

The IRC 199A Deduction - Subtle Limits

Quick-Take: While the One Big Beautiful Bill Act (OB3) just expanded the IRC 199A deduction to more owners of closely held pass-through businesses, there are still some limitations to that qualified business income deduction (QBI) that are not readily apparent.

Background: The IRC 199A deduction generally allows owners of pass-through business entities, e.g., S-corporations, LLCs and partnerships, to take a deduction of up to 20% of their pass-through income, subject to some limitations. As was recently reported, the Once Big Beautiful Bill (OB3) made this IRC 199A deduction permanent, and it also increased the phase-out ranges for the deduction enabling more business owners to take advantage of the deduction.

IRC 199A and OB3: When the pass-through entity owner's taxable income reaches a certain threshold, for a non-service business, the owner can generally deduct the *lesser* of: (i) 20% of the qualified business income (QBI) or (ii) the *greater* of either (a) 50% of W-2 wages paid to employees, or (b) 25% of W-2 wages paid to employees plus 2.5% of the unadjusted basis of qualified property used in the business. However, for owners of specified service trades or businesses (called SSTBs) once their taxable income reaches a certain threshold, they cannot claim any IRC 199A deduction. Starting in 2026, the OB3 creates an inflation adjusted \$400 minimum IRC 199A deduction for owners with at least \$1,000 of QBI from an active business in which they materially participated.

QBI: The statute defines QBI as qualified items of income, gain, deduction, and loss to the extent such items are (i) effectively connected with the conduct of a trade or business within the United States, and (ii) included **or allowed in determining taxable income for the taxable year**. [IRC 199A(c)(3).]

W-2 Wages: W-2 wages are defined for QBI purposes with respect to any person for any taxable year of such person as *"the amounts described in paragraphs (3) and (8) of IRC 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. (B) Such term **shall not include any amount which is not properly allocable to qualified business income** for purposes of subsection (c)(1)."* [IRC 199A(b)(4).]

A recent Tax Court decision concluded that W-2 wages for purposes of the IRC 199A(b)(4)(B) QBI deduction are amounts reported on Form W-2, **but any ‘W-2 wages’ do not include any amount which is not properly allocable to QBI.** To reach this conclusion, yet another federal statute, IRC 280E was involved.

IRC 280E: This statute provides: *No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of Schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.”*

Savage v Commissioner, 165 Tax Court No. 5, (September 11, 2025)

Facts: The S corporation sold cannabis and cannabis-derived products. Hence, the shareholders’ business was subject to IRC 280E.

Dispute: The shareholders and the IRS agreed that IRC 280E limits the amount of W-2 wages the S corporation could deduct. However, they disagreed whether total W-2 wages or deductible W-2 wages should be used to compute the corporation’s IRC 199A deduction.

Tax Court: The Court found that W-2 wages do *not* include any amount that is not properly allocable to QBI. The Court reasoned that W-2 wages are only included in the term ‘qualified items of income, gain, deduction and loss’ ‘to the extent’ that they are allowed in determining taxable income for the year. Therefore, if some wages are not ‘allowed in determining taxable income for the taxable year’ those amounts are not part of the term ‘qualified items of income, gain, deduction, and loss’ for purposes of IRC 199A(c). [Regulation 1.199A-2(b)(4).]

In a footnote to its decision the Court pointed to the shareholders’ inconsistent position:

“We note that the shareholders do not object to using wages limited by section 280E (that is, Deductible W-2 Wages) to calculate qualified business income for the S corporation. That is understandable, as using the lower wage number in this particular calculation purposed greater qualified business income (QBI), and the potential for higher section 199A deductions for the shareholders. But their interpretation of the statute produces an inconsistency. They ask us to use Deductible W-2 Wages for one aspect of section 199A computation and Total W-2 Wages for another. The Commissioner’s interpretation, by contrast, produces no such inconsistency.”

Practical Implications: Obviously, not all that many small pass-through businesses entities are subject to IRC 280E’s ‘trafficking in controlled substances’ non-deductible wage limitation. That said, the *Savage* limit on W-2 wages could be extended to other IRC 199A deductions.

Example: Pete is the sole shareholder-employee of a non-SSTB S corporation. The corporation has no other employees. Pete pays himself \$100,000 of W-2 wages, and his business has \$1.0 million of QBI (after wages.) Pete’s IRC 199A deduction is limited to 50% of W-2 wages, which results in a \$50,000 IRC 199A deduction. Pete decides to increase his W-2 wages to \$285,000, so his IRC 199A deduction is now \$142,500. However, if the IRS determines that Pete’s \$185,000 of W-2 wages is unreasonable and therefore nondeductible, those nondeductible wages would not be considered in the calculation for the IRC 199A deduction.

Conclusion: Before a shareholder-employee increases his/her W-2 wages or the W-2 wages of a key employee, such as through an executive bonus plan, an analysis needs to be made to determine if total compensation is unreasonable. Wages subsequently classified as unreasonable W-2 compensation by the IRS will not ‘enhance’ the business owner’s IRC 199A QBI deduction. What is already a fairly complex income tax deduction to compute just got even a bit more complicated.

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