Section 199A: Job Creator or Tax Giveaway?

by Rodney P. Mock and David G. Chamberlain

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In this report, Mock and Chamberlain discuss section 199A and its inconsistencies regarding job creation policy.

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Introduction

A major overhaul to the tax code finally arrived with the Tax Cuts and Jobs Act (P.L. 115-97). On the individual side of the ledger, the 20 percent passthrough deduction for qualified business income under section 199A is easily the most significant development. While there have long been preferences in the code for capital and investment income, never has there been such a broad tax preference for ordinary income. The legislative history for this rushed provision is woefully slim, but the most coherent policy rationale for it involves Congress’s desire to encourage and reward “job creators.”

On its face, section 199A seemingly supports a job creation purpose. This is illustrated in the restriction of the deduction for a “specified service trade or business.” Congress presumably sought to prevent the conversion of wages for personal services into qualified business income and concluded that income from some specified services was, in essence, the functional equivalent of wages. The focus on job creation is also seen in the restriction of the deduction when the taxpayer’s Form W-2 wages do not reach specified thresholds.

As discussed below, the legislative history of section 199A clearly indicates a job creation purpose. Nevertheless, the plain language of section 199A circumvents its job creation purpose in three major ways:

• First, there is a mile-wide exception for both the specified service and W-2 wage restrictions to the extent the taxpayer’s taxable income falls below threshold amounts ($157,500 for individuals and $315,000 for joint return filers).

• Second, the specified services restriction prevents taxpayers from claiming the deduction even when their businesses create jobs.

• Third, taxpayers with taxable incomes above the thresholds receive the deduction even if they do not create a single job as long as they meet an alternative to the W-2 wage

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1 While the tax cuts were promoted as a Tiny Tim middle-income miracle, it is difficult to see any middle-income benefits in the TCJA. Unlike the corporate provisions, all the individual provisions (including section 199A) expire on January 1, 2026. And not only are the cuts temporary for individuals, but they also nickel-and-dime employees. For example, while the corporate tax rate was reduced to a flat 21 percent, the employer’s ability to deduct many employee benefits were taken away or reduced. Entertainment expenses are no longer deductible, corporate cafeterias are no longer deductible, employee transportation benefits are no longer deductible (for example, parking and mass transit), and employee achievement awards are no longer deductible (for example, parking and mass transit).

2 Defined in section 199A(d)(2).

3 See section 199A(b)(2)(B)(i)-(ii).

4 See section 199A(b)(3)(A) and (d)(3)(A).
restriction by owning “qualified property” exceeding specific thresholds.\textsuperscript{5}

The statutory scheme under section 199A is incoherent in several other ways. Its treatment of wages can only be described as conflicting because it is sometimes beneficial while other times the scheme is not.\textsuperscript{6} For example, wages are disfavored because they generally do not receive the deduction, but at other times it may be beneficial to have wages (in addition to qualified business income) because of the limitation of the deduction based on taxable income.\textsuperscript{7} On the other hand, if the taxpayer has too much wage income, the deduction may be phased out when the taxable income thresholds are crossed.\textsuperscript{8}

Assuming job creation is the desired policy objective,\textsuperscript{9} we suggest several changes to section 199A to make it more coherent, workable, and laser-focused on job creation. The W-2 wage restriction should be the exclusive factor in determining whether a taxpayer qualifies for the 20 percent deduction. If the taxpayer’s business does not employ anybody, the taxpayer should not qualify for the deduction; if the taxpayer has employees, however, the taxpayer should not be subject to the arbitrary limitations in the statute. Thus, the following legislative changes should be made:

• The taxable income thresholds should be eliminated. A taxpayer should not receive the deduction if no W-2 wages are paid, no matter their income level. This change would greatly simplify the provision by eliminating its complex phase-ins and phaseouts.

• The specified service trade or business restriction should be eliminated. The specified service definition is certain to be the most contentious aspect of section 199A, giving rise to endless controversy between taxpayers and the IRS. Yet, it is totally unnecessary: If a taxpayer’s income is the functional equivalent of wages from labor, they will not be able to meet the W-2 wage restriction. But if they do create jobs, there is no reason to make an arbitrary distinction between different industries.

• The alternative to the W-2 wage restriction for ownership of qualified property should be eliminated. The code already rewards capital investment through many other provisions. If no jobs are created, the taxpayer should not receive the deduction.

• Finally, the W-2 wage restriction should be modified to provide that compensation paid by an S corporation to a significant shareholder does not qualify as W-2 wages. Unlike sole proprietors and partners, S corporation shareholders can increase their deduction by paying themselves compensation even if they do not employ any other individuals.

On August 8 Treasury issued proposed regulations (REG-107892-18) implementing section 199A. In addition to providing detailed rules for applying section 199A in the context of a partnership and introducing a few antiabuse rules, the proposed regulations provide a fair amount of guidance on what constitutes a specified service trade or business. The proposed regulations have made progress toward providing certainty in the implementation of section 199A, but have done nothing to make the statutory section more coherent or increase the focus on job creation. Only Congress can do this by revising the statute.

\textsuperscript{5} Section 199A(b)(2)(B)(ii).

\textsuperscript{6} For an extensive analysis of the contradictory effects of wages on the section 199A deduction, see Richard Winchester, “The Deduction for Passthrough Firms: A Hodgepodge of Ideas,” Tax Notes, Mar. 12, 2018, p. 1517.

\textsuperscript{7} Section 199A(a)(2).

\textsuperscript{8} As discussed below, section 199A’s treatment of wages earned by an S corporation shareholder has complex and inconsistent features of its own.

\textsuperscript{9} While this report makes specific legislative recommendations to achieve the goal of “job creation” we do not necessarily agree that this is an appropriate policy objective. In short, we question why hardworking wage-earning employees are treated so badly compared with job creators. Not everyone is a job creator. Arguably, the statute puts an economic axe between employees, service providing partners, S corporation employee-owners, and independent contractors. Is this how good tax policy works? See, e.g., David J. Roberts, “Some Perspective on the New Tax Rate Structure,” Tax Notes, Mar. 19, 2018, p. 1657 (“Some proponents will argue that this new rate structure gives employees an incentive to become entrepreneurs and start their own businesses, which is arguably a good thing. In some circles, there seems to be great respect for ‘job creators,’ and much less regard, or even contempt, for ordinary employees.”).
Navigating the Section 199A Labyrinth

Section 199A is a labyrinth of “greater of” and “lesser of” phase-outs and phase-ins. Congress certainly did not make the provision simple; it imported additional complexity into an already complex code. There are several areas outside the scope of this report in which it appears section 199A was drafted in haste without much thought to internal inconsistencies. A good example is the “grain glitch” in section 199A(g), which has already been revised in an attempt to fix any unintended consequences. Rather than go down all the rabbit holes, we will discuss only the most relevant provisions.

Section 199A(a) provides a 20 percent deduction against qualified business income earned by any taxpayer other than a corporation. Therefore, it applies not only to conduit entities such as partnerships and S corporations, but also to sole proprietorships filing a Schedule C. In other words, there is no requirement that the business income be generated by a legal entity (for example, a single-member limited liability company, partnership, or S corporation).

The deduction is allowed against the “combined” qualified business income of all the taxpayer’s qualified trades or businesses. Income is reduced by losses and loss carryforwards from qualified trades or businesses. A qualified trade or business is any trade or business other than the trade or business of being an employee or, subject to the income thresholds described below, a specified service trade or business.

A specified service trade or business is defined by cross-reference as a business that does not qualify for the section 1202(e)(3)(A) exclusion (gain on qualified small business stock). It includes “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 1 or more of its employees.” Section 199A excludes from the definition, however, those providing engineering and architectural services; it is interesting that those services were deemed more deserving of the deduction.

Subject to the income threshold described below, there is a significant limitation on the amount of the section 199A deduction in the form of restrictions based on W-2 wages or qualified property, which apply separately to each qualified trade or business. The amount of the deduction cannot exceed the greater of:

Section 199A(d)(1). There is no definition of trade or business in section 199A, which gives rise to substantial uncertainty both because the term is used in various contexts throughout the code and because the most established use (section 162) is the subject of inconclusive case law. See, e.g., Tony Nitti, “5 Passthrough Deduction Questions the IRS Must Answer,” Tax Notes, June 11, 2018, p. 1595.

Section 199A(d)(2)(A). Section 199A(d)(2)(B) also includes some investment management, trading, and dealing in securities services as within the definition of a specified service trade or business. It is noteworthy that the cross-reference does not extend to businesses specified in section 1202(e)(3)(B)-(E), which are ineligible for the small business stock exclusion. Thus, for example, farmers and restaurateurs could qualify for the section 199A deduction even though they do not qualify for the section 1202 exclusion.

Section 1202(e)(3)(A). Section 199A(d)(2)(A) modifies the “principal asset” test by replacing “employees” with “employees or owners.” For one perspective, see Kathleen Gregor and Steven Miller, “Essential Guidance in the TCJA’s Wake,” Tax Notes, Mar. 12, 2018, p. 1533 (“Congress likely saw the inherent value that engineers and architects have in creating designs and buildings — tangible products that would differentiate them from just being providers of services.”). In our view, Congress should be more careful in codifying law so defined terms are consistent and distinctions are not arbitrarily made. That is easier said than done. Despite that, if these service-related businesses do not qualify for the section 1202 exclusion, we believe they should not qualify for the section 199A deduction either.

Section 199A(a)(1), (a)(2), (b)(2), and (g)(1). It also contains two “greater of” formulas: Section 199A(b)(2)(B) and (g)(1)(B).


Section 199A(a)(1). The deduction is limited to 20 percent of a taxpayer’s taxable income (reduced by capital gains). Section 199A(a)(2). Taxable income is determined without regard to the section 199A deduction itself. Section 199A(a)(1).

The deduction was promoted by Congress and the media as a “passthrough” deduction, yet it is not limited to passthrough entities. Combined qualified business income includes qualified real estate investment trust dividends and qualified publicly traded partnership income. Section 199A(b)(1)(B). We recommend that this provision also be reconsidered in light of the job creation policy objective.

Section 199A(c)(1) and (2). A net loss is carried forward into succeeding years and treated as a loss from a separate qualified trade or business.
• 50 percent of the W-2 wages paid by the qualified trade or business (W-2 wage restriction),\(^2\) or
• the sum of 25 percent of W-2 wages and 2.5 percent of the unadjusted basis of all qualified property (qualified property restriction).\(^3\)

W-2 wages are defined by reference to section 6051(a), which governs reporting of wages to the Social Security Administration.\(^4\) W-2 wages include both current-year wages and deferred compensation.\(^5\) For wages to qualify for this purpose, wage information must have been filed with the Social Security Administration by the 60th day after its due date.\(^6\) Payments made to independent contractors (reported on Form 1099 rather than Form W-2) do not count. However, under the proposed regulations, wages paid through a third party (that is, a professional employer organization) to the taxpayer’s common law employees do qualify.\(^7\) Note that compensation paid by an S corporation to a shareholder who is also an employee would presumably be included in W-2 wages.\(^8\)

Qualified property is tangible property used in the business that can be depreciated under section 167, if the “depreciable period” has not ended.\(^9\) The depreciable period is the greater of the period over which the property is depreciated (that is, the period specified in section 168) or 10 years.\(^10\) Nondepreciable property, like inventory and land, does not qualify. The unadjusted basis of qualified property is equal to its basis immediately after it was acquired (that is, generally, its original cost basis).\(^11\)

Both the specified services restriction and the W-2 wages/qualified property restriction are subject to income threshold rules. In 2018 the threshold amount is $315,000 for taxpayers filing a joint return and $157,500 for individual filers.\(^12\) If a taxpayer’s taxable income (determined without taking into account the section 199A deduction itself) is below the threshold amount, the specified service restriction does not apply — that is, the taxpayer is able to take the full 20 percent deduction even if the business income is derived from a specified service trade or business.\(^13\) Similarly, if the taxpayer’s income is below the threshold, the restrictions based on W-2 wages and qualified property do not apply — that is, the taxpayer can take the full deduction even if the business has no employees or qualified property.\(^14\)

Finally, section 199A(c)(4) provides that qualified business income does not include “reasonable compensation” paid to the taxpayer by a trade or business or guaranteed payments paid to the taxpayer by a partnership for services rendered to it.\(^15\) The term “reasonable compensation” is a reference to payments that are made — or should be made — by an S corporation to a shareholder as compensation for services performed.\(^16\) Well-established case law provides that S corporation shareholders who perform services must receive reasonable compensation for those services — that is, the

\(^{22}\) Section 199A(b)(2)(B)(i). When a partnership or S corporation is involved, taxpayers only take into account their allocable share of the entity’s W-2 wages.

\(^{23}\) Section 199A(b)(2)(B)(ii). Again, taxpayers only take into account their allocable share of partnership or S corporation W-2 wages and qualified property.

\(^{24}\) Section 199A(b)(4).

\(^{25}\) Section 6051(a)(3) and (8), referenced in section 199A(b)(4)(A).

\(^{26}\) Section 199A(b)(4)(C). Treasury issued Notice 2018-64, 2018-35 IRB 347, at the same time it issued the proposed section 199A regulations to provide guidance on acceptable methods of calculating W-2 wage amounts.

\(^{27}\) Prop. reg. section 1.199A-2(b)(2)(ii).

\(^{28}\) But such compensation does not qualify for the deduction, which creates a reasonable compensation dilemma for S corporation shareholder-owners, as discussed below.

\(^{29}\) Section 199A(b)(6)(A).

\(^{30}\) Section 199A(b)(6)(B).

\(^{31}\) Section 199A(b)(2)(B)(ii).

\(^{32}\) Section 199A(c)(2)(A). The threshold amount is adjusted for inflation annually. Section 199A(c)(2)(B).

\(^{33}\) Section 199A(d)(3). The restriction phases in as the taxpayer’s income exceeds the threshold by $100,000 for joint filers or $50,000 for individual filers. Thus, if joint filers have income exceeding $415,000 or if individual filers have income exceeding $207,500, they will receive no section 199A deduction for income from a specified service trade or business. For income within the phase-in range, a prorated deduction is available.

\(^{34}\) Section 199A(b)(3). This restriction also phases in over the same dollar thresholds as specified services. It is interesting that Congress decided to make the taxable income thresholds so high in light of other phaseout provisions in the code that are typically based on adjusted gross income or some modified version thereof and have much lower thresholds.

\(^{35}\) Guaranteed payments are payments described in section 707(c). As authorized by section 199A(c)(4), the proposed regulations would also exclude other payments made by a partnership to a partner for services provided other than in their capacity as a partner (section 707(a) payments).

\(^{36}\) See, e.g., Rev. Rul. 74-44, 1974-1 C.B. 287; Spicer Accounting Inc. v. United States, 918 F.2d 90 (9th Cir. 1990).
shareholders may not forego salary compensation, which is subject to employment taxes, and take the income in the form of their distributive share of profits, which is not so subject. It is noteworthy that there is no concept of reasonable compensation for sole proprietors. While sole proprietors cannot pay a salary to themselves, their entire profit reported on Schedule C is subject to employment taxes. 37

Like the other individual provisions of the TCJA (but unlike the corporate provisions), section 199A is temporary and will no longer apply in 2026. 38

Once taxpayers have come to rely on the deduction, we can expect there to be great pressure on Congress to make it permanent. 39

Job Creation Policy Goal

Given the revolutionary nature of section 199A, we are naturally extremely interested in discerning its underlying tax policy goals. Section 199A creates a preference for some types of ordinary income over all other types of ordinary income. What is it about business income that warrants preferential treatment over salary compensation and other income from labor? Make no mistake, by giving a preference to the former, Congress is choosing to make salary earners bear a disproportionate share of the federal tax burden. 40 While the legislative history is thin, the goal of promoting and rewarding "job creation" stands out above all others.

Although a preferential rate for qualified business income was introduced in the original House bill that eventually became the TCJA, 41 the 20 percent deduction under section 199A was fashioned largely from scratch when the Senate amended the bill. 42 Despite that, only relatively minor changes were made to the Senate version by the conference committee before the final version was enacted and signed into law. 43 Congress held no hearings at any point in this process, and the floor debates were limited. Thus, the legislative history on section 199A is almost nonexistent.

The title "Tax Cuts and Jobs Act" shows the high value placed by Congress on job creation. A series of releases from major players in the legislative process reinforce the job creation mantra:

- The fact sheet issued by the House Ways and Means Committee on November 2, 2017, 45
- The conference report provides a comprehensive overview of prior law, the House bill, the Senate amendment, and the final bill. H.R. Rep. 115-466, 115th Cong. (2017-2018). This report documents all the twists and turns in drafting the final legislation but provides very little insight on policy objectives and legislative goals.
- The "Big 6" comprises two representatives each from the administration (Treasury Secretary Steven Mnuchin and former chief economic adviser Gary Cohn), the House (Speaker Paul D. Ryan of Wisconsin and Ways and Means Committee Chair Kevin Brady of Texas), and the Senate (Majority Leader Mitch McConnell of Kentucky and Finance Committee Chair Orrin G. Hatch of Utah).
- The "Big 6" comprises two representatives each from the administration (Treasury Secretary Steven Mnuchin and former chief economic adviser Gary Cohn), the House (Speaker Paul D. Ryan of Wisconsin and Ways and Means Committee Chair Kevin Brady of Texas), and the Senate (Majority Leader Mitch McConnell of Kentucky and Finance Committee Chair Orrin G. Hatch of Utah).
boasts: The TCJA “reduces the tax rate on the hard-earned business income of Main Street job creators to no more than 25 percent [and] establishes strong safeguards to distinguish between individual wage income and ‘pass-through’ business income so Main Street tax relief goes to the local job creators it was designed to help most.”

- The policy highlights summary issued by the House and Senate conference committee on December 15, 2017, recites that section 199A “delivers significant tax relief to Main Street job creators by: Offering a first-ever 20 percent tax deduction that applies to the first $315,000 of joint income earned by all businesses organized as S corporations, partnerships, LLCs, and sole proprietorships. For Main Street job creators with income above this level, the bill generally provides a deduction for up to 20 percent on business profits — reducing their effective marginal tax rate to no more than 29.6 percent.”

As for official legislative history, what passed for debates on the House floor during the consideration of the TCJA were scarcely more than a series of platitudes offered by members of Congress in quick succession, but job creation was again a repeated refrain. For example, former Rep. Jeff Sessions said the bill “reduces the tax burden on all passthrough businesses regardless of their structure or their sector. This legislation provides tax relief for job creators and creates capital investments — investments that will drive growth, once again, of paychecks and opportunities for growth.”

It is also instructive to consult the legislative history for repealed section 199 (the domestic production deduction). Section 199A’s numbering provides some indication that section 199 was inspired by similar congressional concerns, and key portions of section 199A are modeled directly on it. Indeed, except for a special provision for domestically produced film, old section 199’s W-2 wage provision was copied word-for-word into section 199A. The House report for section 199 was quite clear on its job creation purpose:

The Committee believes that creating new jobs is an essential element of economic recovery and expansion, and that tax policies designed to foster economic strength also will contribute to the continuation of the recent increases in employment levels. To accomplish this objective, the Committee believes that Congress should enact tax laws that enhance the ability of domestic businesses, and domestic manufacturing firms in particular, to compete in the global marketplace.

In sum, job creation is the strongest and most coherent policy rationale articulated for the TCJA in general and for the section 199A deduction in particular. Unlike old section 199, however, by not sticking to a strict W-2 wage limitation, the statute is riddled with complexity, and many taxpayers will receive the tax benefit without any job creation.

**Other Possible Policy Goals**

There are, however, at least two other plausible policy goals that appear in the legislative history or tax literature. First, some proponents have argued that it would be unfair to reduce the corporate rate without also reducing the passthrough rate. And second, some have argued that the purpose of the passthrough

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46 See previous section 199(b)(2).
47 The similarities to old section 199 have not gone unnoticed. See, e.g., Marie Sapirie, “Not Exactly an A+ on Passthroughs,” *Tax Notes*, Feb. 19, 2018, p. 995 (“The numbering of the provision points to what legislators may have intended it to do — or, less charitably, what legislators wanted to advertise it as being designed to do — because the former domestic production deduction of section 199 was also meant to reward companies for creating or keeping jobs in the United States.”).
the section 199A deduction largely achieves this “goal”:

<table>
<thead>
<tr>
<th></th>
<th>Before TCJA</th>
<th>After TCJA</th>
</tr>
</thead>
<tbody>
<tr>
<td>a Top corporate rate</td>
<td>35%</td>
<td>21%</td>
</tr>
<tr>
<td>b Top rate on dividends</td>
<td>23.8%</td>
<td>23.8%</td>
</tr>
<tr>
<td>c = b * (1 - a) Effective dividend rate</td>
<td>15.47%</td>
<td>18.8%</td>
</tr>
<tr>
<td>d = a + c Combined effective rate</td>
<td>50.47%</td>
<td>39.8%</td>
</tr>
<tr>
<td>e Top individual rate</td>
<td>39.6%</td>
<td>37%</td>
</tr>
<tr>
<td>f Section 199A deduction</td>
<td>0%</td>
<td>20%</td>
</tr>
<tr>
<td>g = e - (e * f) Effective rate</td>
<td>39.6%</td>
<td>29.6%</td>
</tr>
<tr>
<td>g - d Passthrough rate preference</td>
<td>10.87%</td>
<td>10.2%</td>
</tr>
</tbody>
</table>

As shown in the table, while the TCJA reduced the top corporate rate from 35 percent to 21 percent, it did not change the top rate on dividends (that is, 20 percent plus the 3.8 percent net investment income tax rate). Taking into account the dividend tax, the top combined effective rate on distributed corporate income was reduced from 50.47 percent to 39.8 percent. This is very close to the TCJA’s top individual rate when the section 199A deduction is unavailable (37 percent). When the section 199A deduction is available, the top effective rate on passthrough income is 29.6 percent.

In summary, the preference for passthrough income before the TCJA was 10.87 percent (that is, the 50.47 percent top effective rate on distributed corporate income compared with 39.6 percent top individual rate that applied to passthrough income before section 199A). Under the TCJA, the preference for passthrough income is nearly the same, dropping just slightly to 10.2 percent (that is, the 39.8 percent top effective rate on distributed corporate income compared with the 29.6 percent effective rate when the 20 percent section 199A deduction is taken against the top individual rate of 37 percent).

Thus, it is true that by enacting the section 199A deduction, Congress ensured that the rate preference for passthrough income over corporate income was maintained — that is, for those that now qualify for the section 199A deduction. By contrast, before the TCJA, all individual taxpayers (including wage earners) had a distinct rate advantage over C corporations, regardless of whether it was passthrough income or service related. Having said that, in the absence of a clear policy goal behind the preference in the first place, maintaining a preference for some but not others based on arbitrary distinctions involving qualification under section 199A cannot be considered a meaningful policy goal in itself. As this report demonstrates, if the preference is designed to encourage income attributable to “job creators,” section 199A needs further tailoring.

A second purported policy goal was to encourage and reward small business. Indeed, comments extolling the virtues of small business permeate the legislative history of the TCJA in general and the section 199A deduction specifically. However, as Martin A. Sullivan has pointed out (and as the statistics below confirm), passthrough businesses should not be equated with small businesses because many passthrough businesses extol the virtues of small business permeate the legislative history of the TCJA in general and the section 199A deduction specifically. However, as Martin A. Sullivan has pointed out (and as the statistics below confirm), passthrough businesses should not be equated with small businesses because many passthrough businesses...
businesses are quite large. More importantly, we do not believe that encouraging small businesses can be considered a separate policy goal from encouraging job creators. Small business is seen as beneficial to the U.S. economy precisely because it is believed to be the greatest driver of job creation. For example, in an opinion article for The Washington Post, Senate Finance Committee Chair Orrin G. Hatch, R-Utah, wrote: “The Senate proposal would give a leg up to small businesses, which are engines of job creation in our economy, employing about half of all U.S. workers and responsible for significant amounts of job creation.”

## Taxable Income Thresholds

Section 199A fails to serve the job creation policy goal in several ways. First among them are the provisions that set income thresholds below which the specified services and W-2 wages/qualified property restrictions do not apply. With threshold amounts for 2018 of $315,000 for taxpayers filing joint returns and $157,500 for all other taxpayers, a substantial majority of the taxpayers who qualify for the section 199A deduction do not need to employ a single individual.

Statistical information is available to help understand who might be claiming the section 199A deduction. In an analysis of individual tax returns with positive taxable income for the year 2014, the Treasury Office of Tax Analysis found the following regarding those returns reporting any passthrough income:

<table>
<thead>
<tr>
<th>Tax Brackets</th>
<th>Total Returns</th>
<th>Total AGI</th>
</tr>
</thead>
<tbody>
<tr>
<td>≤ 10% - 28% + AMT 26%</td>
<td>24.5 million</td>
<td>89%</td>
</tr>
<tr>
<td>≥ 33% + AMT 28%</td>
<td>3.1 million</td>
<td>11%</td>
</tr>
</tbody>
</table>

Note that these tax brackets (very) roughly correlate with the threshold amounts for section 199A. In 2014 the 33 percent bracket began at taxable income of $186,350 for single filers and $226,850 for joint return filers.

Those statistics suggest that most taxpayers (somewhere around 89 percent) who might claim the section 199A deduction because they have some passthrough income will have income below the thresholds. On the other hand, lest the impression remain that section 199A is a middle-income tax cut, the overall dollar amount of the section 199A deduction is likely to be substantially skewed toward taxpayers with income above the thresholds, as is apparent from the statistics that 69 percent of adjusted gross income reported by taxpayers with some passthrough income was reported by taxpayers in regular tax brackets of 33 percent or higher or in the 28 percent alternative minimum tax bracket.

To ensure the section 199A deduction is claimed only by taxpayers who are job creators that can pass the W-2 wage restriction, we recommend that the income thresholds be abolished.

### Specified Services Morass

Taxpayers whose taxable income exceeds the specified thresholds must contend with the

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53 Sullivan, “The Nowhere Plan,” Tax Notes, Oct. 2, 2017, p. 12 (“The document [that is, the framework issued by the Big 6] says the latter is for small businesses; it cannot be discerned if this means the availability of the 25 percent rate would be limited to businesses below a specific size, or if the framework is playing the usual Washington game of equating pass-through businesses with small businesses even though there are many large pass-through businesses.”).


56 It is important to note that the above data is based on AGI, whereas section 199A uses a threshold based on taxable income.

57 The OTA study uses a definition of pass-through income that is consistent with section 199A: income reported on schedules C, E (rental), or F, and partnership and S corporation income.

58 It is worth considering whether the W-2 wage restriction should be amended to take into account payments made to independent contractors, which are reported on Form 1099-MISC The OTA study concludes that “in many instances, these individuals are not substantially different than employees of the firm to whom they provide labor services,” and therefore includes them when considering whether a firm is truly a small business rather than an extension of an individual proprietor. It is appropriate that section 199A excludes these individuals from the W-2 wage restriction calculation to avoid double counting, because they also would likely qualify to take the deduction. However, if the thresholds were eliminated, most independent contractors would be unable to take the deduction, so there would be very little double counting.
specified services definition. If they are engaged in a specified service trade or business, their pass-through deduction will be phased out or denied entirely. This definition adds tremendous complexity to section 199A and almost certainly will lead to a great deal of controversy.

If the policy goal is to support job creation, the specified services restriction is altogether unnecessary; the W-2 wage restriction will serve the same purpose and will serve it better. That is, many specified service businesses will be entitled to little or no deduction because they are the types of businesses that do not create many jobs. To the extent that the taxpayer is a mere service provider whose income is the equivalent of salary, they will receive no deduction. On the other hand, for taxpayers who do employ large staffs, why should the nature of their business have any effect on the amount of the deduction they receive?

A specified service trade or business is defined by cross-reference to section 1202, which provides an exclusion for gain on the sale of specific small business stock. Despite its 24-year history, section 1202 has not generated much controversy; however, one commentator opines that there may be a slew of cases coming down the pipeline since the exclusion amount was increased to 100 percent of gain only in 2010.

The usual suspects for the specified service trade or business are easy to identify: doctors, lawyers, accountants, and professional athletes. Beyond that, in addition to leading to controversy, the definition is sure to lead to the drawing of many arbitrary distinctions. Indeed, while the proposed regulations provide a measure of clarity, they themselves draw some arbitrary lines. As Sullivan has pointed out, the proposed regulations make it fairly clear that a movie studio will not be considered to be engaged in the field of athletics. One has to wonder what sort of economic distortions section 199A will create.

One aspect of the statute that was expected to create a lot of uncertainty — Sullivan called it a “nightmare” — was the “reputation or skill” clause. The proposed regulations would resolve this issue neatly and decisively. Recall that a specified service trade or business includes “any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or its owners.” Possible approaches to this test were extensively discussed in articles published before the proposed regulations were promulgated. The proposed regulations adopt a novel and very narrow approach: the “reputation or skill” clause would apply only if an individual receives income from endorsing products or from licensing their name or likeness.

In sum, the specified services restriction will drain regulatory resources, clog the courts, and create uncertainty that impairs taxpayer planning. It appears that lawmakers thought it was necessary to devise this sort of restriction to prevent the wealthy from converting wages for personal services into qualified business income. This is clear from the fact sheet that the House put out to accompany their initial bill, which addressed the hypothetical charge that “lowering the tax rate for pass-through businesses creates a massive loophole that wealthy Americans will use to avoid paying their fair share of taxes” with the following response:

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62 Id.
63 See, e.g., Donald B. Susswein, “Understanding the New Passthrough Rules,” Tax Notes, Jan. 22, 2018, p. 497 (suggesting an approach that would require an actual asset on the books, such as an employment contract or workforce in place booked in an acquisition, or an alternative approach that focuses on the skill and reputation of the passthrough entity’s owners); Winchester, supra note 6 (arguing that the skill or reputation of owners may be an appropriate criterion, but that of other employees is not). See also the comments of the New York State Bar Association Section of Taxation.
65 In this regard, the TCJA amended section 6662 to provide that the threshold for the penalty for substantial understatement of income tax is reduced from 10 percent to 5 percent for purposes of section 199A. Section 6662(d)(1)(C).

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See Nitti, “Tax Geek Tuesday: Making Sense of the New ‘20% Qualified Business Income Deduction,’” Forbes, Dec. 26, 2017 (arguing that taxpayers did not care about the section 1202 exclusion very much because, until 2010 the exclusion from gain was only 50 percent, with the other 50 percent taxed at 28 percent).

Another problem with referencing section 1202 to define the types of prohibited services is that not all services appear on the list. The list was designed for section 1202 purposes by Congress to ensure that only specific small business qualified for the exclusion under section 1202.

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The Tax Cuts and Jobs Act includes specific safeguards to prevent tax avoidance and help ensure taxpayers of all income levels play by the rules under this new fairer, simpler tax system. Our legislation will ensure this much-needed tax relief goes to the local job creators it’s designed to help by distinguishing between the individual wage income of NBA All-Star Stephen Curry and the passthrough business income of Steve’s Bike Shop.

However, if one gives only a brief thought to the Stephen Curry example, it is readily apparent that the W-2 wage restriction would achieve the same result. If Curry sets up a single-member LLC (that is treated as a sole proprietorship) and directs the Golden State Warriors to pay his salary to the company, he still will not receive any deduction under section 199A if the company does not employ anyone other than himself. On the other hand, if the company employs staff to run a string of basketball camps, for example, why shouldn’t he receive the deduction to the extent allowed under the W-2 wage restriction?

To repeat, we believe that section 199A should be amended to eliminate the specified service trade or business provisions entirely and rely exclusively on the W-2 wage restriction to achieve desired policy goals.

Qualified Property Boondoggle

Consider a taxpayer whose income is above the specified thresholds and operates a passthrough business that employs no staff. The taxpayer can still qualify for the full section 199A deduction if the business owns sufficient qualified property. Specifically, the deduction is limited to the sum of 25 percent of the business’s W-2 wages plus 2.5 percent of the unadjusted basis of qualified property. Note that the inclusion of the 25 percent of W-2 wages element is essentially just a sop: Wages can be zero as long as 2.5 percent of the unadjusted basis of qualified property is greater than 20 percent of qualified business income.

Qualified property is tangible property used in the business that can be depreciated under section 167 if the depreciable period has not ended. The depreciable period is the greater of the property’s depreciable life or 10 years. As Richard Winchester has noted, there will be many cases in which a taxpayer receives a tax benefit for property that is already fully depreciated. Winchester also points out that because only 2.5 percent of the property’s basis is taken into account, it is unlikely that the rule will operate as an incentive for new investment instead of an unearned boon for business owners who already use high dollar amounts of depreciable property, such as real estate investors like President Trump.

It is also noteworthy that section 199A amends the qualified property alternative by measuring the value of property by its original unadjusted basis rather than by its depreciation-adjusted basis like most code provisions.

We believe that section 199A should be modified to remove the qualified property alternative and rely exclusively on the W-2 wages restriction to ensure the deduction goes to deserving taxpayers. While one might argue that the qualified property alternative serves the policy goal of encouraging capital investment, the code already rewards capital investment in many other provisions, including preferential rates for capital gains, generous depreciation rules, and nonrecognition provisions. If taxpayers do not

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66. See fact sheet, supra note 45. This example did not go unnoticed by Curry, who was quoted as saying, “There’s a lot of people wondering why I was called out, whatever the case may be, but mama, I made it,” and later tweeting, “I wonder if Steve’s Bike shop is hiring.” See Zachary Abate, “For Whom the Bell Trolls,” Tax Notes, Dec. 4, 2017, p. 1382.

67. Note that unlike real estate or manufacturing equipment, technology would generally not qualify. Those entities that own predominately intangibles would therefore fail to qualify for the deduction once the threshold is exceeded. That being said, many start-up companies with intangibles are customarily formed as corporations for many reasons (for example, the section 1202 exclusion, the loss limitation rules, the common industry practice of issuing stock, and stock options versus partnership interests).

68. Winchester, supra note 6.

69. Id. Samuel C. Thompson Jr. has written a pair of entertaining articles illustrating how both the original House bill and the final law will benefit President Trump and concluding that it is Trump’s situation, not Curry’s, that should be compared with that of Steve’s Bike Shop. Thompson, “Taxing Trump and Curry Under the Republican Plan,” Tax Notes, Nov. 20, 2017, p. 1149; Thompson, “The Curry/Trump Split in Tax Reform,” Tax Notes, Jan. 1, 2018, p. 151.

70. It is difficult to imagine what the tax policy justification was for qualified property aside from a tax giveaway to some businesses with no employees.
create jobs, they should not receive an additional preference for capital investment.

**W-2 Wages and Reasonable Compensation**

Once we have decided to rely solely on the W-2 wage restriction to ensure the section 199A deduction goes to its intended recipients, a further issue must be considered: In its current form, section 199A appears to treat compensation paid by an S corporation to a major shareholder (or even a sole shareholder) on par with wages paid to other employees as long as the shareholder compensation is properly reported to the Social Security Administration and employment taxes are paid. The proposed regulations do not provide otherwise; it is doubtful that Treasury would have authority to do so if it wanted to.

S corporation shareholder compensation thus plays two opposing roles in the statutory scheme. On the one hand, section 199A(c)(4) definitively states that qualified business income does not include reasonable compensation due to the taxpayer from an S corporation. Consider the case of an S corporation with a sole shareholder that is not engaged in a specified service trade or business. That shareholder’s taxable income will be the same without regard to the proportion of the S corporation’s income that is paid as compensation versus included in distributive share. Before section 199A, the only difference was the amount of employment tax the taxpayer had to pay (that is, employment tax was only paid on the compensation portion). With the advent of section 199A, before taking into account the W-2 wage restriction, the amount of the deduction will be greater to the extent that the amount of reasonable compensation is minimized.

On the other hand, if the W-2 wage restriction would otherwise limit the amount of the section 199A deduction, paying additional shareholder compensation will actually increase the deduction. Suppose our single-shareholder S corporation has no employees other than the shareholder. Suppose further that the S corporation pays no compensation, none of the potential $2 million section 199A deduction (that is, 20 percent of $10 million) will be available because W-2 wages are zero. If the taxpayer instead has the S corporation pay reasonable compensation equal to $3 million, the taxpayer will then be entitled to a $1.4 million section 199A deduction. This is equal to 20 percent of the $7 million distributive share remaining after the S corporation deducts the $3 million compensation. This works because the deduction is no longer limited by the W-2 wage restriction (that is, 50 percent of $3 million is $1.5 million).

The table below illustrates these calculations:

<table>
<thead>
<tr>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>S corporation income</td>
<td>$10 million</td>
</tr>
<tr>
<td>Reasonable compensation</td>
<td>$0</td>
</tr>
<tr>
<td>Allocable share</td>
<td>$10 million</td>
</tr>
<tr>
<td>20 percent of allocable share</td>
<td>$2 million</td>
</tr>
<tr>
<td>50 percent of W-2 wages</td>
<td>$0</td>
</tr>
<tr>
<td>Section 199A deduction</td>
<td>$0</td>
</tr>
</tbody>
</table>

We believe that this result is inappropriate. There is no economic difference between these two scenarios; in neither case has there been any “job creation.” S corporation shareholders should not be able to create the illusion of job creation merely by paying salaries to themselves.

In the case of the sole shareholder, compensation paid by the S corporation should

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71 On the other hand, if the IRS found on audit that the compensation paid to an S corporation shareholder was insufficient and the taxpayer agreed to pay employment taxes on some amount of additional “reasonable compensation,” this compensation would not qualify for purposes of the W-2 wage restriction because an employment tax return was not filed within 60 days of its due date. See section 199A(b)(4)(C).

72 Putting aside the deduction for 50 percent of employment taxes paid.

73 It is interesting that section 199A was designed to exclude guaranteed payments, section 707(a) payments, and reasonable compensation from the availability of the deduction even when the taxpayer’s taxable income is below the applicable threshold.

74 Sullivan has numerically illustrated that it will always result in overall tax savings (that is, considering both the section 199A deduction and employment taxes) when the W-2 wage restriction limits the deduction. See Sullivan, “A Dozen Ways to Increase the TCJA Passthrough Benefits,” *Tax Notes*, Apr. 9, 2018, p. 147.
not count for the W-2 wage restriction. However, some line-drawing may be appropriate. Wages paid by an S corporation to a key employee who also happens to have a very small ownership interest probably should be counted. One possible rule would be that compensation paid to any shareholder who owns 25 percent or more of the S corporation’s stock does not qualify.

It is important to note that this technique for generating W-2 wages is unavailable to sole proprietors or partners under section 199A in its current form. This is because there is no concept of “reasonable compensation” in either context. While partners can receive “guaranteed payments” for services rendered to a partnership, these do not meet the definition of W-2 wages.

On a side note, the lack of a reasonable compensation concept in the sole proprietor context does lead to some unfairness in the statutory scheme, and that would remain even if the changes we recommend are implemented. Specifically, where the W-2 wage limitation is not at issue, sole proprietors get more favorable treatment than S corporation shareholders.

Consider a case in which the business employs many individuals and therefore would qualify under the W-2 wage restriction without regard to shareholder compensation. If the business is run as a sole proprietorship, the taxpayer receives a deduction for 20 percent of profits, without reduction for what would be reasonable compensation for the taxpayer’s services. Conversely, if it is run as an S corporation, the deduction is limited to 20 percent of profits after being reduced by reasonable compensation.

To be fair, when it uses the term “reasonable compensation,” section 199A does not explicitly restrict it to the S corporation context. Arguably, Treasury would have the authority to issue regulations that expand the concept so that it applies to sole proprietors and partnerships as well. However, in the preamble to the proposed regulations, Treasury clearly and explicitly indicates that they chose not to do so. If Congress were to revisit section 199A along the lines we suggest, they should consider whether to address this issue in the statute.

Conclusion

There is nothing in the statute itself to prevent an employee from leaving her job and setting up shop as a sole proprietorship. If an employee decides to venture out on her own there appears to be nothing in section 199A or otherwise to prevent it. Perhaps this is the beginning of the code’s evolution into the new “gig economy,” in which neither the employee nor employer has any loyalty to the other and employee benefits are a thing of the past.

On the other hand, if a taxpayer and his employer attempt to circumvent section 199A by making an existing employee an independent contractor, that is another matter. In its current form, section 199A encourages employees below the income thresholds to misclassify themselves as independent contractors. The IRS will then presumably be entrenched in the much-litigated and highly factual independent contractor inquiry. Indeed, the proposed regulations attempt to put a finger on the scale with a presumption that a person who was previously treated as an employee by an employer would, for purposes of section 199A, be presumed to still be an employee if he is subsequently treated as an

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76 REG-107892-18, at 39-40 (stating, inter alia, that extending the concept of reasonable compensation to partnerships would require a “change of [the] long-standing Federal income tax principle” that a partner cannot be an employee of their partnership).

77 If they do not want to extend the reasonable compensation concept, Congress could revisit the approach taken in the original House bill. That bill would have “added back” S corporation compensation and partnership guaranteed payments to the taxpayer’s qualified business income; but would have imposed a per se rule that 70 percent of active participants’ income would be attributable to labor services and only 30 percent would be eligible for the deduction (the so-called capital percentage). (Taxpayers would have been able to increase the share of income eligible for the deduction based on a calculation of the actual capital invested in the business.)

78 This is historically known as the “20-factor test.” See Rev. Rul. 87-41, 1987-1 C.B. 296. The latest IRS guidance breaks the factors down to three categories: behavioral, financial, and type of relationship. IRS, “Independent Contractor (Self-Employed) or Employee?”
independent contractor by the same employer for providing substantially the same services.\(^7\)

As we have demonstrated in this report, if Congress believes in section 199A as an engine for job creation, the provision should be revised to accomplish that goal. While there are several other aspects that could be cleaned up, these are the four changes we recommend:

- the taxable income thresholds should be eliminated so that taxpayers below the threshold will not receive the section 199A deduction unless they hire employees;
- the specified service trade or business restriction should be removed in order to greatly simplify the provision while reinforcing the job creation goal;
- the qualified property alternative to the W-2 wage restriction should be eliminated so that payment of wages is the only relevant criterion to qualify for the deduction; and
- compensation paid by an S corporation to a significant shareholder should not be treated as qualifying wages for the W-2 wage restriction to avoid artificial manipulation.

It is a shame that Congress rushed the process to pass the TCJA without holding any hearings on important and radical new provisions like section 199A.\(^8\) Is it too much to hope for a deliberative and nuanced process of amending and refining these provisions in the future?

\(^7\) Prop. reg. section 1.199A-5(d)(3).
\(^8\) Other provisions that were pushed through before they were ready for prime time include many of the international provisions — notably, global intangible low-taxed income rules under section 951A and the base erosion and antiabuse tax under section 59A. It is interesting to note that all those provisions have been squeezed into the code by adding a capital A to preexisting sections.