

Computing Passthrough Deductions Under Section 199A

by John M. Cunningham

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In this article, Cunningham details how to compute the section 199A passthrough deduction for seven different categories of business owners.

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I. Introduction

The most important task of tax professionals in serving clients who are owners of passthrough businesses is to compute the passthrough deduction available to them under section 199A(b)(2) and (3)(B).¹ This article sets forth the rules governing those computations as I understand them.²

Section 199A effectively divides the taxpayers eligible for a passthrough deduction into seven distinct categories. The computation rules for categories 1, 2, 3, 6, and 7 are quite clear. However, the governing rules for categories 4 and 5 are arguably somewhat unclear.

For example, many tax professionals undoubtedly construe the passthrough deduction for category 4 taxpayers as being determined by section 199A(b)(2) — that is, that the deduction is

the lesser of the taxpayer's section 199A(b)(2)(A) deduction and her section 199A(b)(2)(B) deduction. And the IRS will probably take that position. However, as shown in Section VI.A, strong arguments can be made that the deduction for category 4 taxpayers is their section 199A(b)(2)(B) deduction without reduction. Aggressive category 4 taxpayers and their advisers should consider relying on these arguments.

Table 1 identifies the seven categories of passthrough businesses as defined under section 199A and lists the rules governing the passthrough deduction available to the business owner (the taxpayer) in each category. The table is, in effect, an introduction to the rest of the article.

II. Background

A. The Statute

On December 22, 2017, section 199A was enacted as part of the Tax Cuts and Jobs Act.³ It became effective January 1, 2018. It is scheduled to expire at the end of 2025.⁴ However, it provides a major federal income tax deduction to as many as 50 million U.S. business owners — up to 20 percent or more of their business income and arguably even more. Further, it preserves the federal income tax rate parity between C corporations and passthrough businesses that existed before the TCJA reduced the corporate rate from a top 35 percent rate to a flat 21 percent rate, effective January 1, 2018. For these and other reasons, it seems likely that Congress will eventually extend the section indefinitely.

¹This article does not address the four other types of section 199A deductions: the section 199A(e)(3) deduction for investors receiving qualified dividends from real estate investment trusts; the section 199A(e)(4) deduction for investors receiving qualified income from publicly traded partnerships; the section 199A(g)(1)(a) deduction for farm and horticultural cooperatives; and the section 199A(g)(2) deduction for business owners who are farmers or horticulturalists.

²As will be seen, Section VI.A addresses an important section 199A issue whose resolution is not without doubt. I would be grateful for any comments (at lawjmc@comcast.net) on Section VI.A or on any other part of this article.

³P.L. 115-97, section 11011(a).

⁴Section 199A(i).

Table 1. The 7 Categories of Taxpayers Under Section 199A – Definitions and Computation Rules

Category	Definition	Computation Rule
Category 1	Owners of qualified trades or businesses and specified service trades or businesses (SSTBs) whose taxable income does not exceed their threshold amount.	Under section 199A(b)(3)(A), the passthrough deduction of category 1 taxpayers is their section 199A(b)(2)(A) deduction.
Category 2	Owners of qualified trades or businesses whose taxable income is within their phase-in range and whose section 199A(b)(2)(A) deduction exceeds their section 199A(b)(2)(B) deduction.	Under section 199A(b)(3)(B), the passthrough deduction of category 2 owners is their section 199A(b)(2)(A) deduction as reduced under sections 199A(b)(3)(B)(i) through (iii).
Category 3	Owners of SSTBs whose taxable income is within their phase-in range and whose section 199A(b)(2)(A) deduction exceeds their section 199A(b)(2)(B) deduction.	Under section 199A(b)(3)(B) and section 199A(d)(3)(B), the passthrough deduction of category 3 owners is their section 199A(b)(2)(A) deduction as reduced under section 199A(b)(3)(B)(i) through (iii) and under section 199A(d)(3)(B).
Category 4	Owners of qualified trades or businesses whose taxable income is within their phase-in range and whose section 199A(b)(2)(B) deduction exceeds their section 199A(b)(2)(A) deduction.	Section 199A does not expressly provide a computation rule for category 4 taxpayers, and it makes no reference to taxpayers whose taxable income is within their phase-in range. The section 199A deduction for category 4 taxpayers may possibly be determined by section 199A(b)(2). However, reasonable arguments can be made that it is their section 199A(b)(2)(B) deduction without reduction.
Category 5	Owners of SSTBs whose taxable income is within their phase-in range and whose section 199A(b)(2)(B) deduction exceeds their section 199A(b)(2)(A) deduction.	Section 199A(d)(3)(A)(i), the starting point for passthrough deduction for category 5 taxpayers is the category 4 deduction. However, under section 199A(d)(3)(A)(ii), that deduction must be reduced for these taxpayers by the “applicable percentage” defined in section 199A(b)(3)(B).
Category 6	Owners of qualified trades or businesses whose taxable income exceeds their phase-in range.	The passthrough deduction for category 6 taxpayers is their deduction under section 199A(b)(2).
Category 7	Owners of SSTBs whose taxable income exceeds their phase-in range.	No passthrough deduction is allowable to category 7 taxpayers.

Many tax professionals view section 199A as among the most complex and confusing provisions of the TCJA. Further, the section requires many businesses to be substantially restructured to maximize the passthrough deductions allowable to their owners. Because that restructuring is often difficult to plan and implement, section 199A is also one of the most challenging TCJA provisions to apply. Exacerbating those problems is the lack of a useful legislative history under section 199A concerning the meaning of its terms or the deduction computation rules.

B. Regulations

On January 18, 2019, Treasury and the IRS issued final regulations (the “Regulations”) under section 199A.⁵ They consist of regulations (1) explaining or clarifying the provisions of section 199A, including its computation provisions; (2) defining terms used in the statute; (3) authorizing procedures, such as aggregation, not addressed in the statute but useful in applying section 199A;

⁵REG-107892-18.

and (4) designed to prevent abuses of section 199A.

C. Other Authorities

Most of the provisions that tax professionals must master to advise clients under section 199A are those set forth in the statute itself and the Regulations. However, important additional rules are provided in section 11011(b) through (f) of the TCJA, and section 199A incorporates by reference (sometimes with minor qualifications) numerous other code provisions. For example, although prop. reg. section 1.199A-1(b)(14) provides that the key term “trade or business” as used in section 199A means a trade or business under section 162, the meaning of that section and of other provisions cited in section 199A and in the Regulations may be understood only on the basis of the relevant case law.

D. The JCT Blue Book

On December 20, 2018, the Joint Committee on Taxation released its blue book for the TCJA, which includes a lengthy explanation of section 199A.⁶ In my view, however, that explanation provides no significant insight into the meaning or intent behind any of the section 199A provisions relevant to this article.

E. Passthrough Deduction Recipients

Section 199A passthrough deductions are allowable for taxpayers who are owners of trades or businesses except taxpayers that are C corporations. Eligible taxpayers include both active and passive owners of passthrough businesses. Those owners can include foreign individuals subject to U.S. federal taxation, as well as S corporations, partnerships, and fiduciaries and beneficiaries of trusts and estates. For purposes of section 199A (as for many other purposes under the code), passthrough businesses consist of domestic sole proprietorships, S corporations, and partnerships.

⁶JCT, “General Explanation of Public Law 115-97,” JCS-1-18, at 12-38 (Dec. 20, 2018).

F. The Section 199A(a) Caps

Under section 199A(a)(1) and (2), a passthrough deduction cannot exceed the lesser of the taxpayer’s combined qualified business income (QBI) amount or an amount equal to 20 percent of the excess of her taxable income for the tax year over her net capital gain. Section 199A(b)(1) defines the combined QBI amount as the sum of section 199A(b) deductions for each qualified trade or business carried on by the relevant taxpayer plus 20 percent of the aggregate amount of the qualified real estate investment trust dividends and qualified publicly traded partnership income of the taxpayer for the tax year. For tax professionals providing section 199A services to their clients, the provisions of section 199A(a)(1) and (2) serve not only as a cap in determining allowable passthrough deductions, but also as a target in seeking to maximize those deductions.

G. Critical Computation Terms

1. Threshold amount.

Reg. section 1.199A-1(b)(12) defines the term “threshold amount” as meaning, for any tax year beginning before 2019, \$157,500 (or \$315,000 for a taxpayer filing a joint return). Under section 199A(e)(2)(B), those amounts must be adjusted for each later tax year on the basis of the cost-of-living rules in section 1(f)(3).

2. Phase-in range.

Reg. section 1.199A-1(b)(14) defines the phase-in range as “a range of taxable income, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus \$50,000 (or \$100,000 in the case of a joint return).”

3. Trade or business.

The section 199A deduction is available only for the taxpayer’s share of income from a trade or business. As noted earlier, reg. section 1.199A-1(b)(14) defines a trade or business for section 199A purposes by reference to the definition of trade or business under section 162.

4. Qualified trades or businesses and SSTBs.

The distinction between qualified trades or businesses and SSTBs is critical in making passthrough deduction computations.

a. SSTB.

Under section 199A(d)(2), SSTBs consist of the traditional professions identified in section 1202(e)(3)(a), except for architecture and engineering; several types of investment-related professions identified in section 475(c)(2); and businesses whose principal business asset consists of the skill or reputation of one or more of their employees or owners. (However, reg. section 1.199A-5(b)(2)(xiv) defines the “skill or reputation” rule very narrowly.)

b. Qualified trade or business.

Under section 199A(d)(1), qualified trades or businesses comprise all other types of businesses except the business of providing employment services — that is, of serving as an employee.

5. Form W-2 Wages and UBIA

For taxpayers in categories 2 through 7, the passthrough deduction is determined wholly or partially by the Form W-2 wages that the business pays its employees and by the unadjusted basis immediately after acquisition (UBIA) of the business’s qualified property.

a. Form W-2 wages.

Under reg. section 1.199A-1(b)(16), Form W-2 wages are the wages paid by a trade or business properly allocable to QBI as defined in reg. section 1.199A-2(b) — in essence, wages paid by businesses to their employees. These wages do not include compensation by sole proprietors booked as having been paid to the owners themselves or by partnerships to their partners for services in their capacity as partners.

b. Qualified property.

Under section 199A(b)(6)(A), qualified property means, in general, depreciable tangible real or personal property owned by the business entity and used by it in its business during the relevant tax year.

6. QBI

Under reg. section 1.199A-1(b)(5), QBI means the net amount of qualified items of income, gain, deduction, and loss for a trade or business as determined under the rules of reg. section 1.199A-3(b). In general, the QBI of a qualified trade or business or SSTB means, in plain English, its net business income.

7. Excess amount.

Under section 199A(b)(3)(B)(iii), the key section 199A computation term “excess amount” is defined as the excess of a taxpayer’s section 199A(b)(2)(A) deduction over her section 199A(b)(2)(B) deduction.

8. Excess taxable income.

This article uses the term “excess taxable income” (which isn’t found in section 199A itself or the Regulations) because I find it helpful in computing the passthrough deduction. I use it to describe the excess of the taxable income of taxpayers in categories 2 through 5 over their threshold amount. Obviously, one must be careful not to confuse this term with the term “excess amount” in section 199A(b)(3)(B)(iii).

H. Section 199A(b)(2)

The general rule under section 199A that determines the passthrough deduction of qualified business owners is provided in section 199A(b)(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.

By its terms, section 199A(b)(2) can impose either of two types of limits:

- If a taxpayer’s section 199A(b)(2)(A) deduction is larger than her section 199A(b)(2)(B) deduction, the taxpayer’s deduction under section 199A(b)(2) will be her section 199A(b)(2)(B) deduction.
- If a taxpayer’s section 199A(b)(2)(B) deduction is larger than her section

199A(b)(2)(A) deduction, the taxpayer's deduction will be her section 199A(b)(3)(A) deduction.

III. Category 1 Taxpayers

Section 199A(b)(3) is captioned, "Modifications to limit based on taxable income." The limit to which this provision and its subsections refer is the limit imposed by section 199A(b)(2) on deductions under section 199A(b)(2)(A). There are two such modifications — the modification imposed by section 199A(b)(2)(A) and that imposed by section 199A(b)(3)(B).

Section 199A(b)(3)(A) provides:

Exception from limit. — In the case of any taxpayer whose taxable income for the taxable year does not exceed the threshold amount, [section 199A(b)(2)] shall be applied without regard to [section 199A(b)(2)(B)].

Section 199A(b)(3)(A) thus effectively provides that the passthrough deduction of taxpayers whose taxable income does not exceed their threshold amount is the deduction provided to them under section 199A(b)(2)(A). As noted earlier, I refer to those business owners as category 1 taxpayers.

The use of the term "taxpayer" in section 199A(b)(3)(A) unmistakably implies that the provision applies not only to taxpayers who are owners of qualified trades or businesses but also to those who are owners of SSTBs.

As explained next, the modifications described in section 199A(b)(3)(b) determine the passthrough deduction for taxpayers in categories 2 and 3.

IV. Category 2 Taxpayers

A. Overview of Section 199A(b)(3)(B)

The provisions of section 199A(b)(3)(B) are arguably the most complex and difficult under section 199A. However, for millions of passthrough business owners (namely, all seven categories of taxpayers), the provisions of section 199A(b)(3) are by far the most important part of the statute. They are necessarily abstract and written in dense terms. However, their meaning

becomes evident with a basic understanding of their purpose.

The caption of section 199A(b)(3)(B), "Phase-in of limit for certain taxpayers," makes clear that its purpose is to gradually change, in a statutorily determined manner, the passthrough deduction available to specific taxpayers. In sum:

- the passthrough deduction allowable to these taxpayers under section 199A(b)(2)(A) is phased out; and
- a deduction based at least in part on section 199A(b)(2)(B) is correspondingly phased in.

Although the statute doesn't specify the identity of "certain taxpayers," for the reasons detailed in Section VI.A of this article, they likely include only those in category 2 or category 3.

The taxpayers referenced in section 199A(b)(3)(B) are those identified in section 199A(b)(3)(B)(i): taxpayers who meet both of two distinct statutory conditions:

- under section 199A(b)(3)(B)(i)(I), their taxable income for any tax year must exceed their threshold amount, but it must not exceed the sum of their threshold amount plus \$50,000 (\$100,000 for a joint return) — that is, their taxable income must be within their phase-in range; and
- under section 199A(b)(3)(B)(i)(II), their section 199A(b)(2)(B) deduction must be less than their section 199A(b)(2)(A) deduction.

The passthrough deduction of category 2 taxpayers is determined by flush language in section 199A(b)(3)(B)(i) that follows subsections (I) and (II) and begins with the word "then." That language provides that if the conditions of section 199A(b)(3)(B)(i)(I) and (II) are satisfied, section 199A(b)(2) will be applied to the taxpayer's trade or business without any application of section 199A(b)(2)(B) and by reducing the amount of the taxpayer's section 199A(b)(2)(A) deduction by the amount determined under section 199A(b)(3)(B)(ii) (the reduction amount). Determination of the reduction amount is itself based on a complex formula under sections 199A(b)(3)(B)(i) through (iii).

Although there is no useful legislative history for section 199A, the terms of section 199A(b)(3)(B)(i) through (iii) make clear that Congress intended to comply with two broad

policy goals of section 199A that may readily conflict in practice:

- reducing the passthrough deduction allowable to category 2 taxpayers as their taxable income increases; and
- determining the amount of the passthrough deduction allowable to those taxpayers on the basis of the Form W-2 wages paid by their businesses to their employees and the aggregate UBI amount of those businesses — in other words, the goal of ensuring that the greater these wages and UBI amounts, the greater the taxpayers' passthrough deductions.

Congress effectively coordinated those two goals and addressed the potential conflict between them through each of the detailed provisions of section 199A(b)(3)(B) as follows:

- Under section 199A(b)(3)(B)(ii), category 2 taxpayers who want to determine their section 199A(b)(3)(B) deduction must first compute the ratio between the amount by which their taxable income exceeds their threshold amount (taxable income excess) and their phase-in range. This is the section 199A(b)(3)(B)(ii) ratio.
- To compute the reduction amount, those taxpayers then determine the amount that bears the same ratio to their "excess amount" under section 199A(b)(3)(B)(iii) as their excess taxable income bears to their phase-in range. The application of the section 199A(b)(3)(B)(ii) ratio in section 199A(b)(3)(B)(iii) to determine a taxpayer's section 199A(b)(3)(B)(i) passthrough deduction generally means that the larger the taxpayer's taxable income in the relevant tax year, the less may be her section 199A(b)(3)(B) passthrough deduction (depending, however, on the amount of the taxpayer's excess amount under section 199A(b)(3)(B)(iii)).
- Section 199A(b)(3)(B)(iii) defines the term "excess amount" for purposes of section 199A(b)(3)(B)(ii) as the excess of the taxpayer's section 199A(b)(2)(A) deduction over her section 199A(b)(3)(B) deduction.

As noted, the reduction amount determined under section 199A(b)(3)(B)(ii) is the amount that

bears the same ratio to the excess amount as the ratio identified in section 199A(b)(3)(B)(ii). As also noted earlier, the section 199A(b)(3)(B)(ii) ratio is the same as the ratio between:

- the amount by which the taxpayer's taxable income exceeds her threshold amount; and
- the taxpayer's phase-in range.

B. Category 2 Computations

The category 2 taxpayer addressed below in Table 2 is John Doe, a hypothetical passthrough business owner. Doe is married and files his federal tax return jointly with his wife. Their joint taxable income in 2018 is \$365,000. Doe is the only shareholder and employee of JD, a state-law business corporation taxable as an S corporation. JD manufactures and sells widgets. Doe works for JD full time. JD pays Doe a total of \$50,000 in Form W-2 wages in 2018, and its QBI is \$200,000. JD leases its premises and owns no qualified property.

C. Intent of Section 199A

As noted, the implicit but clear purpose of section 199A(b)(3)(B) is to coordinate two key goals of section 199A: to generally reduce the passthrough deduction available to taxpayers as their taxable income increases; but also to reward them for the Form W-2 wages their businesses pay to their employees and for the qualified property owned and used by these businesses. Obviously, the greater Doe's excess taxable income:

- the higher his excess taxable income ratio; the higher his excess amount ratio; and, as a result,
- the greater his reduction amount and the lower his section 199A(b)(3)(B) deduction.

Equally apparent, the above congressional goals are achieved by the reduction of Doe's section 199A(b)(3)(B) deduction, which will result if his section 199A(b)(3)(B)(ii) ratio decreases and his excess taxable income or his excess amount increases.

Table 2. Steps in Computing Section 199A Passthrough Deduction for Category 2 Taxpayers — The Example of John Doe

Step 1: Ascertain Relevant Information	
Inquiry	Response
Does Doe file his federal tax return jointly or separately?	Jointly
What is Doe's taxable income?	\$365,000
What is his threshold amount?	\$315,000
What is the amount of his excess taxable income — that is, the amount by which his taxable income exceeds his threshold amount?	\$50,000
What is his phase-in range?	The \$100,000 between \$315,000 and \$415,000
What are the name, business organization form, and federal tax regimen of his business?	JD Inc., a state-law business corporation taxable as an S corporation
Is his business a section 199A trade or business?	Yes
Is his business a qualified trade or business or an SSTB?	It is a qualified trade or business
What is the qualified business income of his business?	\$200,000
To what share of JD's passthrough deduction is Doe entitled?	100% (Doe is JD's only shareholder)
What is Doe's section 199A(b)(2)(A) deduction?	\$40,000 (20% x \$200,000)
What aggregate Form W-2 wages has his business paid to its employees, including himself?	\$50,000
What is Doe's section 199A(b)(3)(B) deduction?	\$25,000 (50% x \$50,000)
What is the aggregate UBLA of the qualified property owned and used by his business?	\$0
What is Doe's section 199A(b)(3)(B)(iii) excess amount — that is, the excess of his section 199A(b)(2)(A) deduction over his section 199A(b)(2)(B) deduction.	\$15,000
Step 2: Computation Procedures	
Procedure	Result
Determine the ratio of Doe's excess taxable income to his phase-in range under section 199A(b)(3)(B)(ii).	The ratio is \$50,000/\$100,000 — that is, the equivalent of 1 to 2.
Determine the amount (the reduction amount) that bears the same ratio to Doe's excess amount as his excess taxable income bears to his phase-in range.	As noted, Doe's section 199A(b)(3)(B)(ii) ratio is 1 to 2. His excess amount is \$15,000. Thus, his reduction amount is \$7,500 — that is, half of \$15,000.
Subtract Doe's reduction amount from his section 199A(b)(2)(A) deduction. The result will be his passthrough deduction under section 199A(b)(3)(B).	Doe's section 199A(b)(2)(A) deduction is \$40,000. Thus, his section 199A(b)(3)(B) deduction is \$32,500 — that is, \$40,000 - \$7,500.
On the basis of section 199A(a)(2), determine whether the above section 199A(b)(3)(B) deduction exceeds Doe's section 199A(a)(2) cap and, if it does, reduce it accordingly.	Doe's section 199A(a)(2) cap is 20% x \$365,000 = \$67,000. Thus, his section 199A(b)(3)(B) deduction is within his cap.

V. Category 3 Taxpayers

A. Introduction

As noted, owners of SSTBs whose taxable income is within their phase-in range and whose section 199A(b)(2)(A) deduction exceeds their section 199A(b)(2)(B) deduction are referred to in this article as category 3 taxpayers.

By its terms, section 199A(b)(3)(B)(i)(II) could be construed to apply only to taxpayers who “carry on” qualified trades or businesses and thus *not* to apply to taxpayers who own SSTBs. However, section 199A(d)(3) provides, in effect, that if the taxable income of SSTB owners is within their phase-in range:

- They will be treated by virtue of section 199A(d)(3)(A)(i) as qualified trades or businesses for section 199A(b)(3)(B) purposes.
- However, only the “applicable percentage” of the QBI, Form W-2 wages, and UBIA of their business, as determined by section 199A(d)(3)(B), will be taken into account in computing their section 199A(b)(3)(B) deduction. Under section 199A(d)(3)(B), their applicable percentage will be 100 percent minus the percentage reflected in the fraction whose numerator is their excess taxable income and whose denominator is their phase-in range.

Section 199A(d)(3) provides:

Exception for specified service businesses based on taxpayer’s income. —

(A) In general. — If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return), then —

- (i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but
- (ii) only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of

qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

(B) Applicable percentage. — For purposes of subparagraph (A), the term “applicable percentage” means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of —

- (i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to
- (ii) \$50,000 (\$100,000 in the case of a joint return).

Thus, the more the taxable income of SSTB owners exceeds their threshold amount, the less will be their section 199A(b)(3)(B) deduction as compared with that of owners of qualified trades or businesses.

B. Category 3 Computations

If we assume that Joe Doe’s business is not a qualified trade or business, but rather, a specified service trade or business, and thus that John is not a category 2 taxpayer, but rather, a category 3 taxpayer, his section 199A passthrough deduction will be computed as follows:

- His starting point in this computation will be the section 199A(b)(3)(B) deduction he would obtain if he were a category 2 taxpayer — that is, \$32,500 (see computation above).
- As noted above, his excess taxable income ratio is \$50,000:\$100,000 — which can also be expressed as 1:2, 50 percent, or ½.
- In computing his category 3 deduction under section 199A(d)(3)(B)(ii), we must apply his excess taxable income ratio to his section 199A(b)(3)(B) deduction — that is, we must multiply his section 199A(b)(3)(B) deduction times one half.

- Thus, John's section 199A passthrough deduction as a category 3 taxpayer will be \$16,500 — one half of the deduction he would get if his business were a qualified trade or business.

VI. Category 4

A. Introduction

As noted earlier, section 199A(b)(3)(B) expressly describes the category of section 199A taxpayers referred to in this article as category 2 taxpayers — namely, taxpayers whose taxable income is within their phase-in range but whose section 199A(b)(2)(B) deduction is less than their section 199A(b)(2)(A) deduction. Section 199A(b)(3)(B) provides an express rule for computing the section 199A deduction allowable to these taxpayers.

However, no provision of section 199A expressly describes or refers to the taxpayers described in this article as category 4 taxpayers — that is, taxpayers whose taxable income, like that of category 2 taxpayers, is within their phase-in range, but whose section 199A(b)(2)(B) deduction equals or exceeds their section 199A(b)(2)(A) deduction. Indeed, section 199A makes no reference at all to this category of taxpayers. However, there are probably millions of category 4 taxpayers. Thus, in the absence of any express rule governing their section 199A passthrough deduction, it is necessary to determine the computation rule applicable to them on the basis of a careful statutory interpretation of the terms of section 199A read as a whole.

A possible section 199A deduction computation rule applicable to category 4 taxpayers is the rule in section 199A(b)(2) — namely, the section 199 default rule that the passthrough deduction for these taxpayers is the lesser of their section 199A(b)(2)(A) deduction and their section 199A(b)(2)(B) deduction. Among other considerations, the terms of section 199A(b)(2) are broad, and there are no provisions of section 199A that clearly prevent the application of the section to Category 4 taxpayers. Thus, the rule in section 199A(b)(2) is the rule that

some tax professionals may apply in advising category 4 taxpayers; that the IRS will probably apply to them;⁷ and it is the rule that a court may apply in litigation concerning the passthrough deduction of category 4 taxpayers.

However, there are at least four strong arguments against the application of section 199A(b)(2) in the above situation and in favor of the position that the section 199A passthrough deduction of category 4 taxpayers is their section 199A(b)(2)(B) deduction without reduction. These arguments may be briefly stated as follows:

1. Because section 199A(b)(2) applies to category 6 taxpayers, it should not be applied to category 4 taxpayers.

It's clear that section 199A(b)(2) applies in determining the section 199A passthrough deduction of category 6 taxpayers — that is, those whose taxable income exceeds their phase-in range. However, the very fact that category 4 taxpayers are within their phase-in range suggests that section 199A(b)(2) should not apply to them. In other words, it may be argued that because category 4 taxpayers are within their phase-in range, they must be subject to a computation deduction rule *other* than the section 199A(b)(2) rule. Further, it's clear from the caption of section 199A(b)(3)(B) — “Phase-in of limit for *certain taxpayers*” (emphasis added) — that category 4 taxpayers are not subject to the deduction computation formula in section 199A(b)(3)(B), because this formula applies only to the “*certain taxpayers*” identified in section 199A(b)(3)(B)(i)(I) and (II) — namely, category 2 taxpayers.

Thus, it may be argued that because section 199A(b)(2) and section 199A(b)(3)(B) do not apply to category 4 taxpayers, Congress must have intended that their section 199A passthrough deduction be their section 199A(b)(2)(B) deduction without reduction.

⁷For example, in the regulations, the IRS, probably on the basis of section 199A(b)(2), repeatedly refers to section 199A as providing taxpayers with passthrough deductions of “up to” 2 percent of their shares of the QBI of their businesses. However, neither in the Regulations nor elsewhere does the IRS specifically consider the issue concerning category 4 and 5 taxpayers addressed in this article.

2. Category 4 taxpayers are entitled to a phase-in and thus to special phase-in treatment.

As noted earlier, under reg. section 1.199A-1(b)(4), the phase-in range is “a range of taxable income, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus \$50,000 (or \$100,000 in the case of a joint return).” Because, under the terms of reg. section 1.199A-1(b)(4), category 4 taxpayers have a phase-in range, it may be reasonably argued that they are entitled to some form of special phase-in treatment.

Further, section 199A(b)(3)(A) and the caption and terms of section 199A(b)(3)(B) make clear that the phase-in referred to in section 199A refers to a transition for section 199A(b)(3)(A) taxpayers from the inapplicability of section 199A(b)(2) to the application of section 199A(b)(2) without restriction.⁸

Further, although section 199A doesn’t specifically provide a phase-in formula for category 4 taxpayers, the fact that section 199A *does* provide such a formula for category 2 taxpayers — the formula in section 199A(b)(3)(B)(i) through (iii) — arguably implies that category 4 taxpayers should also be entitled to favorable phase-in treatment. In other words, it can be argued that it would be unfair to provide favorable phase-in treatment to category 2 taxpayers but *not* to category 4 taxpayers and that it would violate basic considerations of statutory symmetry.⁹

3. Congress intended to encourage and reward the hiring of employees and the acquisition of qualified property.

The terms of section 199A make clear that in drafting the statute, Congress intended to encourage and reward business owners for hiring employees and acquiring qualified property. For many category 4 taxpayers, the application of section 199A(b)(2) in determining their section

199A passthrough deduction would have exactly the opposite effect.

4. The application of section 199A(b)(2) to category 4 taxpayers would be grossly unfair to many of them.

The application of section 199A(b)(2) to category 4 taxpayers would arguably be grossly unfair to many of them.

Example 2: Mary Roe is married and files jointly with her husband. In 2015 Mary formed MR Inc., an S corporation of which she is the sole shareholder, to manufacture and sell widgets. When she formed MR, Roe was its only employee. In 2018 MR’s QBI is \$100,000, so Roe’s section 199A(b)(2)(A) deduction is only \$20,000 (20 percent of \$100,000). However, although MR owns no qualified property, it now has five employees, and it pays total Form W-2 wages of \$210,000 — namely, \$50,000 to Roe and \$40,000 to each of MR’s four other employees. Thus, Roe’s section 199A(b)(2)(B) deduction is \$105,000 — 50 percent of \$210,000.

The taxable income of Roe’s husband is \$200,000 in 2018, and her own taxable income is \$150,000 (\$100,000 of QBI and \$50,000 of wages). Thus, Roe’s joint taxable income is \$350,000, and she is a category 4 taxpayer. If, however, on her 2018 federal tax return, Roe claims that her section 199A deduction as a category 4 taxpayer is her section 199A(b)(2)(B) deduction without reduction, and if the IRS redetermines that deduction on the basis of section 199A(b)(2), the above result will be patently unfair to Roe. It may be argued that Congress couldn’t have intended that result.

B. Category 4 Computations

If the section 199A passthrough deduction of a category 4 taxpayer is computed on the basis of section 199A(b)(2), it will be the lesser of her section 199A(b)(2)(A) deduction and her section 199A(b)(2)(B) deduction. But if, for the reasons discussed earlier, a category 4 taxpayer accepts the above four arguments, she will claim as her deduction as the amount of her section 199A(b)(2)(B) deduction without reduction.

⁸ As noted earlier, the term “limit” in the caption of section 199A(b)(3)(B) — “Phase in of limit for certain taxpayers” — clearly refers to the limit on section 199A deductions imposed by section 199A(b)(2).

⁹ Obviously, however, it could also be argued that because section 199A expressly provides favorable phase-in treatment for category 2 taxpayers but lacks such a provision for category 4 taxpayers, Congress didn’t intend favorable treatment for category 4 taxpayers.

VII. Category 5 Computations

Under Table 1, category 5 taxpayers are those whose businesses are SSTBs, whose taxable income is within their phase-in range, and whose section 199A(b)(2)(B) deduction equals or exceeds their section 199A(b)(2)(A) deduction. In computing their section 199A passthrough deduction, these taxpayers must start with their deduction as determined under section 199A(b)(2) or with their section 199A(b)(2)(B) deduction without reduction. But whichever of those options they choose, they must then reduce their category 4 deduction under section 199A(d)(3)(B).

their section 199A(b)(2)(B) deduction without reduction. ■

VIII. Category 6 Computations

In Table 1, I define category 6 taxpayers as owners of qualified trades or businesses whose taxable income exceeds their phase-in range. Although the terms of section 199A(b)(2) do not expressly state that that section determines the passthrough deduction for these taxpayers, the section's terms make clear that it does.

IX. Category 7 Computations

I define category 7 taxpayers as SSTB owners whose taxable income exceeds their phase-in range. As noted earlier:

- section 199A(b)(2) by its terms applies only to owners of qualified trades or businesses;
- there is no other provision of section 199A that provides a passthrough deduction to these owners; and
- nothing in the Regulations or in any other federal tax authority suggests that these owners may receive passthrough deductions from their shares of the income of their SSTBs.

X. Conclusion

All the rules that determine the section 199A passthrough deduction allowable to the owners of both qualified trades or businesses and SSTBs in the taxpayer categories defined in this article as categories 1, 2, 3, 6, and 7 are clear. Although it may be argued that category 4 and 5 taxpayers must compute their section 199A passthrough deduction under section 199A(b)(2), strong arguments also support computing it as