

[Section 199A Deduction](#)



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Section 199A deduction, also known as the Qualified Business Income deduction, arises from the Tax Cuts & Jobs Act of 2017. This is a significant tax break for small business owners but there are rules and limits of course.

Section 199, without the A, is the section covering Domestic Production Activities Deduction. Section 199A is seemingly modeled after this (or at least a portion was ripped off by legislators) since the mathematics and reporting is similar between Section 199A and Section 199. Recall that Domestic Production Activities Deduction was reported on [Form 8903](#) and eventually deducted on line 35 of Form 1040.

On January 18, 2019 the [IRS and the Treasury Department](#) released the [Section 199A final regulations](#), including some related guidance such as [IRS Notice 2019-7](#) for rental property owners. We apologize upfront that this blog post is delayed since there are some material changes to previous blog posts, but here we are... post-tax season. The Section 199A final regulation summary is over 240 pages. However, given our attention to small business owners and reviewing our current clients' needs, we [truncated this massive document](#) into about 70 pages that you can zip through in an hour.

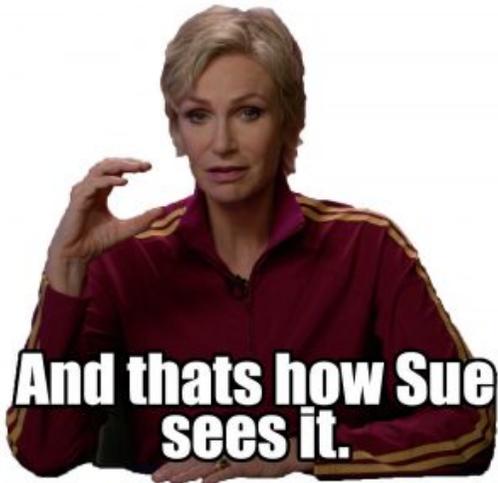
The Tax Cuts and Jobs Act of 2017 created a new tax deduction for business owners (and others) called the Section 199A Qualified Business Income Deduction. Later in August 2018, the IRS released [Proposed Regulations 1.199A](#) to offer some additional insight to Section 199A. The Treasury Department and the IRS held a public hearing on the proposed regulations on October 16, 2018 and later issued Section 199A final regulations summaries on January 18, 2019. Some of the major provisions of the 1986 tax code upheaval took over four years to resolve (such as passive activities).

Before we run through some of those finer details, here are some pertinent blog posts and other information that you might find useful. Otherwise, freshen up that coffee and buckle up buttercup-

Section 199A Defining Terms

Pass-thru entities and structures include-

- Sole proprietorships (no entity, [Schedule C](#)).
- Real estate investors (no entity, Schedule E).
- Disregarded entities (single member LLCs).
- Multi-member LLCs.
- Any entity taxed as an S corporation.
- Trusts and estates, REITs and [qualified cooperatives](#).



Specified Service Trade or Business is defined as-

- Traditional service professions such as doctors, attorneys, accountants, actuaries and consultants.
- Performing artists who perform on stage or in a studio.
- Paid athletes.
- Anyone who works in the financial services or brokerage industry.
- And now the hammer... "any trade or business where the principal asset is the reputation or skill" of the owner. Why didn't they just start with this since everything else would have been moot. Oh well...

Interestingly, removed from the traditional service profession are engineers and architects. But an engineer operating a business based on his or her reputation or skill is still a specified service trade.

Sit on the ledge, sure, but don't jump off a bridge just yet. The specified service trade or business problem only comes up when your taxable income exceeds the limits. So, a financial advisor making \$150,000 might still enjoy the Section 199A deduction. Keep reading!

Income Limits

- Based on taxable income including all sources (not just business income). Also limited to 20% of taxable income. See [Line 10 of 2018's Form 1040](#) to assess your 2019 taxable income using 2018 as a proxy, adjusted for itemized deductions and exemptions (or lack thereof).
- Single is \$157,500 completely phased out by \$207,500 (adjusted for inflation). The \$157,500 should mean something else to you- it is the end of the 24% marginal tax bracket. Recall that the marginal tax rates are indexed each year.
- Married filing jointly is \$315,000 completely phased out by \$415,000 (adjusted for inflation). Same thing here- \$315,000 is the end of the 24% marginal tax bracket.

Calculating the Section 199A Deductions

The basic Section 199A Qualified Business Income pass-through deduction is 20% of net qualified business income which is huge. If you make \$200,000, the deduction is \$40,000 times your marginal tax rate of 24% which equals \$9,600 in your pocket. Who says Obamacare isn't affordable now? Here is the exact code-

(2) DETERMINATION OF DEDUCTIBLE AMOUNT FOR EACH TRADE OR BUSINESS. The amount determined under this paragraph with respect to any qualified trade or business is the lesser of-

(A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

(B) the greater of-

(i) 50 percent of the W-2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property (in other words, prior to any depreciation).

There are some devils in the details of course. The best way is to show some examples-

Wilma makes \$100,000 in net business income from her sole proprietorship but also deducts \$5,000 for self-employed health insurance, \$7,065 for self-employment taxes and \$10,000 for a SEP IRA. These are not business deductions- they are adjustments on Form 1040 to calculate adjusted gross income. Her deduction is the lessor of 20% of \$100,000 (net business income) or 20% of her taxable income, which could be less (see Pebbles below).

Barney owns three rentals with net incomes of \$20,000 and \$5,000, with one losing \$8,000 annually. These are aggregated to be \$17,000. He would deduct 20% of \$17,000. This of course is assuming his activities rise to the level of a qualified business or he meets the safe harbor tests in [IRS Notice 2019-7](#).

Barney has passive losses that carried forward and are “released” because he now has net rental income, those passive losses are taken first. With using the same example above with \$10,000 in passive loss carried forward, Barney’s deduction would equal \$17,000 less \$10,000 or 20% of \$7,000.

Pebbles earns \$100,000 but reports \$80,000 of taxable income on her tax return due to other deductions such as her itemized deductions. Her Section 199A deduction would be \$16,000 since it limited by the lessor of 20 % of \$100,000 or \$80,000.

Mr. Slate operates an online retailer S corporation which pays \$100,000 in W-2 wages and earns \$400,000 in net qualified business income. Because he is considered a “high earner” by exceeding the income limits, his deduction is limited to 50% of the W-2 or \$50,000 which is less than 20% of \$400,000.

If Mr. Slate instead operates as a sole proprietor and earns \$500,000 but does not pay any W-2 wages, his deduction is the lessor of 50% of the W-2 wages (or \$0 in this example) or 20% of the \$500,000. If he paid out \$200,000 in wages and had \$300,000 in net business income, his Section 199A deduction would be the lessor of 50% of \$200,000 or 20% of \$300,000. In other words, he would deduct \$60,000 (\$60,000 is less than \$100,000, even in Canada). **He would want to create an LLC, tax it as an S corporation and pay out W-2 wages to maximize his Section 199A deduction.**



If Mr. Slate instead operates as a specified service trade as defined previously, he would completely phase out of the Section 199A deduction by exceeding the income limit of \$207,500 and \$415,000. **This is the specified service trade “gotchya.”** Recall that the specified service trade or business limits is the top of the 24% marginal tax bracket plus \$50,000 for singles and \$100,000 for married taxpayers.

If Mr. Slate was married and operated a specified service trade, and the taxable income considering all income sources (spouse, investments, etc.) exceeded \$315,000 but was less than \$415,000, there would be a sliding scale of deduction eligibility. Silly rabbit, tax reform doesn’t mean tax simplification.

Fred... yes, we can’t neglect Fred... is single and operates an S Corp as an accountant. Days of busting up rocks for Mr. Slate are in the rear-view mirror. He earns \$100,000 in net qualified business income after paying \$50,000 in W-2 wages to himself. He is

a clearly a specified service trade but because he earns less than \$157,500 total (\$150,000 in this example) he can take advantage of the full Section 199A deduction of 20% of \$100,000. The question of reasonable salary is not being entertained here... focus on the W-2 to income relationship.

Betty becomes a slumlord and earns \$500,000 in rental income. No W-2 since she is operating the properties as an individual (and converting passive income into earned income vis a vis a W-2 would be silly). Let's say she purchased the properties for a \$1,000,000 (unadjusted basis). The math would go like this-

20% x \$500,000 is \$100,000 (straight calculation).

50% of \$0 is \$0 (W-2 limit calculation).

2.5% of \$1,000,000 is \$25,000 (depreciable asset limit calculation).

Section 199A is limited to the lesser of \$100,000 as compared to the greater of \$0 (W-2) and \$25,000 (depreciable assets).

There are examples with spreadsheets and other explanations at the end of this webpage. **Warning- it is dry material and uses spreadsheets which makes it worse.**

Section 199A Takeaways

- No entity is penalized under the new tax law. Some entities and situations might not qualify or be limited in some fashion, but the high-water mark in terms of taxation is the old 2017 tax law.
- Taxable income becomes a big deal for two reasons! First, \$1 over \$157,500 or \$315,000 starts the specified service business disqualification and W-2 limitation (and there is also a depreciation component that we are glossing over in this summary). Second, the Section 199A deduction is limited by 20% of taxable income from all sources (what would be reported on your tax returns).
- W-2 wages include all W-2 wages, not just those paid to the owner(s). Converting a 1099 contractor to a W-2 employee might be beneficial.
- Self-employment taxes will still be calculated on the net business income before the Section 199A deduction since the deduction is taken "below the line" on Form 1040. So you could earn \$100,000 and deduct \$20,000 under Section 199A, but still pay self-employment taxes on \$100,000.
- **S corporations remain a critical tax saving tool for two reasons.** First, the usual self-employment tax savings remains intact for all business owners including specified service trades or businesses. Second, a business owner might need to pay W-2 wages to himself or herself to not be limited by income, and only corporations can pay W-2 wages to owners (in other words, an LLC cannot without an S Corp election).

Section 199A Pass-Thru Optimization

As you can see, there is some optimization that is necessary for a small business owner to get the most from the Section 199A deduction. On one hand we want to reduce W-2 salaries to shareholders to minimize self-employment taxes. On the other hand, we want to increase W-2 salaries so they do not limit the amount of Section 199A that is deducted.

This seems straightforward since payroll taxes are 15.3% plus some unemployment and other insidious stuff and the Section 199A Qualified Business Income deduction is 20%. However, the 20% Section 199A deduction must be multiplied by the marginal tax rate to obtain the true tax benefit. Even at a 37% marginal tax rate, the additional payroll taxes might exceed the Section 199A deduction tax benefit. Again, optimization is important. Here is our Knowledgebase article which expands on this topic (spoiler alert... the optimized percentage is 27.9% before wages are paid... so \$100,000 in net business income should pay \$27,900 in wages to optimize).

Section 199A Decision Tree

Remember that taxable income is all income for the household. The following numbers are using 2018 tax year data... but it is easy to remember. These income limits are the top of the 24% marginal tax bracket plus \$50,000 for singles and \$100,000 for

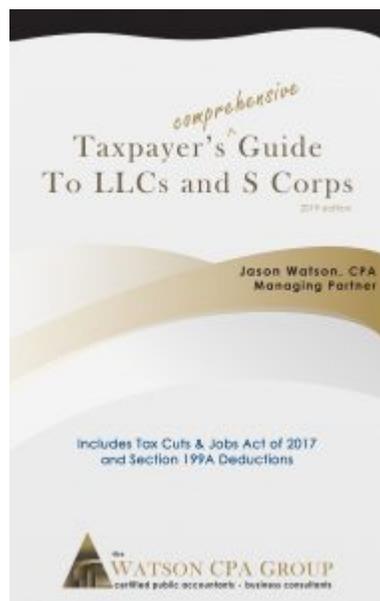
married taxpayers.

Specified Service Trade or Business

- If taxable income is less than \$157,500 / \$315,000 then the 20% deduction is fully available.
- If taxable income is greater than \$157,500 / \$315,000 but less than \$207,500 / \$415,000 then a partial deduction is available.
- If taxable income is greater than \$207,500 / \$415,000 then you are hosed.

All Others

- If taxable income is less than \$157,500 / \$315,000 then the 20% deduction is fully available.
- If taxable income is greater than \$157,500 / \$315,000 but less than \$207,500 / \$415,000 then a partial deduction is available with the W-2 and depreciable asset limit calculations phase in.
- If taxable income is greater than \$207,500 / \$415,000 then the 20% deduction is compared to the full W-2 and depreciable asset limit calculations (see Betty above).



Book Updates

Our book, [Taxpayer's Comprehensive Guide to LLCs and S Corps](#), has been updated to the **2019 Edition** which includes Section 199A deductions and other revisions based on the Tax Cuts & Jobs Act of 2017. If you've purchased it prior to the updates, please send us an email and we will forward you the latest and greatest version.

S Corp Section 199A Deduction

We are going to walk you through a handful of examples comparing non-S Corp scenarios such as sole proprietorships, single-member LLCs (disregarded entity) and other pass-through environments to those same situations being taxed as an S corporation. We will demonstrate the benefits of the Section 199A deduction, and how it plays into the "should I elect S Corp?" question.

Aside from the usual suspects such as not earning more than \$30,000 in net business income after expenses or operating in Tennessee or New York City, every scenario provides an additional benefit by electing S Corp status on top of the Section 199A deduction.

Section 199A Calculation

There are four variables you need to assign values to, a definition to consider, one tax bracket to memorize and two phase-out numbers to understand.

- Taxable Income- You need to determine the amount the entire household reports as taxable income, not just the business income. See Line 43 of your Form 1040 from 2017 to gain perspective of where you are. Write down 20% of this number.
- W-2 and Depreciable Assets- You need to calculate the total amount of W-2 wages the business pays including staff. Write down 50% of this number. You need to calculate the unadjusted basis (the value immediately after purchase before depreciation) of any depreciable assets the business owns. Write down 2.5% of this number (this becomes important for real estate investors).
- Qualified Business Income- Take your net business income after expenses, and write down 20% of this number.
- Specified Service Trade or Business- Does your business survive on the reputation or skill of its owner(s)? Are you an accountant, actuary, attorney, consultant, financial advisor, medical doctor, paid athlete or performing artist? Click on the buttons at the beginning of this page to see updates; there are several involving the SSTB designation.
- End of 24%- The 24% tax bracket ends at \$157,500 for single taxpayers and \$315,000 for married taxpayers (for the 2018 tax year... each year is indexed off of 2018). The next tax bracket leaps to 32%. The 24% to 32% jump is clearly intentional and draws a line in the sand between middle class and upper middle class in our opinion. The Section 199A benefit might erode after the 24% marginal tax bracket depending on your situation.
- Phase Out- The income phase out period is \$50,000 for single and \$100,000 for married.



Section 199A Deduction Limits

We explained the decision tree above, however we want to illustrate the iteration in a different way. The question becomes, “How do I figure out my Section 199A deduction?” Besides using expensive tax software and professional advice, you can consider this flowchart.

If your taxable income is in the 24% marginal tax bracket or less, stop. You are done and can select the lower of 20% of your qualified business income or 20% of your taxable income.

Assuming now that your taxable income is in the 32% marginal tax bracket or above, you must worm in some additional Section 199A limitations based on the following-

- Non Specified Service Business- You must now consider the Section 199A deduction based on W-2 wages or depreciable assets, and use the most restrictive of all Section 199A calculations. If you are in the income phase-out range (or the deduction limitation phase-in range, however you want to view the nomenclature), there is a linear, sliding scale of limitation based on W-2 wages and depreciable assets. In other words, the deeper into the phase-out range you are, the limiting effect of W-2 / assets becomes stronger. No need to hurt ourselves with the calculus at this point.
- Specified Service Business- You must now reduce your Section 199A deduction on a linear, sliding scale that reaches \$0 as you move along the phase-out range (which is \$50,000 for single taxpayers and \$100,000 for married taxpayers). W-2 wages or depreciable assets come into play, but in a different way ([our Section 199A PDF has an example](#)). Your Section 199A simply ends after \$207,500 (single) and \$415,000 (married)

Section 199A Examples

We created a handful of examples in our book and Knowledgebase articles with two intentions. One, to demonstrate how the Section 199A deduction is calculated and two, to show that an S Corp remains a critical tax reduction vehicle. Brace yourself for nauseating spreadsheets that are only meaningful to the spreadsheet designer. We hope our commentary and explanations make sense, and that the logic of the step-by-step iteration becomes clear. We might be dreaming...Don't forget! We have also

created fictitious tax returns for Fred Flintstone operating an S corporation (he bought Slate Rock and Gravel from Mr. Slate). You can see [side by side the differences between 2017 and 2018](#), using the new tax brackets, the new standard deduction and the Qualified Business Income Deduction (QBID) along with Section 199A. Click the button below-

Section 199A Consultation

How does all this Section 199A work? Do you want a tax projection with the new tax laws? Let's schedule a time to chat!

Name (required)	Business Name
<input type="text"/>	<input type="text"/>
Email (required)	Message
<input type="text"/>	<input type="text"/>
Phone Number (slightly required so we can stalk you)	
<input type="text"/>	
State	
<input type="text"/>	
<input type="submit" value="Submit"/>	

Our fee is \$150 for 40 minutes (such a deal for you!). If we decide to press forward with an engagement, we will **credit the \$150 towards future services**. If you don't need convincing and already want our services such as business tax return preparation or S Corporation subscription package, and you simply have some housekeeping questions, we answer those at no charge. Charging a consult fee to tell you how great we are is not cool.

Consultations are scheduled on weekdays during the work day. Yes, we can accommodate other days and after-hours, but those are reluctantly agreed to after some eye-rolling and complaining. We will answer your questions to determine three things-

- Do you need our help?
- Can the Watson CPA Group and its [support staff](#) help you?
- Can we work together as a collaborative partnership?

From there we can determine the best plan which might be a simple "keep on keeping on"; otherwise we will construct a malleable plan together and provide a quote for those services.

Shockingly we actually return all consultation requests via email and phone call. No black holes here!

Section 199A Recap

Hopefully you are still with us and not in the fetal position sucking your thumb. To hammer these points home, the Section 199A small business deduction won't help everyone and the S corporation still has some shine (although perhaps less in some situations) as an overall tax reduction mechanism.

Here is a summary of the previous examples (buttons above)-

Business	Status*	Biz Income	Other Income	Health Ins.	199A Benefit	S Corp Savings
Consultant	Married	100,000			1,496	8,616
Consultant	Married	100,000	60,000		2,742	7,117
Consultant	Married	100,000			1,496	8,616
Consultant	Married	100,000		10,000	1,514	10,404

Retailer	Married	200,000		5,466	6,605
Retailer	Married	200,000	100,000	7,288	3,563
Retailer	Single	250,000		10,906	20,173
Retailer	Married	250,000		7,479	6,441
Retailer	Single	250,000		9,969	20,173
Attorney	Single	250,000		0	9,267
Surgeon	Single	600,000		0	9,109
Goat Herder	Single	600,000		25,792	34,901

Thank you for hanging in there!

Revoke S Corp

The hot question since the passage of the Tax Cuts & Jobs Act of 2017 and Section 199A is, "Should I revoke S Corp status and go to C Corp?" The answer is No.

Quick Numbers-

S Corp Income	100,000	200,000	300,000
Salary	40,000	80,000	120,000
Payroll Tax	6,120	12,240	18,360
Income Tax	6,980	24,150	44,266
Total Tax S Corp	13,100	36,390	62,626
C Corp Income	100,000	200,000	300,000
C Corp Tax	21,000	42,000	63,000
Dividends	79,000	158,000	237,000
Dividend Tax	0	23,700	44,556
Total C Corp Tax	21,000	65,700	107,556
Effective S Tax Rate	13.1%	18.2%	20.9%
Effective C Tax Rate	21.0%	32.9%	35.9%
Delta (extra tax because of C Corp)	7.9%	14.7%	15.0%

Assumptions include

- Section 199A deduction for the S corporation's shareholder
- \$24,000 in standard deduction
- 3.8% surtax on top of the 15% capital gains tax rate for the \$300,000 column

As you can see, a **C Corp does not make sense after you add in capital gains tax on the dividends**. This in turn makes sense- the lawmakers didn't set out to kill S corporations. They set out to give every business owner a tax break. Geez... half of Congress (535 doesn't divide evenly, we get it) probably run S corporations on the side.

And! There's more! C corporations do not enjoy the 20% Section 199A deduction either. Pile that onto the numbers above for even more reasons.

So, please pump the brakes on the "I wanna dump my S Corp for the magical tax arbitrage offered by a C Corp" nonsense. Wow, that was harsh. We have expanded on this idea in a blog post as well. Check it out-As you can tell, this webpage has grown to a ridiculous size. If you want a PDF version of this, use the button below. You might also want to check out our book, **Taxpayer's Comprehensive Guide to LLCs and S Corps**, available on Amazon, Kindle and PDF. We just released the **2019 Edition** which

includes all this crud. Here is our summary of the major issues recently updated by the final regulations, rental property safe harbor ([Notice 2019-7](#)) and how all this crud affects S corporations-