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Is Section 199A's Qualified Business Income Deduction Good Tax Policy?

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ABSTRACT: The qualified business income deduction under Section 199A, which was enacted as part of the Tax Cuts and Jobs Act of 2017, was intended to provide a reduction in federal taxes for businesses operating as passthrough entities commensurate with the rate reduction allowed to corporations. While the Section 199A deduction does achieve its intended objective of reducing taxes on passthrough entities, it does so with unnecessary complexity. In this article, we briefly review the rules governing the deduction and evaluate it critically against nine principles of good tax policy. Our evaluation reveals shortcomings in the structure of the deduction that prevent it from achieving the goals of equity, certainty, convenience, administrative effectiveness, simplicity, neutrality, efficiency, compliance, and revenue predictability. However, with respect to the principle of visibility, the deduction succeeds.

Keywords: Sec. 199A; QBI; TCJA; qualified business income; tax policy.

I. INTRODUCTION

Public Law 115-97, commonly known as the Tax Cuts and Jobs Act (TCJA), was originally conceived to provide tax relief to businesses operating as C corporations (e.g., Sherlock and Marples 2018; Slemrod 2018).[1] Toward this end, the TCJA made two prominent

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[1] The long title of the Tax Cuts and Jobs Act of 2017 is "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018." Although it provides substantial tax relief to individual taxpayers, it was initially motivated by a perceived need to reduce corporate taxes (e.g., Schechter and Windram 2017).

changes to the taxation of C corporations. First, it reduced the corporate tax rate from 35 to 21 percent.[2] Second, it moved the U.S. tax system away from a worldwide approach to one more closely resembling a territorial system.[3] While both of these changes reduced the tax burden of multinationals, they afforded little tax relief to domestic businesses operating as passthrough entities in the form of sole proprietorships, partnerships, S corporations, trusts, and estates.

In an attempt to level the playing field, Congress created Section 199A (hereafter, Sec. 199A) with the presumed goal of preventing an exodus of entity conversions to C corporations (U.S. House of Representatives 2017). But rather than drafting a provision that gave passthrough businesses an analogous rate reduction, Congress provided tax relief to the owners of passthrough entities in the form of a 20 percent deduction for qualified business income. Scheduled to expire after 2025, the Sec. 199A deduction lacks both the simplicity and permanency of the TCJA's reduction in the corporate tax rate. Instead, the Sec. 199A deduction is governed by complicated rules that deny its benefit to the owners of certain service businesses and those with income over specific thresholds. The result is a deduction mired in complexity that encourages gaming.

There is a plethora of articles about the Sec. 199A deduction,[4] plus countless internet blogs and postings. Most of these articles explain the mechanics of the deduction or discuss the optimal entity choice to maximize the deduction. But among this massive literature, there is little in the way of critical analysis of the deduction from the academic community. We fill this gap in the academic literature by highlighting the general rules that govern the deduction and evaluating it critically against nine principles of good tax policy. In addition, we provide examples drawn from our professional experience that illustrate aspects of the deduction that we believe fall short of the goals of good tax policy. The objective of our analysis is to inform policymakers as they consider potential modifications to the deduction.[5]

The paper proceeds as follows. The next section discusses the historical background of Sec. 199A. We then explain the technical details involved in calculating the deduction. We follow this with an assessment of whether Sec. 199A is good tax policy and recommendations for improvement. We close with some concluding remarks.

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[2] Although the rate reduction was accompanied by an increase in the corporate taxable base, it nonetheless led to an overall decrease in corporate taxes. Key changes impacting the corporate base include Section 163(j), which imposes new limits on interest deductions, Section 172, which repeals carrybacks of net operating losses and limits loss carryforward deductions to only 80 percent of business income, Section 965, which establishes a one-time transition tax on unrepatriated foreign earnings, Section 1031, which repeals like-kind exchanges for personal property, and Section 274, which limits deductions for entertain expenses. The TCJA also repealed the Section 199 deduction for domestic production, which had been marred by controversy (e.g., Pryor and Lerner 2017).

[3] The TCJA made three significant changes to the taxation of multinational earnings. The Global Intangible Low-Taxed Income (GILTI) provision imposes a minimum tax on income earned by foreign affiliates of U.S. companies from intangible assets such as patents, trademarks, and copyrights. The Foreign-Derived Intangible Income (FDII) provision created an incentive for domestic corporations to export. The Base Erosion and Anti-Abuse Tax (BEAT) provision reduced the incentive to shift income to low-tax jurisdictions.

[4] A keyword search of ProQuest's ABI/INFORM Collection for the years 2017 to 2021, performed on November 16, 2021 using "qualified business income deduction," returned more than 225 articles among newspapers, magazines, and trade journals.

[5] *See, for example,* the Senate Committee on Finance's draft legislation, *Small Business Tax Fairness Act,* released July 19, 2021, at: https://www.finance.senate.gov/imo/media/doc/7.19.21%20Small%20Business%20Tax%20Fairness%20Act%20One%20Page%20Summary.pdf

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II. BACKGROUND

Prior to the TCJA's corporate tax rate reduction, U.S. corporations faced the highest tax rate in the industrialized world, with a top federal statutory rate of 35 percent and an average state rate of 4.1 percent (Hatch 2017). The combined U.S. average corporate statutory rate of 39.1 percent[6] placed American multinational corporations at a competitive disadvantage, and this disadvantage was made all the more acute when considered in light of investor-level taxes on corporate distributions. In 2017, after a GOP sweep of both houses of Congress and the presidency, a legislative remedy became a reality. Speaking at a Senate Finance Committee hearing on business tax reform held on September 19, 2017, Scott Hodge, President of The Tax Foundation, suggested four pillars for tax reform. First, he called on Congress to provide full expensing for capital investments. Second, he recommended cutting the corporate tax rate to a globally competitive level, such as 20 percent. Third, he suggested moving to a competitive territorial tax system. Fourth, he advocated making the first three changes permanent (Hodge 2017).

Hodge's (2017) suggestions became an integral part of the TCJA, which was signed into law on December 22, 2017. C corporations benefited from the TCJA in two ways. First, the corporate tax rate declined from 35 to 21 percent (a 40 percent decrease). Second, the worldwide system of taxation shifted toward a territorial system that generally no longer requires corporations to pay taxes on repatriated dividends from their foreign subsidiaries.[7] Equally important, the TCJA made these changes permanent.[8] In addition, the law included a full expensing provision that applied to all businesses and an artificial deduction of 20 percent that applied to individuals (including certain trusts and estates) with qualified business income from domestic passthrough entities. This latter deduction was intended to maintain the tax advantage held by the owners of passthrough entities as compared to the investors of C corporations (U.S. House of Representatives 2017).

Unlike C corporations, which pay tax both at the corporate and investor level, the owners of passthrough entities are taxed directly on business income at a single level. Table 1 provides a comparison of the taxation of C corporations and passthrough entities both prior to and after the TCJA. In the table, we assume that a C corporation earns $100 of taxable income, which, prior to the TCJA, was generally taxed at 35 percent and resulted in $35 of corporate tax and $65 of income available for distribution to investors. We further assume that the corporation's investors are subject to the top preferential rate of 20 percent on qualified dividends, causing them to pay an additional $13 of tax if all earnings are distributed. The total tax collected from the C corporation's $100 of income is, therefore, equal to $48. In contrast, the owners of a passthrough entity with $100 of taxable income would pay $39.60 in tax if they were subject to the top individual tax rate in effect during the pre-TCJA years. Prior to the TCJA, the owners of passthrough entities consequently benefited from a tax savings of 8.4 percentage points as compared to investors of C corporations.

After the TCJA's corporate rate reduction, a C corporation with $100 of taxable income pays $21 of corporate tax and has $79 of income available for distribution to investors. Assuming the full amount is distributed and that the C corporation's investors are again subject to the top preferential rate of 20 percent on qualified dividends, the total tax collected from the C corporation's $100 of

[6] The combined rate of 39.1 percent is higher than the effective rate because state and local taxes are deductible against federal income.

[7] The TCJA added Sec. 965, which requires multinational entities to pay a one-time mandatory repatriation tax on undistributed and deferred post-1986 foreign income.

[8] The TCJA also made significant changes for individual taxpayers. Unlike the corporate tax changes, however, the individual tax changes have a sunset provision that causes them to expire after 2025.

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TABLE 1
Tax Liability Comparison in the Pre- versus Post-TCJA Periods

	Pre-TCJA (2017)			Post-TCJA (2018)		
	Taxable	Tax Rate	Tax	Taxable	Tax Rate	Tax
C Corporation						
Net income	$100	35%	$35.00	$100	21%	$21.00
Dividend income	65	20	20.00	79	20	15.80
Total tax			48.00			36.80
Domestic Passthrough Entity						
Without Sec. 199A	$100	39.6%	$39.60	$100	37%	$37.00
With Sec. 199A				80	37	29.60
Rate benefit			8.40			7.20

Table 1 shows the tax implications of income received from a C corporation versus a domestic passthrough entity in the pre- and post-TCJA periods.

income is equal to $36.80. By comparison, in the absence of tax relief to the owners of passthrough entities, the tax they would owe on $100 of taxable income is $37 if they are subject to the TCJA's top rate on individuals of 37 percent. Note that without tax relief, the owners of passthrough entities would no longer hold a tax advantage over the investors of C corporations. However, when the 20 percent deduction of Sec. 199A is added to the example, the owners of passthrough entities retain a 7.2 percentage point tax advantage over the investors of C corporations.

III. CALCULATION OF THE DEDUCTION

Sec. 199A provides a deduction to taxpayers having qualified business income. It replaces the repealed Sec. 199, which had allowed businesses that engaged in construction, manufacturing, production, or similar activities to claim a deduction equal to 9 percent of qualified production activities income.[9] Both Sec. 199A and its predecessor are surprisingly simple in theory. In reality, however, both are marred by complicated rules that encourage gaming. The flowchart in Figure 1 provides a general framework for understanding these rules.

Very generally, Sec. 199A allows the owners of passthrough entities to claim a deduction equal to 20 percent of the sum of their qualified business income (QBI), qualified real estate investment trusts (REIT) dividends, and qualified publicly traded partnership (PTP) income. QBI is defined generally as the net amount of income, gain, deduction, and loss relating to qualified domestic businesses. QBI does not include compensation in the form of wages or guaranteed payments to an owner/employee. For self-employed taxpayers, QBI is reduced by the deductible portion of self-employment taxes, health insurance, and contributions to qualified self-employed retirement plans. Excluded from QBI are income from investments (e.g., capital gains or losses, interest, dividends), non-business annuities, foreign currency gains or losses, and commodity

[9] Under Sec. 199A(g) specified horticultural cooperatives may still take a deduction for income attributable to domestic production activities for tax years beginning after 2017. The deduction under Sec. 199A(g) is beyond the scope of this article.

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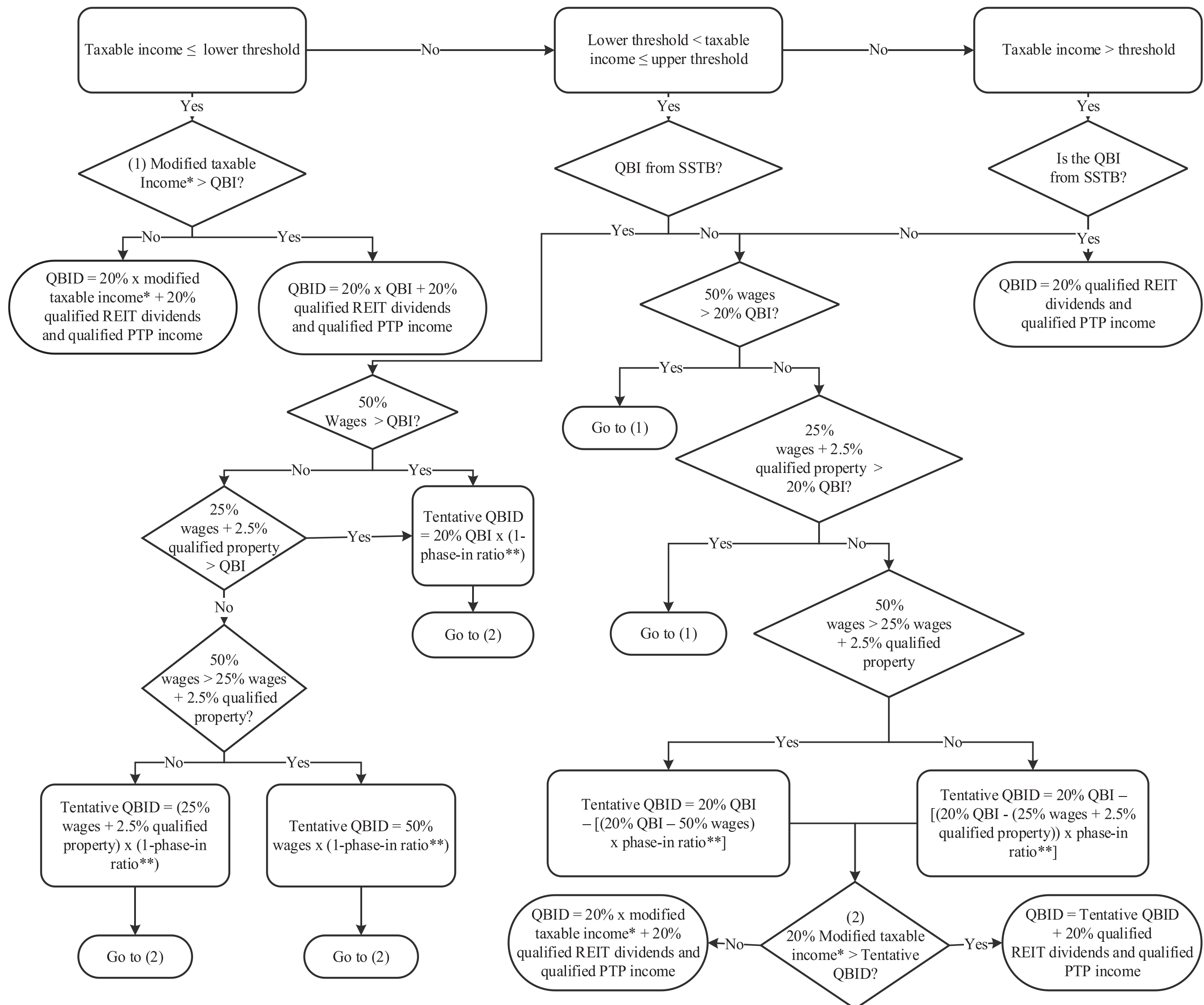
FIGURE 1
Qualified Business Income Deduction (QBID) Flowchart



* Modified taxable income = taxable income − net capital gain.
** Phase-in ratio, not to exceed 100 percent = (taxable income − lower threshold)/phase-in range.
For the tax year 2022, the phase-in range is $50,000 ($100,000 married filing jointly [MFJ]). The lower threshold amount is equal to $170,050 ($340,100 MFJ), and the upper threshold is $220,050 ($440,100 MFJ).

transactions. Qualified PTP income is computed similarly, but it and qualified REIT dividends are not subject to the same limitations as other QBI.[10]

The maximum deduction is the lesser of (1) 20 percent of an owner's QBI plus 20 percent of qualified REIT dividends and qualified PTP income, or (2) 20 percent of an owner's taxable income

[10] The last sentence of §199A(c)(1) states that QBI does not include qualified REIT dividends or qualified PTP income.

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plus 20 percent of qualified REIT dividends and qualified PTP income, excluding net capital gain. Net capital gain is the excess of the net long-term capital gain for the year over the net short-term capital loss, plus qualified dividend income. The deduction may be reduced or eliminated, however, for certain business owners depending on their businesses' wages and property or service activities.

The Wage and Property Limitation

The wage and property limitation reduces the maximum deduction when the owner's taxable income exceeds a prescribed threshold amount determined on the basis of the owner's filing status. Similar to many other provisions of the Code, the threshold amount is indexed annually for inflation. For the tax year 2022, the threshold is $170,050 ($340,100 for married filing jointly). The wage and property limitation is phased in ratably over $50,000 ($100,000 for married filing jointly) and it applies in full when taxable income exceeds $220,050 ($440,100 for married filing jointly).[11]

The wage and property limitation is equal to the greater of (1) 50 percent of W-2 wages paid by the business, or (2) 25 percent of W-2 wages paid by the business plus 2.5 percent of the unadjusted basis (e.g., cost) of tangible depreciable property for which the depreciable period has not ended (UBIA). The depreciable period is the later of (1) the date ten years after the property is first placed in service, or (2) the last day of the last full year of the property's modified accelerated cost recovery system (MACRS) recovery period. The limitation is applied separately to each of a taxpayer's qualified businesses unless the owner elects to aggregate businesses having common ownership, common operations, and common tax reporting years. Aggregation is not permitted for certain service businesses. Because aggregation is itself complex, we discuss it in greater detail later.

Specified Service Trades or Businesses

Owners of successful service businesses face another hurdle. Depending on taxable income, the deduction allowed to these business owners may be partially reduced or entirely eliminated when the business performs services in the fields of accounting, health, law, actuarial science, athletics, brokerage services, consulting, financial services, performing arts, investing and investment management, and trading or dealing in securities, partnership interests, or commodities. Likewise, the deduction may be reduced or eliminated when the principal asset of the business is the reputation or skill of one or more of its employees. Collectively, Sec. 199A refers to any one of these businesses as a specified service trade or business (SSTB). Excluded from the definition of an SSTB, however, are businesses operating in the fields of engineering, architecture, banking, and insurance—a contradictory exclusion since the Sec. 1202(e)(3(A) definition of a qualified trade or business includes these fields.[12]

As for whether a business is considered an SSTB by virtue of the reputation or skill of an employee, Reg. Sec. 1.199A-5(b)(2) clarifies that this definition applies only to those businesses

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[11] Rev. Proc. 2021-45, 2021-48 IRB (November 10, 2021).

[12] For taxpayers other than corporations, Sec. 1202 excludes from gross income at least 50 percent of the gain recognized on the sale or exchange of qualified small business stock (QSBS) that is held more than five years. When Congress wrote the law defining what constitutes an SSTB, it explicitly included only the businesses listed under Sec. 1202(e)(3)(A) and not Sec. 1202(e)(3)(B). Some argue that businesses listed under Sec. 1202(e)(3)(B) were excluded from the definition of an SSTB by an administration incentivized to protect industries directly related to real estate development.

that generate fees, compensation, or other income from endorsements, media appearances, or use of an individual's image, likeness, name, signature, voice, trademark, or similar symbol. This rather benign interpretation of skill or reputation stands in contrast to the Regulation's SSTB definition of financial services, which includes investment bankers (but not traditional bankers), wealth planners, retirement advisors, and any business receiving fees for investing, asset management, or investment management services, including providing advice with respect to buying and selling investments.

To address blended businesses that engage in more than one specific activity, Reg. Sec. 1.199A-5(c) provides a de minimis rule. This rule excludes from the SSTB classification those businesses with gross receipts in 2022 no greater than $27 million[13] and less than 10 percent of gross receipts attributable to specified service activities. For businesses with gross receipts of more than $27 million, the de minimis rule applies where less than 5 percent of gross receipts are attributable to specified service activities. Where gross receipts from specified service activities exceed the applicable 5 or 10 percent thresholds, the entire business is treated as an SSTB.

Where a trade or business provides property or services to an SSTB and there is common ownership of 50 percent or more, then a portion of the trade or business is treated as a separate SSTB, but only with respect to providing property or services to the 50 percent commonly controlled SSTB.[14] Common ownership includes direct and indirect ownership by related parties, as defined in Secs. 267(b) and 707(b).

The SSTB limitation applies before the wage and property limitation, and it reduces the calculation of the wage and property limitation proportionately. To illustrate, assume that a service business owner's taxable income exceeds the lower end of the phase-in range by 85 percent. Because the owner's QBI is derived from an SSTB, the owner's tentative Sec. 199A deduction and the wage and property limitation applicable to that deduction are both reduced by 85 percent. However, because most service businesses pay substantial wages, the wage and property limitation, by itself, generally does not result in a reduction of the allowable Sec. 199A deduction. Instead, it is the phase-in provision that typically curtails much of the deduction. Returning to the example and assuming that the SSTB has sufficient wages or property, the owner's Sec. 199A deduction is reduced to 15 percent of the amount that would have been allowed to a similar non-SSTB business. This reduction occurs simply because the entity was classified as an SSTB and the owner's taxable income exceeded the lower end of the phase-in range. Had the owner's taxable income exceeded the upper end of the phase-in range, no Sec. 199A deduction would be allowed.

Rental Activities

Under Reg. Sec. 1.199A-1(b)(14), rental real estate is treated as a trade or business for purposes of the passthrough deduction if it rises to the level of a Sec. 162 trade or business or is a self-rental. Because the case law under Sec. 162 is voluminous and inconsistent, the Internal Revenue Service (IRS) issued Notice 2019-7[15] and Rev. Proc. 2019-38,[16] which created a safe harbor under which a rental real estate enterprise is treated as a trade or business for purposes of Sec. 199A when at least 250 hours of services are performed each tax year with respect to the

[13] The gross receipts test is indexed for inflation, and for 2018 was originally set at $25 million.
[14] Reg. Secs. 1.199A-5(c)(2)(i) and 1.199A-5(c)(2)(iii)(B).
[15] Notice 2019-7, 2019-9 IRB 740 (January 18, 2019).
[16] Rev. Proc. 2019-38, 2019-42, IRB 942 (September 24, 2019).

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enterprise. Among other things, the safe harbor requires that contemporaneous service records must be maintained, and that residential and commercial properties cannot be combined into a single enterprise except for certain mixed-use property.

Excluded from the safe harbor are properties rented or leased under a triple net lease, which is a type of lease agreement that requires the tenant to pay taxes, fees, insurance, and maintenance, in addition to rent and utilities. The exclusion of triple net leases from the safe harbor is surprising given that this type of lease is common among commercial lessors. Presumably, the rental activities of lessors with multiple triple net leased properties rise to the level of a Sec. 162 trade or business and the safe harbor is not needed. The IRS position with respect to single triple net leases, however, is clear. They are neither a Sec. 162 trade or business nor a rental activity eligible for the safe harbor.[17] Passthrough entities with a single property leased under a triple net lease are, therefore, not eligible for the Sec. 199A deduction while those with two or more properties often may qualify.

Aggregation

Sec. 199A generally requires taxpayers to apply the wage and property limitation separately for each of their qualified businesses. For taxpayers with multiple passthrough businesses, some of which have generous amounts of wages or property and others have little or no such amounts, separate calculations may limit the owner's overall Sec. 199A deduction. The separate reporting requirement may also create an administrative burden on passthroughs owning interests in other passthroughs, such as tiered partnerships and S corporations with qualified subsidiaries (QSubs). To remedy this, Reg. Sec. 1.199A-4 allows the deduction to be electively calculated on an aggregated basis when certain conditions are met.

One of the key conditions necessary to aggregate is that the same group of persons owns 50 percent or more of each qualified business directly or by attribution under Secs. 267(b) or 707(b) for the majority of the tax year, including the last day of the tax year. In addition, none of the businesses to be aggregated can be an SSTB, all items must be reported on the same tax year, and all must share at least two of three factors: (1) the businesses provide products, property, or services that are the same or customarily offered together, (2) the businesses share facilities or significant business elements, and (3) the businesses are operated in coordination with one or more of the businesses in the aggregated group. Any taxpayer who elects to aggregate businesses must disclose this fact on Schedule B of Form 8995-A each tax year and must remain consistent in the choice of aggregated businesses from one year to the next.

Losses

When a taxpayer owns multiple qualified passthrough businesses, Sec. 199A requires that income, gain, deduction, and loss with respect to all the businesses be netted together. If the net QBI is less than zero, then that amount carries forward to the next year as a loss from a qualified business and it reduces the succeeding year's QBI. In some instances, the qualified business loss creates a net operating loss (NOL) that also carries forward to future tax years. For taxpayers with dual loss carryforwards (QBI and NOL), the NOL reduces the succeeding year's taxable income,

[17] Internal Revenue Service (IRS) website FAQ Q57, available at: https://www.currentfederaltaxdevelopments.com/blog/2019/11/22/irs-expands-199a-faq-page-to-include-issues-related-to-rentals

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which impacts the allowable passthrough deduction because it is capped at 20 percent of taxable income before net capital gain.

The Sec. 199A deduction with respect to dividends and income received from real estate investment trusts (REITs) and publicly traded partnerships (PTPs) is not impacted by a qualified business loss sustained on passthrough entities owned by the taxpayer, nor does the wage and property limitation apply. The taxpayer is allowed a deduction of 20 percent of the qualified dividends and income received from REITs and PTPs regardless of the profitability of other passthrough entities. However, a net loss from a PTP must be netted against qualified REIT dividends. Since income or loss from REITs and PTPs is recorded separately from income or loss from other passthrough entities, losses are also carried forward separately. Loss carryforwards must be used in the carryforward year on a first-in, first-out basis, with the oldest loss absorbed first.

Multiple Qualified Businesses

Table 2 illustrates the Sec. 199A deduction for a married couple with income from multiple qualified businesses, as well as income from capital gains and REIT and PTP dividends. Entities 1, 2, and 3 are not classified as SSTBs, have majority common ownership, report using the same taxable year, and satisfy two of the three aggregation tests regarding shared or similar products or services, facilities, and operations. Entity 4 is a qualified rental enterprise consisting of several rental properties operated in tandem. Entity 5 is an SSTB. Because the couple's taxable income falls within the phase-in range, their Sec. 199A deduction is subject to reduction. In Panel A, the wage and property limitation affects the deduction for entities 1, 3, and 4, but not entities 2 and 5. Aggregation of entities 1, 2, and 3 increases the allowable deduction for these entities by $4,050 (from $37,050 to $41,100) because the wage and property limitation is calculated using the aggregate wages and property for all three entities. Note that entities 2 and 5 have identical income, wages, and property. The deduction for these entities, however, differs because entity 5 is an SSTB.

In Table 2, Panel B, entity 5, which is not part of an aggregated group, sustains a loss that is apportioned across the profitable entities. Because entity 5 is an SSTB, the SSTB limitation rules apply, and the apportioned loss is reduced by the ratio of the couple's taxable income that exceeds the lower end of the phase-in range divided by the $100,000 range. Had it not been an SSTB and otherwise eligible for inclusion in the aggregated group consisting of entities 1, 2, and 3, the loss would have been netted against the qualified business income of the members, and its wages and property would have been used to determine the wage and property limitation for the aggregated group. In this panel, aggregation of entities 1, 2, and 3 increases the allowable deduction for these entities by $4,450 (from $36,068 to $40,518). For a better understanding of the steps involved in calculating the Sec. 199A deduction for the married couple, please see Figure 1.

IV. EVALUATION OF THE DEDUCTION

The Association of International Certified Public Accountants (AICPA 2017) developed a framework that provides 12 guiding principles of good tax policy. Among these 12 principles, we consider nine as relevant when evaluating Sec. 199A. These nine principles are (1) equity and fairness, (2) certainty, (3) effective tax administration, (4) simplicity, (5) neutrality, (6) economic growth and efficiency, (7) transparency and visibility, (8) minimum tax gap, and (9) appropriate government revenues. We do not consider the principles of (10) convenience of payment, (11) information security, or (12) accountability to taxpayers. We view the Service's efforts to facilitate

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TABLE 2

Sec. 199A Calculation for Taxpayer with Multiple Qualified Businesses

Panel A: Profitable Businesses

	Entity 1	**Entity 2**	**Entity 3**	**Aggregation**	**Entity 4**	**Entity 5**	**Total**
Entity classification	Non-SSTB	Non-SSTB	Non-SSTB	Entities 1, 2, 3	Rental	SSTB	
Taxable income							$400,100
Qualified business income	$80,000	$110,000	$50,000	$240,000	$90,000	$110,000	
Tentative Sec. 199A deduction (20%)	16,000	22,000	10,000	48,000	18,000	22,000	
Sec. 199A phase-in threshold, married filing jointly							340,100
Phase-in ratio ($400,100 − 340,100/ 100,000)							60%
Wages paid	8,000	60,000	5,000	73,000	7,000	60,000	
Unadjusted basis in qualified property (UBIA)	50,000	6,000	100,000	156,000	500,000	6,000	
Wage and property amount	4,000	30,000	3,750	36,500	14,250	30,000	
Tentative Sec. 199A deduction as reduced for SSTB							
Tentative Sec. 199A deduction × (1 − phase-in ratio)						8,800	
Tentative wage and property reduction							
Tentative Sec. 199A deduction − wage and property amount	12,000	0	6,250	11,500	3,750	0	
Wage and property reduction							
Tentative wage and property reduction × phase-in ratio	7,200	0	3,750	6,900	2,250	0	
Tentative wage and property reduction × (1 − phase-in ratio)							
Sec. 199A deduction before income limitation and dividends							
Tentative Sec. 199A deduction − wage and property reduction	8,800	22,000	6,250	41,100	15,750		
Tentative Sec. 199A deduction as reduced for SSTB − wage and property reduction as reduced for SSTB						8,800	65,600

(continued on next page)

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TABLE 2 (continued)

	Entity 1	Entity 2	Entity 3	Aggregation	Entity 4	Entity 5	Total
Net capital gain							20,000
Modified taxable income							380,100
Modified taxable income limitation (20%)							76,020
REIT dividends and PTP income							5,000
QBID from REITs and PTPs (20%)							1,000
Allowable Sec. 199A deduction							$66,600

Panel B: Profitable and Unprofitable Businesses

	Entity 1	Entity 2	Entity 3	Aggregation	Entity 4	Entity 5	Total
Entity classification	Non-SSTB	Non-SSTB	Non-SSTB	Entities 1, 2, 3	Rental	SSTB	
Taxable income							$400,100
Qualified business income	$80,000	$110,000	$50,000	$240,000	$90,000	($25,000)	
Reduction in QBI for SSTB loss (1 – phase-in ratio)	(2,424)	(3,334)	(1,515)	(7,273)	(2,727)	10,000	
Adjusted qualified business income	77,576	106,666	48,485	232,727	87,273	0	
Tentative Sec. 199A deduction (20%)	15,515	21,333	9,697	46,545	17,455		
Sec. 199A phase-in threshold, married filing jointly							340,100
Phase-in ratio ($400,100 – 340,100)/100,000							60%
Wages paid	8,000	60,000	5,000	73,000	7,000	60,000	
Unadjusted basis in qualified property (UBIA)	50,000	6,000	100,000	156,000	500,000	6,000	
Wage and property amount	4,000	30,000	3,750	36,500	14,250	30,000	
Tentative wage and property reduction							
Tentative Sec. 199A deduction – wage and property amount	11,515	0	5,947	10,045	3,205		
Wage and property reduction							
Tentative wage and property reduction × phase-in ratio	6,909	0	3,568	6,027	1,923		
Sec. 199A deduction before income limitation and dividends							
Tentative Sec. 199A deduction – wage and property reduction	8,606	21,333	6,129	40,518	15,532		56,050

(continued on next page)

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TABLE 2 (continued)

	Entity 1	Entity 2	Entity 3	Aggregation	Entity 4	Entity 5	Total
Net capital gain							20,000
Modified taxable income							380,100
Modified taxable income limitation (20%)							76,020
REIT dividends and PTP income							5,000
QBID from REITs and PTPs (20%)							1,000
Allowable Sec. 199A deduction							$57,050

Table 2 shows the Sec. 199A deduction for a married couple with income from multiple qualified businesses, as well as income from capital gains, qualified REIT dividends, and qualified PTP income. The first three businesses are eligible for aggregation. Because the couple's taxable income falls within the phase-in range, their Sec. 199A deduction is subject to phase-out. The amount of the loss from entity 5, an SSTB, that reduces the QBI of the other entities is also reduced. See Figure 1 and the discussion in the text for more details about the calculations.

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TABLE 3

Comparison of Non-SSTB and SSTB

	Madison Non-SSTB	Taylor SSTB
Taxable income	$410,100	$410,100
Qualified business income	250,000	250,000
Tentative Sec. 199A deduction (20%)	50,000	50,000
Sec. 199A phase-in threshold, married filing jointly	340,100	340,100
Phase-in ratio ($410,100 − 340,100/100,000)	70%	70%
Wage and property amount ($80,000 × 50%)	40,000	40,000
Tentative Sec. 199A deduction as reduced for SSTB		
Tentative Sec. 199A deduction × (1 − phase-in ratio)		15,000
Tentative wage and property reduction		
Tentative Sec. 199A deduction − wage and property amount	10,000	10,000
Wage and property reduction		
Tentative wage and property reduction × phase-in ratio	7,000	
Tentative wage and property reduction × (1 − phase-in ratio)		3,000
Allowable Sec. 199A deduction		
Tentative Sec. 199A deduction − wage and property reduction	$43,000	
Tentative Sec. 199A deduction as reduced for SSTB − wage and property reduction as reduced for SSTB		$12,000

Table 3 shows the tax implications of income received from a non-SSTB and an SSTB when both owners are subject to phase-out of the Sec. 199A deduction. Since 50 percent of Taylor's wages ($50 percent × $80,000) is less than 20 percent of her QBI (20 percent × $250,000), her allowable Sec. 199A deduction can also be calculated as 50 percent of wages multiplied by 1 − phase-in ratio (50 percent × $80,000 × (1 − 70 percent) = $12,000). See the discussion in the text for more details about the calculations.

convenient tax payments, protect taxpayer information from improper disclosure, and make tax information accessible to taxpayers as applicable to its broad tax collection and enforcement responsibilities rather than to one particular tax provision such as Sec. 199A.

The first principle we address relates to equity and fairness. This principle states that similarly situated taxpayers should be taxed similarly. On one hand, Sec. 199A appears to satisfy this goal in that it maintains the tax advantage held by passthrough entities over C corporations prior to the TCJA. However, this advantage is temporary and scheduled to expire at the end of 2025, in contrast to the permanence of the corporate rate reduction. An inequity consequently arises from differences in the longevity of the two provisions. In addition, other inequities arise among similarly situated owners of passthrough entities whose benefits under Sec. 199A differ depending on the nature of their businesses' service activities.

Consider, for example, two taxpayers named Madison and Taylor. Both are married, file a joint return with their spouse, and report taxable income of $410,100 in Table 3. Both operate small passthrough businesses with wages of $80,000 (excluding compensation to owners/employees) and qualified business income of $250,000. Neither business owns a significant amount of qualified depreciable property.

Madison is an architect and the owner of Madison Designs, LLC. Because the primary activity of the business is architectural services, it is not an SSTB. Madison's Sec. 199A deduction is

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$43,000, calculated as shown in the second column of Table 3. Taylor is a CPA. Because the primary activity of Taylor's business is accounting, her business is considered an SSTB. Her Sec. 199A deduction is $12,000, calculated as shown in the third column of Table 3.

Assume now that the taxable incomes of Madison and Taylor exceed $440,100 (the upper bound of the phase-in range for married taxpayers in 2022). Madison's Sec. 199A deduction is reduced to $40,000 because the wage and property limitation applies in full. In comparison, Taylor's Sec. 199A deduction is eliminated because her business is an SSTB.

The theoretical argument for reducing or eliminating the Sec. 199A deduction of high-income service professionals who operate their businesses as passthroughs is that other professionals in the same field who receive wages do not get the deduction. But this argument fails to explain why the deduction differs for service professionals based on their taxable income; specifically, why those having income below the lower bound of the phase-in range are allowed a full deduction while those with income above the upper bound of the phase-in range are denied the deduction. It also ignores the modern economy, in which large service passthrough entities compete globally and invest significant sums in the development of their skilled workforce. It is not surprising, therefore, that both the American Institute of CPAs, an organization representing the accounting profession, and the American Bar Association, an organization representing the legal professional, have advocated eliminating the distinction between SSTBs and other businesses (American Bar Association [ABA] 2018; American Institute of Certified Public Accountants [AICPA] 2021).[18]

The second principle of good tax policy relates to certainty. It states that tax law should clearly specify how a tax liability is determined, when payment is due, and how payment should be made. Sec. 199A is a complex provision and the allowable deduction depends not only on the amount of a taxpayer's qualified business income, but also on the amount of taxable income, net capital gain, wages, and property, as well as the type of business (e.g., SSTB or non-SSTB) and ownership. Given the number of variables involved in calculating the deduction, many business owners find the amount of the deduction difficult to predict, particularly when it passes through from multiple or tiered entities.

Consider the case of Surety, an LLC that provides insurance products. Joe, a partner in the business, is a certified financial planner who provides retirement and estate planning services to the clients of Surety. Although the revenue from these activities is recorded separately, Surety maintains only one set of books. The total gross sales in 2022 is $1.4 million inclusive of $139,000 received from the consultancy services provided by Joe. Since this amount is less than 10 percent of the total gross sales, Surety is not considered an SSTB under Reg. Sec. 1.199A-5(c). If Surety has identical sales revenue in 2023, but revenue from Joe's consultancy services increases by $1,000 to $140,000, Surety is classified as an SSTB because revenue from the consultancy services equals 10 percent of total gross sales. Thus, depending on the owner's taxable incomes in 2023, the Sec. 199A deduction may be reduced or eliminated.

The third principle we consider is effective tax administration and the cost of compliance. Because many of the terms of Sec. 199A are new, the Treasury originally issued detailed regulations in six parts[19] and later expanded these to include an additional six parts.[20] In addition,

[18] Members of both the ABA and AICPA are heavily involved in assisting clients with compliance issues related to Sec. 199A. Both organizations justify their positions regarding SSTBs on the basis of equity and simplicity.

[19] Reg. Secs. 1.199A-0 through 6, issued on February 4, 2019; Reg. Secs. 1.199A-1, 2, 4, and 5, corrected on April 16, 2019; Reg. Secs. 1.199A-3 and 6, amended on June 24, 2020.

[20] Reg. Secs. 1.199A-7 through 12, issued on January 14, 2021.

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the IRS released several rulings, notices, news releases, and FAQs.[21] Together, the multiple and lengthy explanations of the Service suggest that the Sec. 199A deduction increased administrative and compliance costs both for the IRS and taxpayers.

Another aspect related to compliance is the recordkeeping requirements of Sec. 199A. Not only does Sec. 199A require separate tracking of items of income, gain, deduction, and loss for each of a taxpayer's qualified businesses, REITs, and PTPs, but it also mandates the tracking of excess losses that carry forward to the next tax year. Given that a qualified business loss under Sec. 199A may create an NOL, some taxpayers may be required to maintain records on carryforwards arising from the same source, but limited under different rules.

Consider the following example involving a single taxpayer named Jing. Jing operates two qualified businesses and in 2022, one of the businesses generates QBI of $60,000 and the other sustains a loss of $80,000. Jing's net qualified business loss for 2022 is $20,000 and this amount carries forward to 2023. If Jing has no other sources of income, Jing also sustains a net operating loss in 2022 of $20,000 that carries forward to 2023. Assume now that in 2023, the first of Jing's businesses again generates QBI of $60,000 while the second has no gain or loss. The tentative amount of Jing's Sec. 199A deduction is $8,000, which is 20 percent of the net QBI of $40,000 ($60,000 QBI in 2023 less $20,000 Sec. 199A loss carryforward). This tentative deduction, however, is subject to the taxable income limitation that caps the allowable deduction at $5,300, which is 20 percent of taxable income ($60,000 income less $20,000 NOL less the greater of itemized or the standard deduction, which we assume to be $13,500[22] for purposes of this example). In this example, the requirement to keep separate records regarding qualified business loss carryforwards is unnecessary because the taxable income limitation of Sec. 199A already caps the deduction.

The recordkeeping requirement involving losses from REITs and PTPs imposes a similar compliance burden. While it is possible that the intent behind the tracking requirements of losses was to eliminate the incentive for taxpayers to allocate losses to one year and gains to another, the rules regarding NOLs, which prohibit most carrybacks, would seem sufficient to constrain such behavior without the additional burden imposed by Sec. 199A.

Simplicity, the fourth of our nine relevant principles, looks for tax policy that is easy to understand. As discussed earlier and as illustrated in the flowchart in Figure 1, the Sec. 199A deduction is anything but simple. But simplicity could be achieved by eliminating the distinction between service and other businesses, streamlining recordkeeping requirements, raising or removing the phase-in thresholds, expanding the definition of qualified rental activities, making the aggregation election automatic for qualifying taxpayers, and reevaluating the notion that passthrough businesses should pay less tax than C corporations.

The Sec. 199A deduction also does not adhere to the principle of neutrality, number five on our list of relevant principles. Neutrality, as it relates to taxation, means that the tax law has only minimal effect on a taxpayer's decisions as to how to carry out or structure a particular transaction.

[21] Notice 2018-64, 2018-34 IRB 347 (August 8, 2018); News Release 2018-162 (August 8, 2018); Notice 2019-7, 2019-9 IRB 740 (January 18, 2019); News Release 2019-4 (January 18, 2019); Rev. Proc. 2019-38, 2019-42 IRB 942 (September 24, 2019); News Release 2019-158 (September 24, 2019). *See the* IRS FAQ website at: https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs

[22] The taxpayer is allowed to claim the larger of itemized deductions or the standard deduction. In this example, we assume this amount to be $13,500 because at the time of this paper, the standard deduction amount for 2023 has not been released.

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Contrary to the goal of this principle, Sec. 199A's treatment of blended businesses and triple net leases creates incentives for taxpayers to modify their current business practices and structures.

Consider the following two examples. In our first example, Angel, Inc. is an S corporation that operates a chain of restaurants. In 2022, the chief chef, Angel, who is also a part-owner of the business, receives $1.5 million from endorsements. The company's total gross revenue inclusive of the endorsement income is $28 million. Since the endorsement activity is considered an SSTB and its revenue is more than 5 percent of the total revenue, Angel, Inc. will be treated as an SSTB and the owners' Sec. 199A deduction may be reduced or eliminated, depending on their taxable incomes. From a behavioral perspective, the percentage threshold stipulated in Reg. Sec. 199A-5(c) creates an incentive for the owners to carve out Angel's endorsements as a separate business from the restaurants.

Our second example features a partnership that is owned equally by Tina and Todd. The partnership holds a commercial rental property with a triple net lease that brings in basic rental income of $300,000 per year. As equal owners, Tina and Todd each report $150,000 of rental real estate income on their personal tax return and, because the property is leased under a single triple net lease, they are not eligible for the Sec. 199A deduction.[23] After consulting with their tax adviser, they decide to renegotiate the lease terms such that the tenant continues to pay the basic rental income of $300,000 per year, but with the partnership now responsible for paying the real estate taxes and insurance of $50,000. The partnership then charges these expenses back to the tenant as escalations. The net profit remains the same and each owner continues to report $150,000 of net rental real estate income on their personal tax return. However, now that the partnership no longer holds triple net leased property, Tina and Todd are eligible to claim Sec. 199A's 20 percent deduction of $30,000, which reduces their taxable income from the partnership to $120,000 each.

The sixth principle on our list—economic growth and efficiency—is difficult to assess since Sec. 199A is relatively new in its implementation and data on whether it aids the productive capacity of the economy are tentative. According to six studies, the Sec. 199A deduction has had only minimal impact on noncorporate business investment and almost no effect on the labor market (Kopp, Leigh, Mursula, and Tambunlertchai 2019; Gravelle and Marples 2019; Furman 2020; Gale and Haldeman 2021; Goodman, Lim, Sacerdote, and Whitten 2019; Guenther 2021). These conclusions are based, in part, on the deduction's structure. As a tax cut for the owners of passthrough entities, the deduction creates a disincentive to invest in debt-financed assets because it decreases the marginal value of interest deductions relative to investment made before the deduction was enacted. In contrast, it has the opposite effect for equity-financed investment. The overall effect on investment, therefore, appears to be minimal. As for the deduction's job-creating effect, it provides no incentive to create jobs for those passthrough business owners with taxable income below the lower bound of the phase-in range or for owners of SSTBs with taxable income above the upper bound of the phase-in range. For high-income owners of non-SSTBs, the incentive to create jobs is balanced against the incentive to invest in qualified property, and neither incentive is operational if an owner's passthrough entity already has the prerequisite amounts of wages and/or property.

Another aspect related to the deduction's economic impact is that Sec. 199A is a temporary provision scheduled to expire at the end of 2025. Because taxes play a role in investment decisions and these decisions are forward-looking, temporary provisions have less economic

[23] Depending on their taxable income, the rental income Tina and Todd receive may be subject to the net investment income tax of Sec. 1411 of 3.8 percent. *See* Reg. Sec. 1.1411-4.

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impact than permanent ones (e.g., Hoopes 2018). Prior to the COVID-19 pandemic, the Tax Foundation estimated that the TCJA would boost the economy by 1.7 percent from 2018 to 2027. The Tax Foundation attributed almost all of the expansion in economic activity to the permanent reduction in the corporate tax rate, with almost no economic growth attributable to Sec. 199A (Pomerleau 2019).

The seventh principle on our list is transparency and visibility. According to Statistics of Income (SOI) data for the 2018 and 2019 tax years, about 18.6 and 22.2 million individual income tax returns, respectively, claimed the Sec. 199A deduction at an aggregate cost to the government of approximately $150 billion in 2018 and $155 billion in 2019 (IRS 2020b, 2021b). This represents approximately 13 percent of the total number of individual returns filed for those years and more than 1.2 percent of the income reported on those returns. Additional statistics regarding the Sec. 199A deduction are provided in Table 4. Obviously, taxpayers with passthrough businesses are aware of the deduction. A quick internet search, however, indicates that many find its complexity daunting, and this may explain the vast number of articles in newspapers, magazines, and journals explaining the deduction's rules. To the credit of the IRS, the agency has responded to questions about the deduction with a series of notices, news releases and FAQs (see footnotes 13, 14, 15, 17, and 18).

Minimum tax gap is the eighth principle, and it asks that tax laws be structured to minimize noncompliance. Since Sec. 199A provides a tax benefit to taxpayers in the form of a deduction, noncompliance is likely to arise when taxpayers overstate their deduction or incorrectly claim one. The provision's complexity is one probable factor contributing to its compliance risk. To date, the IRS has not released data regarding noncompliance with Sec. 199A. However, an audit by the Treasury Inspector General for Tax Administration (2021) for the tax year 2019 noted that IRS processes do not ensure that filers who claim the deduction are entitled to it. Additionally, the audit identified $48.7 million in erroneous Sec. 199A deductions. The Treasury Inspector's report provided the IRS with five recommendations aimed at improving the Service's ability to verify Sec. 199A deductions. The IRS agreed or partially agreed with two recommendations and disagreed with the other three. The IRS did, however, respond to the report by updating Forms 8995 and 8995-A to address some of Sec. 199A's compliance risk.

The last principle on our list—appropriate government revenues—asks that tax systems have appropriate levels of predictability, stability, and reliability to enable the government to determine the timing and amount of tax collections. Sec. 199A was originally estimated by the Joint Committee on Taxation (2018) to result in a loss of tax revenue to the government of $414.5 billion over the provision's life (2018 to 2025), with $27.7 billion expected in FY 2018, $47.1 billion expected in FY 2019, and approximately $50 to $53 billion expected in each of the provision's remaining years. Tax collection data from the IRS's Statistics of Income (SOI) program, however, show that the actual loss in tax revenue is much greater than expected, with the Sec. 199A deduction costing the government $150 billion in the tax year 2018 and $155 billion in the tax year 2019 (IRS 2020b, 2021b). Whether the substantial gap between the estimated and actual cost of the provision is attributable to noncompliance or faulty estimation techniques is an open question, but the data do suggest that the provision's revenue impact was not, at least initially, predictable.

Beyond the nine principles of good policy discussed above, there remains the question of whether Sec. 199A achieved its intended goal. One of the stated objectives of Sec. 199A was to provide passthrough entities with a level playing field relative to C corporations (Joint Committee on Taxation 2018). Although the tax deduction provided to many owners of passthrough businesses is not equivalent to the rate reduction provided to C corporations, SOI data from the IRS do suggest that the provision prevented widespread conversions. According to these data, the

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TABLE 4

Qualified Business Income Deduction (QBID) Statistics

Panel A: Tax Year 2018

Adjusted Gross Income (AGI)	(1) Number of Returns	(2) Income ($000)	(3) Total Deductions (including QBID) ($000)	(4) Number of Returns with QBID	(5) % Returns with QBID	(6) QBID Amount ($000)	(7) Avg QBID per Tax Return ($)	(8) QBID as % of Total Income	(9) QBID as % of Total Deductions
AGI below $100,000	123,561,557	4,322,576,245	2,007,855,786	10,261,866	8.3%	21,852,468	2,129	0.5%	1.09%
$100,000 under $500,000	28,052,207	4,910,070,492	796,220,302	7,535,257	26.9%	60,382,256	8,013	1.2%	7.58%
$500,000 under $1,000,000	1,108,430	759,810,563	67,852,150	531,912	48.0%	14,947,541	28,102	2.0%	22.03%
$1,000,000 under $5,000,000	482,307	892,956,839	81,100,022	296,671	61.5%	29,136,622	98,212	3.3%	35.93%
$5,000,000 under $10,000,000	34,788	239,466,596	22,498,073	24,155	69.4%	8,268,076	342,293	3.5%	36.75%
$10,000,000 or more	22,112	660,397,211	76,338,889	14,730	66.6%	15,363,946	1,043,038	2.3%	20.13%
Total tax returns	153,261,401	11,785,277,946	3,051,865,222	18,664,591	12.2%	149,950,909	8,034	1.3%	4.91%

Source: IRS 2020b, Table 1.4.

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TABLE 4 (continued)

Panel B: Tax Year 2019

Adjusted Gross Income (AGI)	(1) Number of Returns	(2) Income ($000)	(3) Total Deductions (including QBID) ($000)	(4) Number of Returns with QBID	(5) % Returns with QBID	(6) QBID Amount ($000)	(7) Avg QBID per Tax Return ($)	(8) QBID as % of Total Income	(9) QBID as % of Total Deductions
AGI below $100,000	126,183,235	4,412,049,201	2,078,054,435	11,878,012	9.4%	22,896,415	1,928	0.5%	1.10%
$100,000 under $500,000	29,295,465	5,157,047,799	837,575,335	9,269,154	31.6%	62,151,278	6,705	1.2%	7.42%
$500,000 under $1,000,000	1,162,371	795,166,354	70,391,346	691,862	59.5%	15,767,385	22,790	2.0%	22.40%
$1,000,000 under $5,000,000	500,786	917,690,462	81,623,902	362,483	72.4%	30,675,341	84,626	3.3%	37.58%
$5,000,000 under $10,000,000	34,738	238,811,478	21,863,973	26,751	77.0%	8,502,849	317,852	3.6%	38.89%
$10,000,000 or more	20,876	591,034,197	64,922,991	15,282	73.2%	15,255,896	998,292	2.6%	23.50%
Total tax returns	157,197,471	12,111,799,491	3,154,431,982	22,243,544	14.2%	155,249,164	6,980	1.3%	4.92%

Source: IRS 2021b, Table 1.4.

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number and percentage of passthrough entities filing returns for the tax years 2016 (pre-TCJA) and 2018 (post-TCJA) are similar. Specifically, of the 6.2 million active corporations filing returns for 2016, approximately 4.6 million (74 percent) were passthrough entities (IRS 2020a). Of the 6.4 million active corporations filing returns for 2018, 4.9 million (77 percent) were passthrough entities (IRS 2021a). SOI data also indicate that the average Sec. 199A deduction claimed by individual taxpayers for the tax year 2018 was slightly over $8,000, with the largest deductions (over $1 million, on average) claimed by those having adjusted gross income above $10 million. Similar trends are noted for tax year 2019, as shown in Table 4. Based on these data, it appears that despite Sec. 199A's complexity, it has succeeded in providing significant tax savings to the owners of passthrough entities.

Policy Options

Because Sec. 199A is scheduled to expire at the end of 2025, its long-term future is uncertain. Depending on the political and economic environment in 2025, it is possible that Congress will allow the deduction to expire. Alternatively, Congress might permanently extend the deduction in its current form. More likely, however, is that Congress will either modify the structure of the deduction or replace it with a less complicated method of taxing passthrough business income.

The Tax Policy Center estimates that permanent extension of Sec. 199A in its current form will reduce tax revenue by $1.7 trillion from 2026 to 2040 (Page, Rohaly, Matheson, and Boddupalli 2020). Of that total revenue loss, $279 billion (16.4 percent) is attributed to wage earners and corporations converting to passthrough status in order to take advantage of the lower tax rates on passthrough business income. Given the high cost of Sec. 199A, as well as its failure to align with many of the tenets of good tax policy, we believe the deduction should be modified. Toward this end, we offer six suggestions.

First, the treatment of SSTBs and non-SSTBs creates differences in the tax liabilities of service and non-service passthrough businesses. Similarly, the safe harbor exclusion discriminates against rental property leased under a triple net lease. We recommend that Sec. 199A eliminate the distinctions between different types of businesses and rental activities. This change will more closely align the deduction with the principles of equity, simplicity, and neutrality.

Second, the recordkeeping requirements under Sec. 199A are burdensome. As explained earlier, the rules prohibiting NOL carrybacks are sufficient to deter most taxpayers from allocating losses to one year and gains to another. We, therefore, recommend that the requirement to maintain records on loss carryforwards be eliminated.

The complexity in Sec. 199A provides incentives to modify business practices and/or structures to maximize the deduction. Our third recommendation is that the deduction be modified such that aggregation is automatic for taxpayers with business income from multiple passthrough entities. Our fourth recommendation is that the wage and property limitation apply to all owners of passthrough businesses irrespective of the amount of their taxable income. This recommendation would eliminate the threshold and phase-in provisions and, by so doing, treat all business owners more equitably at the expense of increased complexity for lower-income business owners. In addition, we recommend that calculation of the wage and property limitation be modified so as to use a business' average wages and property in the prior three years plus the amount by which the current year's wages and property exceed the average. By adding an incremental component to the calculation of the wage and property limitation, together with extending the limitation to all passthrough owners, Sec. 199A would provide a greater incentive for passthrough business

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owners to grow either the labor or capital components of their businesses. These changes would enhance the economic impact of the deduction and reduce its revenue cost to the government.

Our fifth recommendation is for the IRS to strengthen its ability to verify Sec. 199A deductions, possibly by requiring partnerships, S corporations, and trusts to report tentative amounts of the deduction for each owner. Such reporting would be feasible only if the taxable income thresholds are removed, as recommended above. Our sixth and final recommendation relates to the permanency of Sec. 199A. Given that the intent of this provision was to provide commensurate tax benefits to businesses operating as passthrough entities and C corporations, we recommend that the deduction under Sec. 199A be made permanent in a manner analogous to the corporate tax rate under Sec. 11.

V. CONCLUSION

Despite a massive literature on the Sec. 199A deduction, it has yet to be evaluated critically by the academic tax community. In this article, we provide an overview of the rules that govern the deduction and a comprehensive flowchart for use in navigating through these rules. We also analyze how well the deduction measures up against nine principles of good tax policy. Our analysis suggests that the deduction falls short on eight of these principles. The deduction fails to achieve the goal of equity and fairness because SSTBs and certain rental activities are treated differently than other passthrough entities and the amount of the deduction differs among businesses providing identical services. Because the deduction involves numerous variables, some of which are difficult to predict, the policy goal of certainty also is not achieved. The deduction does not stand the test of effective tax administration because it imposes significant recordkeeping requirements on some taxpayers. It also fails to achieve the policy goal of simplicity because in its brief four-year existence, it has required clarification and elaboration in the form of detailed Treasury Regulations and numerous IRS rulings, notices, and news releases.

The deduction fails the test of neutrality because its design encourages non-qualifying taxpayers to modify their business practices and structures solely for the purpose of qualifying for the deduction. These modifications, however, do little to grow the economy or create jobs. The deduction, therefore, fails the test of economic efficiency. Another failure of the deduction relates to its compliance risk. According to a report by the Treasury Inspector General for Tax Administration (2021), IRS processes do not safeguard the deduction against erroneous claims and abuse. The deduction is also proving to be much more expensive to the government in terms of lost tax revenue than originally estimated by the Joint Committee on Taxation in 2017. It, therefore, scores poorly when evaluated against the policy goal of appropriate government revenues. The deduction does succeed, however, when measured against the policy goal of transparency and visibility. In addition, it has achieved its intended goal of providing tax relief to passthrough business owners commensurate to that provided to C corporations. As policymakers evaluate proposed changes to the tax laws, we suggest that they consider revising Sec. 199A to reduce its inequity, uncertainty, recordkeeping burden, complexity, bias, economic inefficiency, noncompliance risk, and unpredictable impact on government revenues.

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