualifies for the Deduction? 1
What Is a Specified Service Trade or Business? 2
What Income Qualifies for the Deduction? 2
Do Any Limits Apply to the Deduction? 3
WQP Limitation 4
SSTB Limitation 4
Five Scenarios 5
First Scenario: Taxable Income Below the Lower Income Threshold for SSTB and Non-SSTB Qualified Income 6
Second Scenario: Taxable Income Above the Upper Income Threshold for SSTB Qualified Income Only 6
Third Scenario: Taxable Income Above the Upper Income Limitation for Non-SSTB Qualified Income 6
Fourth Scenario: Taxable Income Within the Phase-in Range for the WQP Limit for Non-SSTB Qualified Income 7
Fifth Scenario: Taxable Income Is Within the Phase-in Range for the SSTB and WQP Limitations for SSTB Qualified Income 7
Net Operating Losses and the 199A Deduction 10

Tables

Table 1. Lower and Upper Income Thresholds for the SSTB and WQP Limitations for the Section 199A Deduction 4
Table 2. Summary of Five Scenarios for Claiming the Section 199A Deduction 8

Appendixes

Appendix. Final Regulations (TD 9847) on Classifying Businesses as an SSTB 11

Contacts

Author Information 12

Congress made numerous changes to the federal tax code for individuals and corporate and noncorporate businesses in December 2017, as part of P.L. 115-97 (referred to in this report as the 2017 tax revision but also known as the Tax Cuts and Jobs Act).[1] At the core of the law was a permanent cut in the corporate income tax rate from a top rate of 35% to a flat rate of 21%.

During the congressional debate over the 2017 tax revision, pass-through business owners sought tax relief comparable to any reduction in corporate tax rates.[2] Heeding this request, Congress added a new deduction under Section 199A of the federal tax code. The deduction allows pass-through business owners to deduct up to 20% of their qualified business income (QBI) in determining their personal tax liability. This reduces effective tax rates for pass-through business profits by up to 20%. Like most of the changes in the individual income tax in P.L. 115-97, the new Section 199A deduction is temporary: it is available from 2018 to 2025.

This report examines how the deduction is calculated. It includes several stylized examples intended to illustrate the deduction's impact in several likely scenarios.

Structure of the Section 199A Deduction

In general, between 2018 and 2025, Section 199A allows individuals, trusts, and estates with income from pass-through businesses to deduct up to 20% of their QBI in determining their federal tax liability. (Owners of certain agricultural or horticultural cooperatives, real estate investment trusts [REITs], and publicly traded partnerships [PTPs] are also eligible for the deduction, but they are not covered in this report.) Key considerations in claiming the deduction are

- the pass-through business owner's taxable income,
- the nature of pass-through businesses owned by high-income persons, and
- the owner's share of W-2 wages and the original cost of qualified assets from the business.

The deduction may be claimed on Form 1040, after eligible taxpayers take the standard deduction or the sum of their itemized deductions.[3]

Who Qualifies for the Deduction?

Generally, the Section 199A deduction applies to a broad range of business activities. The final regulations for the Section 199A deduction (Treasury Decision, or TD, 9847) define a trade or business as having the same meaning as a trade or business under Section 162.[4] An activity qualifies as a Section 162 business if it is conducted with continuity, regularity, and the intent of

[1] For more details on those changes, see CRS Report R45092, *The 2017 Tax Revision (P.L. 115-97): Comparison to 2017 Tax Law*, coordinated by Molly F. Sherlock and Donald J. Marples.

[2] For example, see Brian Faler, "What You Need to Know about the Senate's Pass-through Tax Debate" *Politico*, November 28, 2017, at https://www.politico.com/story/2017/11/28/what-is-pass-through-tax-debate-senate-192470.

[3] See CRS Infographic IG10014, *The U.S. Individual Income Tax System, 2019*, by Molly F. Sherlock.

[4] U.S. Department of the Treasury, Internal Revenue Service, "Qualified Business Income Deduction," Final Regulations, TD 9847, *84 Federal Register*, February 8, 2019, pp. 2952-3013. The final regulations for the deduction, issued by the IRS on January 18, 2019, in TD 9847, addressed these questions and several others. TD 9847 represented the culmination of a process that commenced on August 16, 2018, when the IRS released proposed regulations for Section 199A (REG-107892-18) and included a public hearing on October 16, 2018. The IRS received 335 comments in response to its proposed rulemaking.

earning a profit. Such an activity can be done full-time or part-time. In the case of the Section 199A deduction, there are two basic kinds of trades and businesses: a specified service trade or business (SSTB) and a non-specified service trade or business (non-SSTB).

What Is a Specified Service Trade or Business?

According to Section 199A(d)(2), a specified service trade or business (SSTB) is any trade or business that is

- involved in the performance of services in the fields of accounting, health, law, actuarial science, athletics, brokerage services, consulting, financial services, or the performing arts; or
- involved in the performance of services in investing and investment management, trading, or dealing in securities, partnership interests, or commodities; or
- whose principal asset is the reputation or skill of one or more of a firm's owners or employees.

This list largely matches the list of businesses that do not qualify for a 50% to 100% tax exclusion for long-term capital gains that owners realize on the sale or exchange of qualified small business stock, under Section 1202. A number of requirements must be met in order to benefit from this exclusion.

Section 1202(e)(3)(A) identifies the businesses that are eligible for the exclusion by listing the ineligible businesses, which are

> any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. [5]

There is at least one difference between SSTBs and businesses not eligible for the Section 1202 gains exclusion. Engineering and architecture are not included in the list of SSTBs, making them eligible for the Section 199A deduction, regardless of the owner's taxable income. Under Section 1202, by contrast, the two industries are among those deemed ineligible for capital gains tax relief. In general, SSTBs can be described as professional service firms whose success rests on the skills and reputation of their owners and employees. It can be argued that many engineering and architecture firms fit that description, and thus should be classified as SSTBs.

The criteria for identifying an SSTB are not necessarily mutually exclusive. Many professional service firms considered an SSTB based on their primary line of business (e.g., accounting or law) may also have as a principal asset the reputation and skills of owners and employees.

The final regulations for the deduction addressed several complicated issues regarding the classification of a business as an SSTB. Those issues are discussed in the **Appendix**.

What Income Qualifies for the Deduction?

The deduction a pass-through business owner may claim is based, in large part, on the owner's QBI. Section 199A defines QBI as the net amount of items of income, deduction, loss, and gain for each qualified pass-through business someone owns. Only income items connected with a

[5] Other businesses are ineligible for the small business stock gains exclusion, but they are not considered SSTBs under Section 199A. These businesses include farming, banking, insurance, leasing, investing, restaurants, and lodging.

trade or business conducted in the United States or Puerto Rico can be used to compute QBI. In claiming the deduction, owners are required to determine QBI separately for each trade or business in which they have an ownership interest. QBI does not include (1) wage income; (2) reasonable compensation received by an S corporation shareholder for services provided to the business; (3) guaranteed payments to a partner for services provided to a partnership; and (4) investment income unrelated to a trade or business.

Owners of multiple pass-through businesses, some of which might be SSTBs, are allowed to combine (or "aggregate") those businesses, even if they are conducted as separate legal entities, in determining their QBI. This treatment is permitted under certain conditions.[6]

Do Any Limits Apply to the Deduction?

There are three limitations on the deduction, one of which applies to *every* claim for the deduction.[7] A key consideration in determining whether the other two limitations apply is a pass-through business owner's taxable income. Under the Section 199A deduction, taxable income is defined as a taxpayer's adjusted gross income (AGI) less allowable deductions, except for the Section 199A deduction.

The limitation that applies to every claim for the deduction is an **overall cap on the deduction** a business owner may take in a tax year. This can be referred to as the *maximum deduction*. It is the lesser of

- the sum of 20% of QBI for each qualified trade or business and (if applicable) 20% of REIT dividends and PTP income, or
- 20% of a taxpayer's taxable income, less any net capital gain, which is equivalent to an owner's taxable ordinary income.

Two other limitations may apply, depending on taxable income:

- **Wage and qualified property limitation** (WQP), which reduces the maximum deduction an owner may claim according to the owner's share of a business's W-2 wages and the unadjusted basis (or original cost) of its qualified assets;[8] and
- **SSTB limitation**, which reduces the maximum deduction an owner may claim for qualified income from SSTBs.

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[6] First, a taxpayer must prove that the same person (or group of persons) directly or indirectly owns 50% or more of each trade or business to be combined. Second, the ownership structure has to be maintained for a majority of a tax year, including the last day. Finally, taxable items attributable to each trade or business to be combined have to be reported on returns for the same tax year. Aggregation is not allowed for SSTBs. Trades or businesses to be aggregated must satisfy at least two of the following three conditions: (1) they provide goods and services that are the same or usually sold together; (2) they share facilities or key business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology; or (3) they are operated in connection with one or more of the other businesses in the combined group.

[7] This discussion of the limitations for the Section 199A deduction is based on a detailed explanation of how the deduction works given in a report by the Joint Committee on Taxation. See Joint Committee on Taxation, *Overview of Deduction for Qualified Business Income: Section 199A*, March 13, 2019, https://www.jct.gov/publications.html?func=startdown&id=5171.

[8] W-2 wages are a firm's total wages subject to withholding, elective deferrals, and deferred compensation.

The unadjusted basis of qualified property refers to the cost of tangible, depreciable assets when a pass-through firm acquires them. The property must be depreciable under Section 167 of the federal tax code, used in a qualified business at the close of the tax year for which the Section 199A deduction is claimed, and have a "depreciable period" that does not end before the close of that year. Under Section 199A, that period ends either 10 years after a depreciable asset is

The SSTB and WQP limitations do not apply to the deduction for REIT and PTP income. The SSTB and WQP limitations phase in, reducing the maximum deduction, when the owner's income exceeds a lower income threshold. Their full impact is realized when taxable income exceeds an upper income threshold. **Table 1** shows the lower income and upper income thresholds for both limitations from 2018 to 2020; the amounts are indexed for inflation. More details on the potential impact of the two limitations are provided below.

Table 1. Lower and Upper Income Thresholds for the SSTB and WQP Limitations for the Section 199A Deduction

	Lower Income Threshold		Upper Income Threshold	
Tax Year	Joint Filers	All Other Filers	Joint Filers	All Other Filers
2018	$315,000	$157,500	$415,000	$207,500
2019	$321,400	$160,700	$421,400	$210,700
2020	$326,600	$163,300	$426,600	$213,300

Source: P.L. 115-97 and IRS Procedures 18-57 and 19-44.

Notes: All other filers are single and head-of-household filers and married persons filing as a single person. The amounts for 2019 and 2020 have been indexed for inflation.

WQP Limitation

This limit on the deduction is tied to a pass-through business owner's share of a business's W-2 wages and the original cost of its tangible, depreciable assets. Three outcomes are possible when the WQP limit applies to the deduction and QBI is from a non-SSTB business only. (The scenario when both the WQP limit and SSTB limit apply is discussed subsequently.)

(1) An owner's taxable income is less than the lower income threshold: in this case, the maximum deduction may be claimed.

(2) An owner's taxable income is in the phase-in range for the WQP limit: in this case, the maximum deduction is calculated and compared with the deduction with the full WQP limit. The difference between these two deductions is multiplied by the *reduction percentage* (RP, see below for more details) to determine the reduction amount. This reduction amount is subtracted from the maximum deduction to determine the deduction the owner may claim.

(3) An owner's taxable income exceeds the upper income threshold: in this case, the deduction is subject to the full WQP limit. As a result, the deduction cannot exceed the greater of 50% of the owner's share of W-2 wages for a business, or 25% of those wages plus 2.5% of the owner's share of the unadjusted basis of qualified property used in the business.

SSTB Limitation

This limitation applies to the deduction claimed by an SSTB owner whose taxable income is greater than the lower income threshold. There are four basic outcomes when this limit applies:

(1) An owner's taxable income is less than the lower income threshold: in this case, the maximum deduction may be claimed.

first placed in service, or on the last day of the last full year of the cost recovery period for the asset under Section 168. Special considerations apply to S corporations and partnerships in determining an owner's allocable share.

(2) An owner's taxable income is between the lower and upper income thresholds (also known as the phase-in range for the SSTB limitation) and only the SSTB limit applies: in this case, the maximum deduction is reduced by a phased-in SSTB limit. As shown in **Table 1**, the phase-in range for both the SSTB and WQP limits in 2020 is $326,600 to $426,600 for joint filers, a range of $100,000; and $163,300 to $213,300 for all other filers, a range of $50,000. When a pass-through business owner's taxable income falls within that range, the maximum deduction is reduced according to a formula derived, in large part, from the extent to which the owner's taxable income exceeds the lower income threshold. This excess is divided by $100,000 for joint filers, or $50,000 for all other filers, to determine the RP.[9] In this outcome, the owner's QBI from an SSTB is first reduced by an amount equal to (QBI x RP), and the deduction is then calculated as 20% of this reduced QBI.

(3) An owner's taxable income lies in the phase-in range and the SSTB and WQP limits both apply: in this case, the maximum deduction is reduced in two steps: first by a phased-in SSTB limit, and then by a phased-in WQP limit.

The first step is to reduce the owner's QBI from an SSTB and his/her share of a business's W-2 wages and the unadjusted basis of its qualified property, by the RP.[10] For example, if an owner's taxable income is 90% of the way through the phaseout range (i.e., $405,000 for married joint filers in 2020), then the owner's QBI is reduced by 90%. Similarly, the owner's wage and unadjusted basis of qualified property must also be reduced by 90%, resulting in a modified WQP limit. This produces two possible deductions:

1. 20% of the reduced QBI under the SSTB limit without the modified WQP limit, and
2. 20% of the reduced QBI under the SSTB limit with the modified WQP limit.

In the second step, the difference between those two deductions is multiplied by the RP. This yields a *reduction amount*, which is subtracted from the deduction without the WQP limit (i.e., deduction 1 above) to determine the Section 199A deduction an owner may claim when both limits apply.

(4) An owner's taxable income exceeds the upper income threshold: in this case, no deduction may be claimed, as QBI comes from an SSTB.

Five Scenarios

One way to understand how the Section 199A deduction is intended to work is to consider how it would be calculated under different scenarios. The following five scenarios explore the effects of the SSTB and WQP limits on a single filer with different amounts of taxable income. The results are summarized in **Table 2**. These stylized examples address only some of the possible scenarios for claiming the deduction. Still, they illustrate the deduction that may be claimed under the three possible conditions facing a pass-through business owner: (1) taxable income does not exceed the lower income threshold; (2) taxable income falls in the phase-in range for the two limits; and (3) taxable income exceeds the upper income threshold.

[9] For example, if a pass-through business owner has a taxable income of $400,000 and files jointly, then their reduction percentage would be equal to $400,000 - $326,600/$100,000, or $73,400/$100,000, or 73.4%.

[10] For example, if QBI is $200,000, W-2 wages are $50,000, and the RP is 40%, then after applying the RP, QBI is $120,000 (i.e., $200,000 – ($200,000 x 0.4)), and W-2 wages become $30,000 (i.e., $50,000 – ($50,000 x 0.4)).

First Scenario: Taxable Income Below the Lower Income Threshold for SSTB and Non-SSTB Qualified Income

Assume that in 2020

- James owns a restaurant (non-SSTB) as a sole proprietor;[11]
- he has a taxable income of $160,000, with no net capital gains;
- his filing status is single; and
- QBI for his business totals $140,000.

In this scenario, James's taxable income ($160,000) is below the lower income threshold for single filers ($163,300 in 2020), and the deduction is not subject to the SSTB and WQP limitations. The deduction, in this case, is the lesser of 20% of James's total QBI, or 20% of his ordinary income. Thus, he may claim a Section 199A deduction in 2020 of **$28,000**.[12]

Second Scenario: Taxable Income Above the Upper Income Threshold for SSTB Qualified Income Only

Assume that in 2020

- James is part owner of a law firm (SSTB);
- his taxable income is $215,000, with no net capital gains;
- his filing status is single; and
- QBI for his SSTB is $190,000.

The second scenario involves a pass-through business owner whose taxable income exceeds the upper income threshold ($213,300) for a single filer in 2020, and whose entire QBI comes from a SSTB. James may claim **no deduction** for that tax year.

Third Scenario: Taxable Income Above the Upper Income Limitation for Non-SSTB Qualified Income

Assume that in 2020

- James owns a restaurant (non-SSTB) as a sole proprietor;
- James's taxable income totals $220,000, with no net capital gains;
- his filing status is single;
- QBI from his restaurant comes to $180,000; and
- W-2 wages from the business are $60,000, and the unadjusted basis of qualified property used in the restaurant totals $100,000.

In this scenario, QBI is from a non-SSTB, and taxable income is above the upper income threshold ($213,300) for a single filer in 2020. As a result, the deduction is subject to the full WQP limit, but not to the SSTB limit. The deduction James may claim cannot exceed the larger

[11] Restaurants are not SSTBs, so income from his restaurant is eligible for the Section 199A deduction.

[12] This amount is the lesser of 20% of his QBI (0.2 x $140,000 = $28,000), and 20% of his ordinary income (0.2 x $160,000 = $32,000).

of these two amounts: 50% of his share of the restaurant's W-2 wages, or 25% of those wages plus 2.5% of his share of the restaurant's unadjusted basis of qualified property. In his case, those amounts are $30,000 or $17,500, respectively.[13] Thus, James may claim a Section 199A deduction of **$30,000** for 2020.[14]

Fourth Scenario: Taxable Income Within the Phase-in Range for the WQP Limit for Non-SSTB Qualified Income

Assume that in 2020

- James owns a restaurant (non-SSTB) as a sole proprietor;
- his taxable income is $200,000, with no net capital gain;
- he files as a single taxpayer;
- QBI from his restaurant business totals $180,000; and
- his share of W-2 wages from the business and the unadjusted basis of qualified property used in it are $60,000 and $100,000, respectively.

In this scenario, James's QBI comes entirely from a non-SSTB, and his taxable income is within the phase-in range for the SSTB and WQP limits, although only the WQP limit applies. The deduction he may claim is the deduction without the WQP limit, reduced by an amount derived from the difference between the deduction without that limit and the deduction with that limit, multiplied by James's RP.

The first step in determining his deduction is to calculate the RP. It is equal to James's taxable income less the lower income threshold, divided by $50,000 (the difference between the lower income threshold and the upper income threshold for a single filer). In this case, the RP is 73.4%.[15] His reduction amount is calculated by multiplying the RP by the difference between the deduction with no WQP limit and the deduction with the full WQP limit. The deduction with no limit is $36,000,[16] whereas the deduction with the full WQP limit is $30,000.[17] As a result, the reduction amount is $4,404,[18] and James may claim a Section 199A deduction of **$31,596**[19] for the 2020 tax year.

Fifth Scenario: Taxable Income Is Within the Phase-in Range for the SSTB and WQP Limitations for SSTB Qualified Income

Assume that in 2020

- James is a partner in a law firm (SSTB);
- he files as a single person;

[13] In this example, 50% of W-2 wages equal $30,000 (i.e., 0.5 x $60,000) and 25% of those wages plus 2.5% of the unadjusted basis of qualified property equal $17,500 (i.e., (0.25 x $60,000) + (0.025 x 100,000)).

[14] The maximum amount of the deduction without the limitation would be $36,000 (i.e., 20% of $180,000). As a result of the WQP limitation, he can only claim $30,000.

[15] $200,000 - $163,300 = $36,000, and $36,000/$50,000 = 0.734.

[16] 0.20 x $180,000.

[17] See footnote 11.

[18] $36,000 - $30,000 = $6,000, and $6,000 x 0.734 = $4,404.

[19] $36,000 - $4,404 = $31,596.

- his taxable income is $200,000, with no net capital gains;
- his share of QBI for the firm is $180,000; and
- his share of the firm's W-2 wages and the unadjusted basis of the firm's qualified property are $60,000 and $100,000, respectively.

The fifth scenario is the most complicated. It involves calculating the deduction under the SSTB and the WQP limits, since James's taxable income is within the phase-in range for both limits, and his entire QBI comes from an SSTB.

The calculation entails several steps. The first step is to determine his deduction under the SSTB limit. James's QBI is reduced by an amount equal to his RP multiplied by the QBI. Then the reduced QBI is multiplied by 20% to calculate the deduction he could claim under the SSTB limit without the WQP limit; in this case, the deduction is $9,576.[20]

The next step is to determine his deduction with the phased-in WQP limit. (Because James's taxable income lies within the phase-in range for the deduction, his full WQP limit must also be reduced by the RP.) The deduction James could take under the modified (i.e., phased in) WQP limit is the greater of 50% of James's share of W-2 wages multiplied by the RP ($7,980),[21] or the sum of 25% of those wages and 2.5% of James's share of the total unadjusted basis of qualified property, multiplied by the RP ($4,655).[22] Thus, James's deduction under the modified WQP limit is $7,980.

In the final step, the difference between the deduction under the SSTB limit without the modified WQP limit ($9,576) and the deduction under the SSTB limit with the modified WQP limit ($7,980) is multiplied by James's RP. The result is subtracted from the deduction with no WQP limit ($9,576) to determine the Section 199A deduction James may claim for the 2020 tax year, which is $8,405.[23]

This deduction is about 73% less than the deduction James could claim in the fourth scenario ($31,596), even though his taxable income and QBI, as well as his share of W-2 wages and unadjusted basis of qualified property, are identical in both cases. The difference reflects the effect of the SSTB limit in the fifth scenario but not in the fourth.

Table 2. Summary of Five Scenarios for Claiming the Section 199A Deduction

Taxable Income	Selected Service and Trade Business (SSTB) Limit	Wage /Qualified Property (WQP)[a] Limit	Deduction
Scenario 1: Single filer with taxable income below the lower income threshold. (See **Table 1**.)	No	No	The deduction is the lesser of • 20% of QBI, or

[20] This is the result of multiplying his RP ($36,000/$50,000 = 73.4%) by his QBI ($180,000), subtracting that amount ($132,120) from his QBI ($180,000) to determine his adjusted QBI ($47,880), and then calculating 20% of that amount (0.2 x $47,880).

[21] [(0.5 x ($60,000 - ($60,000 x 0.734))] = (0.5 x $15,960) = $7,980.

[22] [0.25 x ($60,000 – ($60,000 x 0.734))] + [0.025 x ($100,000-($100,000 x 0.734)) = (0.25 x $15,960) + 0.025 x (26,600) = $3,990 + $665 = $4,655.

[23] [($9,576 - $7,980) x 0.734)] = $1,171, and $9,576 - $1,171 = $8,405.

Taxable Income	Selected Service and Trade Business (SSTB) Limit	Wage /Qualified Property (WQP)[a] Limit	Deduction
Total qualified business income (QBI) from a SSTB and/or a non-SSTB.			• 20% of taxable income less any net capital gain (or 20% of ordinary income). (This amount is also referred to as the maximum deduction).
Scenario 2: Single filer with taxable income above the upper income threshold. (See **Table 1**.) QBI from a SSTB only.	Yes	Yes	No deduction is allowed because QBI is from a SSTB and taxable income exceeds the upper income threshold.
Scenario 3: Single filer with taxable income above the upper income threshold. (See **Table 1**.) QBI from a non-SSTB only.	No	Yes	The deduction is the lesser of • 20% of QBI or 20% of ordinary income, or • the deduction with the full WQP limit.
Scenario 4: Taxable income is within the phase-in range for the SSTB and WQP limitations. (See **Table 1**.) QBI is from a non-SSTB only.	No	Yes	The maximum deduction is reduced by an amount equal to the RP[b] multiplied by the difference between the deduction without the WQP limit and the deduction with the full limit.
Scenario 5: Taxable income is within the phase-in range for the SSTB and WQP limitations. (See **Table 1**.) QBI is from an SSTB only.	Yes	Yes	The deduction is determined in three steps. First, the SSTB limit is applied. In this case, the deduction equals 20% of a reduced QBI. This reduced QBI equals QBI less QBI multiplied by the RP[b]. Second, the WQP limit is applied. In this case, the deduction cannot exceed the greater of 50% of an owner's share of adjusted wages or 25% of adjusted wages plus 2.5% of adjusted property. Adjusted wages are a business's W-2 wages less those wages multiplied by the RP. Adjusted property is an owner's share of the original cost of qualified assets, reduced by that cost multiplied by the RP[b]. Third, the difference between the two deductions from steps 1 and 2 is multiplied by the RP. The result is subtracted from the deduction under the SSTB limit with no WQP limit (step 1) to determine the deduction that may be claimed.

Sources: Congressional Research Service and Joint Committee on Taxation, *Overview of Deduction for Qualified Business Income: Section 199A*, March 2019.

Notes:

a. The wage/qualified property limit specifies that the deduction cannot exceed the greater of 50% of a business's W-2 wages attributable to a taxpayer or 25% of those wages plus 2.5% of the unadjusted basis of depreciable, tangible property used in the business attributable to the same taxpayer.

b. The reduction percentage is the ratio of the amount by which a taxpayer's taxable income exceeds the lower income threshold for the deduction to either $100,000 for joint filers or $50,000 for all other filers.

It helps determine the amount by which the deduction without limits should be reduced when a taxpayer's income falls in the phase-in range for the SSTB and WQP limits.

Net Operating Losses and the 199A Deduction

Another element of the Section 199A deduction that affects effective tax rates for pass-through business profits is its interaction with net QBI operating losses. When a pass-through business owner realizes a net operating loss (NOL) on his or her combined QBI from all qualified businesses, the deduction is zero for that tax year.[24] This loss may be carried forward to the next year and treated as a negative QBI from a trade or business and subtracted from any positive net QBI for the year. (Generally, no carryback of the loss is allowed, but a provision in the Coronavirus Aid, Relief, and Economic Security Act [P.L. 116-136] allows corporate and noncorporate businesses to carry back up to five years NOLs incurred in 2018 to 2020.)[25] If the result of carrying the NOL forward to the next tax year is another QBI net operating loss, then the loss is carried forward until the taxpayer realizes a positive net QBI in a future tax year. When that happens, a taxpayer's QBI for that tax year is reduced, but not below zero, by 20% of the carryover loss.[26]

[24] For any individual, estate, or trust, the Section 199A deduction in a tax year is equal to 20% of QBI plus 20% of qualified REIT dividends and qualified publicly traded partnership income. Negative QBI in a tax year results in no deduction for the business portion of that equation.

[25] For more information, see CRS Insight IN11296, *Tax Treatment of Net Operating Losses (NOLs) in the Coronavirus Aid, Relief, and Economic Security (CARES) Act*, by Jane G. Gravelle, and CRS Insight IN11240, *COVID-19: Potential Role of Net Operating Loss (NOL) Carrybacks in Addressing the Economic Effects*, by Mark P. Keightley.

[26] For example, assume that John owns two pass-through businesses, Alpha and Beta. In year one, the QBI from Alpha is $20,000, while the QBI from Beta is a loss of $50,000, yielding a net QBI of -$30,000. In year two, Alpha has a QBI of $20,000 and Beta a QBI of $50,000. The $30,000 loss from year one is carried over to year two. To calculate his Section 199A deduction for year two, John adds 20% of the combined QBI amount for that year ($70,000) to 20% of the loss carried over from year one (-$30,000), allowing him to take a deduction of $8,000 for year two: $14,000 - $6,000 = $8,000.

Appendix. Final Regulations (TD 9847) on Classifying Businesses as an SSTB

One significant issue addressed by the final regulations for the Section 199A deduction was what it meant to perform services in the professions of health care, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. Section 199A(d)(2) and (3) denies the deduction to owners of these professional businesses if their taxable income is greater than the upper income threshold of the deduction. Owners of the same set of businesses whose taxable income is below the lower income threshold are eligible for the maximum deduction. The deduction they can claim phases out as their taxable income increases within the phase-in range for both the SSTB and WQPR limitations. Thus, the federal income tax burden on profits from these SSTBs depends critically on the criteria the IRS will employ to classify firms engaged in these activities to varying degrees as SSTBs or non-SSTBs, making them eligible for the deduction.

For example, in TD 9847, the IRS noted that skilled nursing, assisted living, and similar facilities offer a range of services to residents. Consequently, whether those facilities and their owners are eligible for the Section 199A deduction depends on the "facts and circumstances" of each case. The final regulations did point out two instances where the income-producing activities of a facility providing medical services did not constitute health care services under Section 199A—and thus were eligible for the deduction, subject to the limitations discussed earlier in the report. One was an extended care facility for senior citizens that earned its income solely from the living facilities it offered residents, while contracting with outside entities to provide medical services to residents. The other was a surgery center that did not employ health care professionals and billed patients only for facility costs related to surgical procedures.

TD 9847 also specified that ownership of an athletic team fell within the scope of services not eligible for the deduction, even though the owners did not directly engage in athletic activities, because their income ultimately was due to the performance of such activities.

Under the final regulations, brokerage services did not include taking deposits or making loans, but they did include arranging lending transactions between a lender and a borrower. Similarly, financial services excluded taking deposits and issuing loans, but the regulations did not provide a broad exemption for all services that may be performed by banks. The origination of loans by securities dealers also fell outside the range of financial services considered SSTBs.

Another issue addressed by the final regulations was the definition of a business whose principal asset was the reputation or skill of one or more of its employees or owners. In this case, the regulations adopted what can be regarded as a narrow position. According to the regulations, such a business incorporated one or more of the following elements: (1) a person who received fees, compensation, or other income for endorsing products or services; (2) a person who licensed or received fees, compensation, or other income for the use of someone's likeness, name, signature, voice, trademark, or any other symbol associated with that person's identity; and (3) a person who received fees, compensation, or other income from appearing at an event or on radio, television, or some other media format. A broader view of this aspect of SSTB income might substantially reduce the amount of business income eligible for the deduction.

If a business provides goods and services to an SSTB and the same person owns 50% or more of both businesses, the portion of the business providing those goods and services must be treated as a separate SSTB by the related parties.

TD 9847 included a de minimis rule for determining whether trades or businesses with gross receipts of $25.0 million or less should be considered SSTBs. Under the rule, if less than 10% of those receipts can be attributed to a SSTB, then the business is not an SSTB. The receipt threshold decreases to 5% for businesses with more than $25.0 million in gross receipts. Owners who receive income from SSTBs in excess of the de minimis threshold but conduct a separate trade or business may be able to claim a Section 199A deduction for income from the latter trade or business.

Remaining uncertainties about which specific businesses can be considered SSTBs make it difficult to determine the percentage of pass-through firms that will eligible for the deduction in 2020, regardless of their owners' taxable income.

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