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Tax Reform: Will Section 199A Phase In or Phase Out Your 20 Percent Deduction?

New tax code Section 199A creates a totally uncomplicated 20 percent tax deduction for you on your qualified business income if you operate a proprietorship, partnership, or S corporation and you[1]

- are married and file a joint tax return with $315,000 or less in taxable income, or
- are single and file your tax return with $157,500 or less of taxable income.

Example. You operate a proprietorship, file as a single taxpayer with $135,000 of taxable income, and have qualified business income of $120,000. Your new 20 percent tax deduction is $24,000 ($120,000 x 20 percent).

Once your taxable income exceeds the threshold amounts above, you arrive in one of the four possible categories below:

1. Phase-in range for a non-specified service trade or business
2. Phaseout range for a specified service trade or business
3. Above the phase-in range for an in-favor non-specified service trade or business (for a straightforward look at what happens when you are not a service trade or business and you are above the phaseout range, see Tax Reform: Wow, New 20 Percent Deduction for Business Income)
4. Above the phaseout range for an out-of-favor specified service trade or business that puts you in the "no deduction for you" category (this applies to doctors, lawyers, accountants, actors, athletes, traders, etc.); for more on this group, see Tax Reform Sticks It to Doctors, Lawyers, Athletes, Traders, and Others.

Phaseout, Phase-In Range

For the single taxpayer, the taxable income phaseout, phase-in range is the $50,000 between $157,500 and $207,500.[2]

For the married filing jointly taxpayer, the taxable income phaseout, phase-in range is the $100,000 between $315,000 and $415,000.[3]

Phaseout, Phase-In Big Picture

New tax code Section 199A treats the specified service trade or business (doctors, lawyers, etc.) less well than it treats a business that is not in this out-of-favor group.

We—unlike the tax code, which uses "phase-in" only—use both "phaseout" and "phase-in" because those terms better explain what happens as below:

- **Phaseout** explains how Section 199A decreases deductions for those in specified service trades or businesses that have income in the phaseout, phase-in range above. Phaseout best describes what happens to this group as they go from the possible 20 percent deduction with taxable income of less than the thresholds to zero with taxable income above $207,500 (single), $415,000 (married filing jointly).

- **Phase-in** explains how Section 199A increases deductions for those not in the out-of-favor specified service trades or businesses when such taxpayers have taxable income in the phase-in ranges.

Phase-In of Benefits for the Tax-Favored Business

If your business is not a specified service trade or business (doctors, lawyers, etc.) and you have taxable income equal to or less than the threshold amounts of $157,500 (single) or $315,000 (married filing jointly), you qualify for the 20 percent deduction on your qualified business income.[4] There is no other computation.[5] You use the simple math.

Once income is above $207,500 (single) or $415,000 (married), the formula for the qualified business income deduction for that qualified business is the lesser of[6]

- 20 percent of your qualified business income, or (get ready for this)

- the greater of (a) 50 percent of that business's W-2 wages or (b) the sum of 25 percent of the W-2 wages, plus 2.5 percent of the unadjusted basis immediately after acquisition of all that business's qualified property.

Example 1. Your business is in the in-favor group. Your qualified business income is $260,000, and the business pays zero in wages and owns no property. You are single with taxable income of $300,000. Your 20 percent Section 199A deduction is zero.

For you as a single taxpayer to qualify for the 20 percent deduction with taxable income of $300,000, which is more than the $207,500 above, you need either W-2 wages or property.

Example 2. The facts are the same as in example 1, except that your business paid $100,000 in W-2 wages. Now your deduction is the lesser of

- $52,000 (20 percent of $260,000), or
- $50,000 (50 percent of W-2 wages).

You deduct $50,000.

You can see that if you are above $207,500 (single)/$415,000 (married) or below $157,501 (single)/$315,001 (married), calculating your Section 199A deduction is pretty clear and straightforward.

When your income is between those numbers, you use a phase-in calculation as in example 3 below.

Example 3. Again, your business is in the in-favor group. Your qualified business income is $345,000, and the business pays $100,000 in W-2 wages and owns no property. You are married with taxable income of $345,000 that with other income and deductions somehow matches your qualified business income.

Before considering the phase-in, your tentative deductions are the following:[7]

- $69,000 (20 percent of $345,000 qualified business income)
- $50,000 (50 percent of W-2 wages)

Your phase-in is 30 percent. You have $30,000 over the $315,000 threshold, which gives you 30 percent of the $100,000 phase-in range. You take the $19,000 difference between $69,000 and $50,000 and multiply that by 30 percent to get your phase-in amount of $5,700.

Your Section 199A deduction is $63,300 ($69,000 - $5,700).

Note. With this calculation, you phase in the benefit of the wage and property calculation, which does not apply when your married taxable income is $315,000 or less.

Phaseout of Benefits for Doctors, Lawyers, Accountants, and Others in Out-of-Favor Businesses

Remember, with the out-of-favor business, you qualify for the 20 percent deduction in exactly the same way as an in-favor business when you have taxable income of $157,500 or less (single) or $315,000 or less (married filing jointly).[8]

But when your out-of-favor business has taxable income of more than $207,500 (single) or $415,000 (married filing jointly), lawmakers give you a zero Section 199A deduction.[9]

When you are between the two amounts, you are in the phaseout of your benefits range.

Example 4. You are married, file a joint tax return, and do business as a dentist in private practice operating as a proprietorship with taxable income of $345,000. Your dental practice earned $345,000 and paid $100,000 in W-2 wages to your employees.

Your $345,000 of taxable income puts you $30,000 over the $315,000 married threshold, and that $30,000 is 30 percent of the $100,000 phaseout range, leaving you with 70 percent. You calculate your qualified business deduction by first finding the deduction you would have as an in-favor business. Example 3 has the same facts and it's in-favor business deduction was $63,300. Your out-of-favor business deduction is 70 percent of that, or $44,310.

Comparison

Note that the taxable and business incomes in examples 3 and 4 are the same. The only difference in the examples is that example 3 is for the in-favor business and example 4 is for the out-of-favor medical business.

And solely because of the business difference, you see that

- the in-favor business qualifies for a $63,300 deduction, and
- the out-of-favor specified service trade or business (dentist) qualifies for a $44,310 deduction.

Reminder

Don't forget that no matter what, the Section 199A deduction may not exceed 20 percent of taxable income.

Takeaways

The phase-in of the wage and depreciable property benefits for the in-favor business provides a striking contrast to the phaseout of the benefits for the out-of-favor specified service trade or business (doctors, lawyers, accountants, actors, athletes, musicians, traders, etc.).

The good news for the in-favor business is that once you find yourself in the $50,000 (single) or $100,000 (married filing jointly) phase-in range, you benefit nicely when you have wages and/or property, as you saw in example 3.

Although the benefits for the out-of-favor business group during the phaseout do not match the benefits of the in-favor group, the benefits are still pretty good and certainly beat the no benefits at all that come when the out-of-favor business owner has taxable income above the combined threshold and a phaseout amount of $207,500 (single) or $415,000 (married).

Note. Example 4 in this article was corrected and simplified on June 27, 2018.

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1 IRC Sections 199A(b); 199A(e)(2).
2 IRC Sections 199(e)(2)(A); 199A(b)(3); 199A(d)(3).
3 IRC Sections 199(e)(2)(A); 199A(b)(3); 199A(d)(3).
4 IRC Section 199A(b)(3)(A).
5 Ibid.
6 IRC Section 199A(b)(2).
7 The calculation follows IRC Section 199A(3)(B). See H.Rpt. 115-466, p. 220, Example 1.
8 IRC Section 199A(b)(3)(A).
9 IRC Section 199A(d)(3)(A).