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

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

Congress made numerous changes to the taxation of individuals and corporate and noncorporate businesses as part of P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act or TCJA). Among those changes was a permanent cut in the corporate income tax rate from a top rate of 35% in a graduated rate structure to a single rate of 21%.

During the congressional debate over the TCJA, pass-through business owners sought tax relief comparable to any reduction in corporate tax rates included in the bill. In response, Congress added a new deduction for pass-through business under Internal Revenue Code (IRC) Section 199A. Like most of the individual income tax changes in P.L. 115-97, the IRC Section 199A deduction is temporary: it is available from 2018 to 2025.

IRC Section 199A allows individuals, trusts, and estates with pass-through business income to deduct up to 20% of their qualified business income (QBI) from their taxable ordinary income. (Owners of certain agricultural or horticultural cooperatives, real estate investment trusts, and publicly traded partnerships are also eligible for the deduction, but their use of it is 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 a qualified domestic trade or business. If a taxpayer owns more than one business, then the taxpayer's total QBI in a year is the sum of the QBIs for all businesses.

The *maximum deduction* is the lesser of

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

Two limitations that reduce the maximum deduction may apply:

- **Wage and qualified property limitation (WQP)**, which reduces the maximum deduction according to a formula based on an 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 SSTB owner may claim for QBI. An SSTB is any trade or business involved in accounting; health care; law; actuarial science; athletics; brokerage services; consulting; financial services; the performing arts; investing and investment management; or dealing in securities, partnership interests, or commodities. An SSTB can also be a business 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 when the owner's income exceeds a lower income threshold (\$364,200 for joint filers and \$182,100 for other filers in 2023). Their full impact is realized when taxable income exceeds an upper income threshold (\$464,200 for joint filers and \$232,100 for other filers in 2023).

This report provides a brief overview of the deduction and several examples of how it is calculated in the presence of the WQP and SSTB limitations.

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Congress made numerous changes to the taxation of individuals and corporate and noncorporate businesses in December 2017, as part of P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act or TCJA).¹ A key change was a permanent cut in the corporate income tax rate from a top rate of 35% within a graduated corporate tax rate structure to a single rate of 21%.

During the congressional debate over the tax bill, pass-through business owners sought tax relief comparable to any reduction in corporate tax rates included in the legislation.² In response, Congress added a new deduction for pass-through businesses under Internal Revenue Code (IRC) Section 199A. The deduction allows pass-through business owners to deduct up to 20% of their qualified business income (QBI) in determining their individual income tax liability. Like most of the changes in the individual income tax in P.L. 115-97, the Section 199A deduction is temporary: it is available from 2018 to 2025.

This report provides a brief overview of the deduction and examples of how it is calculated in five basic scenarios.

Overview of the Section 199A Deduction

Between 2018 and 2025, IRC 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 their use of it is not covered in this report.) The deduction may be claimed on the Form 1040, after eligible taxpayers take the standard deduction or the sum of their itemized deductions.³

Several considerations are key in claiming the deduction:

- a pass-through business owner's adjusted gross income (AGI),
- the nature of a pass-through business, and
- an owner's share of a business's W-2 wages and the original cost of its qualified assets.

Who Qualifies for the Deduction?

The IRC Section 199A deduction applies to a broad range of business activities. The deduction's final regulations (Treasury Decision [TD] 9847) specify that a trade or business under IRC Section 199A has the same meaning as a trade or business under Section 162.⁴ An activity qualifies as an IRC Section 162 business if it is conducted with continuity, regularity, and the intent of earning a profit. Such an activity can be done on a full-time or part-time basis. In the

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.

case of the IRC 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?

IRC Section 199A(d)(2) specifies that an SSTB is any trade or business that

- provides services in accounting, health, law, actuarial science, athletics, brokerage services, consulting, financial services, or the performing arts; or
- provides services in investing and investment management, trading, or dealing in securities, partnership interests, or commodities; or
- derives much of its income from the reputation or skill of one or more of a firm's owners or employees.

There is considerable overlap between SSTBs and businesses that do not qualify for a tax exclusion for long-term capital gains on the sale or exchange of qualified small business stock under IRC Section 1202. According to IRC Section 1202(e)(3)(A), qualified stock issued by these businesses is ineligible for the gains exclusion:

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 IRC Section 1202 gains exclusion. For a reason that is not clear from IRC Section 199A's legislative history, engineering services and architecture are excluded from the list of SSTBs, making them eligible for the deduction, regardless of an owner's taxable income. Under IRC Section 1202, by contrast, those two professional services are ineligible for the gains exclusion. Since SSTBs generally are professional service firms whose success may stem from the skills and reputation of their owners and employees, it is difficult to understand why engineering and architecture firms are not classified as SSTBs.

The deduction's final regulations 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 depends partly on the owner's QBI. IRC Section 199A defines QBI as the net amount of items of income, deduction, loss, and gain for a pass-through business. Only income items connected with a trade or business conducted in the United States or Puerto Rico can be used to compute a firm's QBI. If someone owns more than one pass-through businesses, the owner is required to determine the QBI separately for each trade or business. Under certain conditions, an owner of multiple pass-through businesses is allowed to combine (or "aggregate") those businesses, even if they are conducted as separate legal entities, in determining the owner's QBI.⁶

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.

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

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.

Do Any Limits Apply to the Deduction?

Technically, there are three limitations on the deduction. One applies to *every* claim for the deduction, while the other two apply only if a pass-through business owner's AGI exceeds a specified amount.⁷

The unavoidable limitation is an *overall cap on the deduction* a business owner may take in a tax year, a cap that can be thought of as the *maximum deduction*. It is the lesser of

- the sum of 20% of an owner's QBI and (if applicable) 20% of any REIT dividends and PTP income the owner receives, 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:

- **a 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
- **an SSTB limitation**, which reduces the maximum deduction an owner may claim for SSTB QBI.

The SSTB and WQP limitations do not apply to the 20% deduction for REIT and PTP income. They phase in if a pass-through business owner's income exceeds the deduction's lower income threshold (\$364,200 for joint filers and \$182,100 for other filers in 2023). Their full impact is realized when an owner's AGI exceeds an upper income threshold (\$464,200 for joint filers and \$232,100 for other filers in 2023). **Table 1** shows the lower income and upper income thresholds for both limitations from 2018 to 2023; the amounts have been indexed for inflation starting in 2019. More details on the potential impact of the two limitations are provided below.

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 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.

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

Tax Year	Lower Income Threshold		Upper Income Threshold	
	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
2021	\$329,800	\$164,900	\$429,800	\$214,900
2022	\$340,100	\$170,050	\$440,100	\$220,050
2023	\$364,200	\$182,100	\$464,200	\$232,100

Source: P.L. 115-97 and IRS Revenue Procedures 2018-57, 2019-44, 2020-45, 2021-45, and 2022-38.

Notes: All other filers are single and head-of-household filers and married persons filing as a single person. The amounts for 2019 and 2023 have been indexed for inflation.

WQP Limitation

This limitation 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 if the WQP limit applies to the deduction and QBI is from non-SSTB businesses only.

- (1) An owner’s AGI is less than the lower income threshold:** in this case, the maximum deduction may be claimed.
- (2) An owner’s AGI falls in the phase-in range for the WQP limit:** in this case, the maximum deduction and the deduction with the full WQP limit are calculated and compared. The difference between the two deductions is multiplied by a *reduction percentage* to determine a reduction amount, which is subtracted from the maximum deduction to determine the deduction amount an owner may claim.⁹
- (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 if an owner’s AGI is greater than the lower income threshold. There are four basic outcomes:

- (1) An owner’s AGI is less than the lower income threshold:** the maximum deduction may be claimed.

⁹ The deduction’s reduction percentage (RP) reflects the degree to which an owner’s AGI exceeds the lower income threshold. For example, if an owner were a joint filer with an AGI of \$400,000 in 2023, his/her RP would be 35.8%: \$400,000 in AGI less \$364,200 lower income threshold equals \$35,800, and that amount divided by the \$100,000 phase-in range for joint filers is equal to 0.358, or 35.8%. As a formula, $RP = (AGI - \text{lower income threshold} / \$100,000 \text{ for joint filers or } \$50,000 \text{ for other filers}) \times 100$.

(2) An owner's AGI falls in the phase-in range but only the SSTB limit applies: the maximum deduction is reduced by a phased-in SSTB limit.

The phase-in range for both the SSTB and WQP limits in 2023 is \$364,200 to \$464,200 for joint filers (a range of \$100,000), and \$182,100 to \$232,100 for other filers (a range of \$50,000). When a pass-through business owner's AGI falls within either range, the maximum deduction is reduced according to a formula based on the extent to which the owner's AGI exceeds the lower income threshold. This excess is divided by \$100,000 for joint filers and \$50,000 for all other filers, to determine the deduction's RP. So if only the SSTB limitation applies, an owner's QBI from an SSTB is first reduced by an amount equal to (QBI x RP), and then the deduction equals 20% of the reduced QBI.

(3) An owner's AGI lies in the phase-in range and the SSTB and WQP limits both apply: the maximum deduction is reduced 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. For example, if an owner's AGI above the lower income threshold is 90% of the phaseout range for a joint filer (i.e., \$454,200 for married joint filers in 2023), then the owner's SSTB QBI and the owner's share of a firm's W-2 wages and the unadjusted basis of its qualified property are each reduced by 90%. These adjustments produce two possible deductions:

- one equal to 20% of the reduced SSTB QBI without the modified WQP limit, and
- one equal to 20% of the reduced SSTB QBI 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 (deduction 1 above) to determine the Section 199A deduction an owner may claim when both limits apply.

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

Five Basic Scenarios

One way to understand how the IRC Section 199A deduction is intended to work is to calculate it under different scenarios. The following five scenarios explore the effects of the SSTB and WQP limits on a single filer with different amounts of AGI. The results are summarized in **Table 2**. The scenarios can be regarded as basic in that they illustrate how the deduction is calculated if a pass-through business owner's AGI (1) does not exceed the lower income threshold; (2) falls in the phase-in range for the two limits; or (3) exceeds the upper income threshold.

Scenario 1: Taxable Income Below the Deduction's Lower Income Threshold

Assume that in 2023

- James owns a restaurant (non-SSTB) as a sole proprietor;
- he is a single filer with an AGI of \$180,000 and no net capital gains; and
- his business's QBI totals \$140,000.

In this scenario, James's taxable income (\$180,000) is slightly below the lower income threshold for single filers (\$182,100 in 2023), which means that he may claim the maximum deduction. So his 2023 deduction is the lesser of 20% of James's QBI, or 20% of his ordinary income, or **\$28,000**.¹⁰

Scenario 2: Taxable Income Above the Upper Income Threshold for SSTB QBI only

Assume that in 2023

- James is part owner of a law firm (SSTB);
- he is a single filer with an AGI of \$245,000 and no net capital gains; and
- his SSTB's QBI is \$190,000.

Because this scenario involves a pass-through business owner whose AGI exceeds the deduction's upper income threshold (\$232,100) for a single filer in 2023, and whose entire QBI comes from an SSTB, James may claim **no deduction** for that tax year.

Scenario 3: Taxable Income Above the Upper Income Limitation for Non-SSTB QBI only

Assume that in 2023

- James owns a restaurant (non-SSTB) as a sole proprietor;
- he is a single filer with an AGI of \$250,000 and no net capital gains;
- his QBI comes to \$180,000; and
- his share of the restaurant's W-2 wages is \$60,000, and his share of the unadjusted basis of its qualified property is \$100,000.

In this scenario, the QBI is entirely from a non-SSTB, and James's AGI is above the upper income threshold (\$232,100) for a single filer in 2023. As a result, the deduction is subject to the WQP limit, but not the SSTB limit. The deduction James may claim cannot exceed the larger of 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.¹¹ Thus, James may claim a **\$30,000** Section 199A deduction for 2023.¹²

Scenario 4: Taxable Income Within the Phase-in Range for the SSTB and WQP Limits for Non-SSTB QBI only

Assume that in 2023

- James owns a restaurant (non-SSTB) as a sole proprietor;

¹⁰ This amount is the lesser of 20% of his QBI ($0.2 \times \$140,000 = \$28,000$), and 20% of his ordinary income ($0.2 \times \$180,000 = \$36,000$).

¹¹ In this example, 50% of W-2 wages equal \$30,000 (i.e., $0.5 \times \$60,000$) and 25% of those wages plus 2.5% of the unadjusted basis of qualified property equal \$17,500 (i.e., $(0.25 \times \$60,000) + (0.025 \times 100,000)$).

¹² The maximum amount of the deduction without the limitation would be \$50,000 (i.e., 20% of \$250,000). But with the WQP limitation, he can claim only \$30,000.

- he files as a single taxpayer with an AGI of \$200,000 and no net capital gains;
- his QBI totals \$180,000; and
- his share of the restaurant's W-2 wages and the unadjusted basis of its qualified property is \$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 maximum deduction reduced by the difference between that deduction and the deduction with the full WQP limit, multiplied by James's RP.

The first step is to calculate the RP, which 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 35.8%.¹³ 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 \$40,000,¹⁴ whereas the deduction with the full WQP limit is \$30,000.¹⁵ As a result, the reduction amount is \$3,580,¹⁶ and the IRC Section 199A deduction that James may claim in 2023 is **\$36,420**.¹⁷

Scenario 5: Taxable Income Is Within the Phase-in Range for the SSTB and WQP Limitations for SSTB Qualified Income Only

Assume that in 2023

- James is a partner in a law firm (SSTB);
- he is a single filer with an AGI of \$200,000 and no net capital gains;
- his share of the firm's QBI is \$180,000; and
- his share of the firm's W-2 wages and the unadjusted basis of the firm's qualified property is \$60,000 and \$100,000, respectively.

This scenario is the most complicated of the five because it requires calculating the deduction under both the SSTB and the WQP limits. This is because James's taxable income is within the phase-in range for both and his entire QBI comes from an SSTB.

The calculation involves several steps. The first step is to determine his deduction under the SSTB limit only. To do so, James's QBI is reduced by an amount equal to his RP multiplied by his QBI share. The reduced QBI is then multiplied by 20% to calculate the deduction he could claim under the SSTB limit without the WQP limit; in this case, the deduction is \$23,112.¹⁸

The next step is to determine his deduction with the WQP limit only, which is the greater of 50% of James's share of W-2 wages multiplied by his RP (\$19,260),¹⁹ or the sum of 25% of those

¹³ $\$200,000 - \$182,100 = \$17,900$, $\$17,900/\$50,000 = 0.358$, and $0.358 \times 100 = 35.8\%$.

¹⁴ $0.20 \times \$200,000$.

¹⁵ See footnote 11.

¹⁶ $\$40,000 - \$30,000 = \$10,000$, and $\$10,000 \times 0.358 = \$3,580$.

¹⁷ $\$40,000 - \$3,580 = \$36,420$.

¹⁸ This is the result of multiplying his RP ($\$17,500/\$50,000 = 35.8\%$) by his QBI (\$180,000), subtracting that amount (\$62,440) from his QBI (\$180,000) and then multiplying that amount by 20% ($0.2 \times \$115,560 = \$23,112$).

¹⁹ $[(0.5 \times (\$60,000 - (\$60,000 \times 0.358)))] = (0.5 \times \$38,520) = \$19,260$.

wages and 2.5% of share of the law firm’s total unadjusted basis of qualified property, multiplied by the RP (\$25,680).²⁰ Thus, James’s deduction under the WQP limit is \$25,680.

In the final step, the difference between the deduction under the SSTB limit without the WQP limit (\$23,112) and the deduction under the SSTB limit with the modified WQP limit (\$25,680) is multiplied by James’s RP. The result is subtracted from the deduction with no WQP limit (\$23,112) to determine the Section 199A deduction James may claim for the 2023 tax year: **\$20,544.**²¹

This deduction is about 44% less than the deduction James could claim in the fourth scenario, which is identical to the fifth scenario regarding James’s taxable income, QBI, and share of W-2 wages and unadjusted basis of qualified property. The difference illustrates the impact of both limits on the allowable deduction when part or all of a pass-through business owner’s QBI comes from an SSTB and the owner’s AGI lies in the phase-in range for the limits. The results of the first three scenarios are not comparable because they are based on differing owner AGIs and QBIs.

Table 2. Summary of Five Scenarios

	SSTB Limit	WQP^a Limit	Deduction	Deduction Amount (\$)
Scenario 1: Single filer has adjusted gross income (AGI) below the 2023 lower income threshold (see Table I). Qualified business income (QBI) comes from an SSTB, a non-SSTB, or both.	No	No	The deduction is the lesser of <ul style="list-style-type: none"> • 20% of QBI, or • 20% of ordinary taxable income less net capital gains. (This amount can also be referred to as the maximum deduction.)	\$28,000
Scenario 2: Single filer has AGI above the 2023 upper income threshold (see Table I). QBI comes from an SSTB only.	Yes	No	No deduction is allowed because QBI is from an SSTB only and AGI exceeds the upper income threshold.	\$0

²⁰ $[0.25 \times (\$60,000 - (\$60,000 \times 0.358))] + [0.025 \times (\$100,000 - (\$100,000 \times 0.358))] = (\$9,630 + \$16,050) = \$25,680.$

²¹ $[(\$9,576 - \$7,980) \times 0.734] = \$1,171, \text{ and } \$9,576 - \$1,171 = \$8,405.$

	SSTB Limit	WQP ^a Limit	Deduction	Deduction Amount (\$)
<p>Scenario 3: Single filer has AGI above the 2023 upper income threshold (see Table I). QBI comes from a non-SSTB only.</p>	No	Yes	<p>The deduction is the least of</p> <ul style="list-style-type: none"> • 20% of QBI, • 20% of ordinary income, or • the deduction with the full WQP limit. 	\$30,000
<p>Scenario 4: Single filer's AGI is within the phase-in range for the SSTB and WQP limitations (see Table I). QBI is from a non-SSTB only.</p>	No	Yes	<p>The maximum deduction is reduced by an amount equal to the reduction percentage (RP)^b multiplied by the difference between the deduction without the WQP limit and the deduction with the full limit.</p>	\$36,420
<p>Scenario 5: Single filer's taxable income is within the phase-in range for the SSTB and WQP limitations (see Table I). QBI is from an SSTB only.</p>	Yes	Yes	<p>An owner's deduction is calculated in three steps.</p> <p>First, the SSTB limit is applied. The deduction equals 20% of a reduced QBI, which equals QBI less QBI multiplied by the RP.^b</p> <p>Second, the WQP limit is applied. The deduction cannot exceed the greater of 50% of an owner's share of a business's adjusted wages or 25% of such wages plus 2.5% of the owner's share of its adjusted qualified property. Adjusted wages are a business's W-2 wages less those wages multiplied by the RP. Adjusted property is the original cost of a business's qualified assets, reduced by that cost multiplied by the RP.^b</p> <p>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 an owner may claim.</p>	\$20,544

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

Notes:

- The WQP limit requires that the deduction not 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 also attributable to the same taxpayer.

- b. The reduction percentage is the ratio of the amount by which a taxpayer's AGI exceeds the deduction's lower income threshold to either \$100,000 for joint filers or \$50,000 for all other filers. The RP helps determine the amount by which the deduction without limits should be reduced when a taxpayer's AGI falls in the SSTB and WQP phase-in range.

Net Operating Losses and the IRC 199A Deduction

Another aspect of the IRC Section 199A deduction that can affect a pass-through business's effective tax burden is the treatment of net QBI operating losses. When a pass-through business owner realizes a net operating loss (NOL) on his or her QBI from all qualified businesses, the deduction is \$0 for that tax year.²² The loss may be carried forward to the next year and treated as a negative QBI that is subtracted from any positive QBI for the year. A QBI NOL may be carried forward until a taxpayer realizes a positive QBI. In the year that happens, a taxpayer's current-year QBI is reduced, but not below zero, by 20% of the carried over loss.²³

Generally, no carryback of the loss is allowed, but the Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136) permitted corporate and noncorporate businesses to carry back up to five years NOLs incurred in 2018 to 2020.²⁴

²² 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.

²³ 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.

²⁴ 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.

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

One significant issue addressed by the final regulations for the IRC 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. IRC Section 199A(d)(2) and (d)(3) deny the deduction to owners of these professional businesses if their taxable income is greater than the deduction's upper income threshold. 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 employs to classify firms engaged in these activities to varying degrees as SSTBs or non-SSTBs, making them eligible for the deduction.

For example, in the final regulations (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 IRC 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 IRC Section 199A—and thus were eligible for the deduction, subject to the limitations discussed earlier in this 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, regardless of their owners' taxable income.

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