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UNDERSTANDING THE QUALIFIED BUSINESS INCOME DEDUCTION

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The Tax Cuts and Jobs Act of 2017 (TCJA) is likely the most significant tax legislation since 1986.[1] *While the legislation is comprehensive, one of its major features is corporate tax rate reduction. In order for unincorporated businesses to remain competitive, the TCJA allows certain unincorporated businesses to claim the qualified business income deduction. Virtually every unincorporated business will have to consider the implications of this deduction. The underlying rules governing the applicability and computation of the deduction are extensive and require a thorough understanding in order to be properly implemented by taxpayers and practitioners. Although the Department of the Treasury and the Internal Revenue Service have provided extensive guidance, many uncertainties remain. The deduction applies to tax years 2018 through 2025, but it is unsure whether it will become permanent. This article discusses the rationale for enacting these provisions, explains the provisions in detail, and concludes that implementation will be an ordeal for tax practitioners and the government.*

INTRODUCTION

Among the TCJA's most important and confusing provisions is new § 199A,[2] which provides for the "qualified business income deduction." The

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[1] Pub. L. No. 115-97, 131 Stat. 2054 (2017). The TJCA is officially known as "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[2] Unless otherwise noted herein, all section references are to the Internal Revenue Code of 1986, as amended.

deduction is intended to reduce the disparity between business income taxed at the 21 percent flat corporate tax rate and income derived by individuals from the conduct of trade or business activities that is potentially taxed at a higher individual rate. Thus, the effective tax rate paid by owners of certain businesses conducted by passthrough entities, including some sole proprietorships and individually owned rental properties, is reduced. This article explains the provisions, why they were implemented, and how they affect unincorporated businesses and their owners. Following a detailed discussion of the rules, this article concludes that their implementation is complex and it may take years for a complete administrative framework to evolve.

I. RATE REDUCTIONS OF THE TCJA

Since 1980, American businesses have increasingly operated in passthrough form. In 2017, a study by the Tax Foundation[3] showed that, from 1980 to 2012, the number of passthrough businesses had grown significantly, both in terms of the number of businesses and the percentage of the total number of businesses.[4] During this period, the number of passthrough tax returns filed annually increased by 20.2 million. By 2012, the percentage of business returns filed by taxable C corporations was only 4.9 percent of the total.

Although the TCJA reduced corporate tax rates by as much as 14 percent, individual tax rate reductions were relatively modest by comparison. With the revised rate structure, operating as a passthrough business would result in a significantly greater effective tax rate when compared to operating as a taxable corporation. After enactment of the TCJA, a corporation is subject to tax at the rate of 21 percent. Thus, 79 percent of its income (ignoring state and local income taxes) is retained by the business. If the remaining 79 percent is distributed to the corporation's individual shareholders, the shareholders pay up to a 20 percent tax on the dividend. When the shareholder is subject to the Medicare tax on net investment income under § 1411, the dividend is subject to an additional 3.8 percent tax. Thus, after double taxation at both the corporate and shareholder levels, the shareholder retains 60.198 percent of the corporate earnings.

However, if we consider a passthrough business owned by an individual in the highest tax bracket, that owner will pay a marginal rate of

[3] The Tax Foundation is a not-for-profit research organization that collects data on U.S. federal and state tax policies and publishes the results of its research. More information about its activities can be obtained at https://taxfoundation.org.

[4] Scott Greenberg, *Pass-Through Businesses: Data and Policy* (Jan. 17, 2017), https://taxfoundation.org/pass-through-businesses-data-and-policy/.

37 percent on his income derived from the passthrough business. Furthermore, if the income is subject to self-employment tax and Medicare tax, the owner will pay additional taxes of as much as 18.2 percent. For such owners, their after-tax income is substantially less than the 60.198 percent that a corporate shareholder could expect to retain. Undistributed earnings from a corporation are only subject to a 21 percent federal corporate level tax, whereas the owner of a passthrough business frequently pays tax at a higher rate. Income earned by a passthrough entity is taxable to its owner(s) whether or not it is distributed. Thus, a corporation can typically retain a greater share of its earnings after taxes than a passthrough business.

To cure this problem, the Tax Foundation recommended that income from passthrough businesses be subject to a lower tax rate.[5] Indeed, the initial House version of the TCJA contained a provision subjecting qualified business income from a passthrough business to a maximum tax rate of 25 percent.[6] The Senate apparently believed that the mechanics of the House provisions were too complicated and replaced them with a regime wherein the owner of a passthrough business would obtain a deduction that was generally equal to 23 percent of the sum of qualified business income, plus certain other amounts.[7] The Conference Committee agreement generally followed the Senate version with several modifications, including reducing the amount of the deduction from 23 percent to 20 percent.[8] Because of some technical problems with § 199A, the section was modified in 2018, effective retroactively to January 1, 2018.[9] Regulations implementing § 199A were issued in February 2019,[10] finalizing proposed regulations issued in August 2018 (2018 Proposed Regulations).[11] New proposed regulations addressing certain technical matters not previously considered were published in February 2019 (2019 Proposed Regulations).[12]

The provisions of § 199A generally address the concerns raised by the Tax Foundation in its 2017 report. Unfortunately, they are extremely complex. Although the Department of the Treasury and the Internal Revenue Service (IRS) have issued extensive guidance, numerous questions remain unanswered.

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[5] *Id.*

[6] *See* H.R. 1, 115th Cong. § 1004, as introduced by the House, which provided for a maximum 25 percent tax rate on the percentage of income that was deemed to be derived from the investment of capital (generally 30 percent) and a reduced rate of 9 percent on the first $75,000 of qualified income.

[7] *See* Engrossed Senate Amendment, § 11011, of H.R. 1, 115th Cong. (2017).

[8] H.R. Rep. No. 115-466, at 223 (2017) (Conf. Rep.).

[9] Pub. L. No. 115-141, § 101, Div. T (Consolidated Appropriations Act, 2018).

[10] T.D. 9847, 84 Fed. Reg. 2,952 (Feb. 8, 2019).

[11] REG-107892-18, 83 Fed. Reg. 40,884 (Aug. 16, 2018).

[12] REG-134652-18, 84 Fed. Reg. 3,015 (Feb. 8, 2019).

II. EFFECTIVE DATES

The provisions of § 199A are effective for tax years beginning after December 31, 2017,[13] but will not apply to tax years beginning after December 31, 2025.[14] The TCJA was enacted through the reconciliation process. The reconciliation process is governed by the so-called "Byrd Rule," and accordingly, could not increase the budget deficit by more than $1.5 trillion over ten years.[15] In order to stay within the constraints imposed by the Byrd Rule, the provisions of § 199A could not remain in effect after 2025. Prior to the end of 2018, the 115th Congress initiated the process to make many TCJA changes permanent.[16] Extending §199A was not included in any of these bills. Given that no extension of § 199A was included in legislation passed by the 115th Congress and the political composition of the 116th Congress changed, an extension of these rules beyond 2025 is uncertain.

III. GENERAL SCHEME

Individuals, and certain other non-corporate taxpayers, are allowed a deduction of up to 20 percent of their income from a qualified trade or business operated as a sole proprietorship, a partnership, an S corporation, a trust, or an estate. For these purposes, the term sole proprietorship is not limited to a business reported on Schedule C; it can also include a rental property that rises to the level of a trade or business for purposes of § 162.

The title of § 199A is "Qualified Business Income" (QBI). While many think of this as income conducted by an individual through a passthrough business, the mechanics of § 199A are actually quite complicated. The intent of the original version of § 199A introduced by the House was to tax income from capital investment at lower preferential rates while continuing to tax income from providing services at regular rates.[17]

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[13] Pub. L. No. 115-97, § 11011(e), 131 Stat. 2054 (2017).

[14] I.R.C. § 199A(i).

[15] 2 U.S.C. §§ 641, 644. Summary of the Byrd Rule, *U.S. House Reps. Comm. Rules*, https://archives-democrats-rules.house.gov/archives/byrd_rule.htm. A detailed discussion of the reconciliation process and the Byrd Rule is beyond the scope of this article.

[16] Brett Matthews and Jack Peterson, *House passes "Tax Reform 2.0," extending provisions from 2017 tax reform efforts* (Oct. 1, 2018), https://www.naco.org/blog/house-passes-tax-reform-20-extending-provisions-2017-tax-reform-efforts. In September 2018, the House passed three bills extending numerous provisions included in the TCJA beyond their expiration in 2025. Those bills include H.R. 6756, 115th Cong. (2018); H.R. 6757, 115th Cong. (2018); and H.R. 6760, 115th Cong. (2018). Because these bills were not supported by any Senate Democrats and required 60 votes to pass in the Senate, they were not voted on before the close of the 115th Congress. The bills would have to be reintroduced in the 116th Congress for further consideration.

[17] H.R. Rep. No. 115-466, at 108-13 (2017) (Conf. Rep.). The House Bill states that the intent was to apply a capital percentage to any active (i.e., non-passive) business income

Accomplishing this objective was cumbersome, so the Senate constructed a set of rules with many new terms that focused on allowing a so-called "passthrough deduction." To properly explain the mechanics of § 199A, one has to understand each of the terms and apply them to a maze of operational requirements. Certain taxpayers who have income that meets those requirements are allowed to deduct an amount equal to 20 percent of such income. The deduction is equal to the taxpayer's "combined qualified business income amount," subject to an overall limitation of 20 percent of taxable income reduced by net capital gain.[18] Although the statute refers to "a taxpayer other than a corporation,"[19] the regulations refer to an "individual," which includes a non-grantor trust or an estate to the extent that those entities have combined QBI that is not passed through to a beneficiary.[20]

The deduction itself is a so-called "below the line deduction" (i.e., it is not allowed in computing adjusted gross income).[21] It is instead allowed as a deduction reducing taxable income. Similarly, the Conference Committee agreement clarifies that the deduction is allowed to taxpayers whether or not they claim itemized deductions.[22] Form 1040 for 2018 shows the QBI deduction as a deduction from adjusted gross income appearing on the line after the standard/itemized deduction.

IV. DETAILED PROVISIONS

The remainder of this article contains a detailed discussion of the provisions of § 199A. Avoiding pitfalls is of paramount importance. Practitioners who deal with these provisions must understand their mechanics and nuances in order to successfully implement them.

A. *Combined Qualified Business Income Amount*

The term "combined qualified business income" amount is the total of (1) the sum of "deductible amounts" determined for each "qualified trade or business" carried on by the taxpayer, plus (2) 20 percent of the aggregate "qualified REIT dividends" and "qualified publicly traded partnership" (PTP) income.[23] Qualified REIT dividends and qualified PTP income are computed and accumulated in a separate basket and therefore do not affect

to determine the amount of such income that qualified for the lower rate. With respect to passive income, the capital percentage was 100 percent.

[18] I.R.C. § 199A(a). The limitation is computed without regard to the § 199A deduction.

[19] I.R.C. § 199A(a).

[20] Treas. Reg. § 1.199A-1(a)(2).

[21] I.R.C. § 63(b)(3).

[22] H.R. Rep. No. 115-466, at 224 (2017) (Conf. Rep.).

[23] I.R.C. § 199A(b)(1).

the determination of the deductible amounts.[24] Similarly, if the qualified trade or business activity generates a loss, the amount of qualified REIT dividends or qualified PTP income is not reduced.

B. *Qualified REIT Dividends/Qualified PTP Income*

Qualified REIT dividends are paid out of REIT earnings and profits from stock owned for at least 45 days.[25] They do not include capital gain dividends as defined in § 857(b)(3) or qualified dividend income as defined in § 1(h)(11). Furthermore, a REIT shareholder must hold the shares for a 45-day period including the ex-dividend date for the dividend to be a qualified REIT dividend.[26] Qualified PTP income represents (1) the taxpayer's allocable share of post-2017 trade or business income from a PTP that is taxed as a partnership under § 7704(a), plus (2) any amounts treated as ordinary income under § 751 that is considered attributable to the PTP's trade or business activity.[27]

There are some potential pitfalls surrounding qualified REIT dividends and qualified PTP income. The first involves a taxpayer owning a mutual fund that has invested in REIT shares or PTP interests. Since the mutual fund is a regulated investment company (RIC) under § 851, it is taxable as a C corporation. Therefore, neither it nor its shareholders appear to be entitled to a deduction under § 199A for qualifying REIT dividends or qualifying PTP income. The Joint Committee on Taxation, however, has stated:

> It is intended that in the case of an individual shareholder of a RIC that itself owns stock in a REIT or interests in a publicly traded partnership, the individual is treated as receiving qualified REIT dividends or qualified publicly traded partnership income to the extent any dividends received by the individual from the RIC are attributable

[24] Treas. Reg. § 1.199A-1(d)(3).
[25] Treas. Reg. § 1.199A-3(c)(2).
[26] Treas. Reg. § 1.199A-3(c)(2)(A). There is a practical problem for many publicly traded REITs inasmuch as most pay dividends on December 31. Form 1099-DIV is the mechanism for reporting qualified dividends to shareholders. Since the Forms 1099-DIV must be distributed to shareholders by January 31 of the following year, at the time the Forms 1099-DIV are issued, the REIT will not know whether the dividends paid to shareholders who acquired their shares in late December are qualified because that determination will not occur until after the Forms 1099-DIV are issued. In the preamble to the final regulations, the Treasury instructed the IRS to notify taxpayers that the amount shown as qualified REIT dividends on Form 1099-DIV may not qualify if the 45-day test is not met. T.D. 9847, 84 Fed. Reg. 2,952, 2,966 (Feb. 8, 2019).
[27] Treas. Reg. § 1.199A-3(c)(3).

to qualified REIT dividends or qualified publicly traded partnership income received by the RIC.[28]

In February 2019, the Treasury issued proposed regulations providing that a RIC can pay a "Section 199A dividend," which includes qualified REIT dividends, as well as PTP income received by the RIC.[29] Thus, the RIC is effectively treated as an RPE (as defined below) that is subject to some additional computational rules. Unfortunately, this proposed regulation was issued after the IRS finalized 2018 Form 1099-DIV, which includes a box to report qualified REIT dividends but does not have a box in which to report Section 199A dividends.

Furthermore, a PTP owner may be allocated trade or business losses that are suspended under § 465, § 469, § 704(d), or § 1366(d). Such suspended losses are not taken into account for purposes of § 199A until they are recognized.[30] Suspended PTP losses that originated in years prior to 2018 are apparently not considered for purposes of § 199A. Therefore, suspended losses must be segregated by the years in which they arose. There is a first in-first out (FIFO) ordering rule providing that losses are utilized in chronological order. A modification to the rule was proposed in February 2019 providing that the FIFO ordering rule must be applied separately for each PTP owned.[31]

If the amount of an individual's combined qualified REIT dividends and qualified PTP income is less than zero, the § 199A deduction pertaining to qualified REIT dividends/qualified PTP income is zero. The negative amount is carried forward to the next taxable year and reduces the amount of qualified REIT dividends/qualified PTP income for that year.[32]

C. *Deductible Amounts*

The deductible amount is 20 percent of the taxpayer's QBI for each qualified trade or business subject to a limitation.[33] The limitation is the

[28] STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF PUBLIC LAW 115–97 (JCS-1-18, Dec. 21, 2018), at 30. The Joint Committee on Taxation attempted to correct a congressional oversight. However, the Joint Committee's commentary raises a new question with respect to PTP losses incurred by a RIC. Although individual PTP losses are generally suspended under § 469, § 469 does not apply to corporations that are not closely held. Because RICs are taxable as corporations and are not closely held, the provisions of § 469 do not apply to them. Consequently, the view espoused by the Joint Committee that PTP holdings through a RIC mirror those of an individual RIC shareholder may require further analysis by the Treasury before final regulations can be issued with respect to this matter.

[29] Prop. Treas. Reg. § 1.199A-3(d).

[30] Treas. Reg. § 1.199A-3(b)(1)(iv).

[31] Prop. Treas. Reg. § 1.199A-3(b)(1)(iv)(B).

[32] Treas. Reg. §§ 1.199A-1(c)(2)(ii), 1.199A-1(d)(3).

[33] I.R.C. § 199A(b)(2).

greater of: (1) 50 Percent of the W-2 wages paid with respect to the trade or business or (2) the sum of 25 percent of the W-2 wages paid plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of all qualified property. For many businesses, obtaining the information necessary to compute the limitations requires that the trade or business provide considerable data that they may not have previously maintained.

The statute implies that deductible amounts are first determined separately for each trade or business and then the combined QBI amount is computed by taking the sum of the deductible amounts for all of the trades or businesses. However, Regulation § 1.199A-1(d)(2)(iii) states that a taxpayer owning multiple businesses with an overall net gain must net the gains and losses before computing the deductible amounts for these businesses. The application of this rule is illustrated by the following example:

> Jake owns two qualified businesses—QTB 1 and QTB 2. QTB 1 generates $500,000 of QBI in 2018, while QTB 2 generates negative QBI of $100,000. QTB 1 paid W-2 wages of $200,000 in 2018. Jake must first offset QTB 2's loss of $100,000 against QTB 1's income of $500,000. The deductible amount is the lesser of (i) 20 percent of net QBI ($400,000 x 20% = $80,000) or (ii) 50 percent of QTB 1's wages (50% x $200,000 = $100,000).

If an individual has more than one business generating positive QBI, QBI losses reduce positive QBI proportionately for the profitable businesses. For example:

> Jane has three qualified businesses with the following taxable income/loss: QTB 1 $40,000, QTC 2 $60,000, and QTB3 ($50,000). Jane's overall QBI is $50,000, 40 percent of which comes from QTB 1 and 60 percent from QTB 2.

The deductible amounts are computed by applying the W-2 wage and UBIA limitations to QBI for each business (Limitations). To the extent that a trade or business has a loss, the Limitations from that trade or business are not considered.

D. *Qualified Business Income*

QBI is generally the net amount of qualified items of income, gain, deduction, and loss from a qualified trade or business that is conducted by

the taxpayer for any taxable year.[34] In order to be treated as qualified items of income, gain, deduction, and loss, such items must be effectively connected with the conduct of a domestic trade or business within the meaning of § 864(c). When applying the § 864(c) definition to § 199A, the term "qualified trade or business" is substituted for the terms "nonresident alien individual or a foreign corporation" and "foreign corporation" where such terms are used in § 864(c).[35] Generally § 864(c) applies to domestic trade or businesses, which include businesses in Puerto Rico if the income therefrom is subject to federal income tax.[36]

Generally, a net operating loss deduction is not taken into account when computing QBI.[37] However, an excess loss under § 461(*l*) is treated as a net operating loss carryover to subsequent years and reduces QBI in the year in which such excess loss is deducted. Certain deductions are considered to be attributable to a qualified trade or business to the extent that the income from that trade or business is taken into account in calculating the amount of the allowable deduction.[38] Examples include self-employment tax deductible under § 164(f), the self-employed health insurance deduction under § 162(*l*), and the deduction for contributions to qualified retirement plans under § 404.

Regulation § 1.199A-1(d)(2)(iii)(B) states that, if the net QBI is less than zero, the loss is carried over to the next taxable year. This rule does not affect the deductibility of the loss for other purposes of the Internal Revenue Code. If the taxpayer has changed an accounting method and there is a § 481 adjustment, such adjustment, whether positive or negative, is taken into account, provided that the requirements of § 199A are met and that the adjustment arose in a post-2017 year.[39]

Several items are statutorily excluded from the definition of qualified items of income, gain, deduction, or loss.[40] Those items include capital gains and losses, dividend income, interest income not allocable to a trade or business, gain or loss from commodities transactions (other than in the capacity as a broker dealer), net foreign currency gains unless such gains relate to a domestic trade or business, income from notional principal contracts, and annuity income. Because qualified REIT dividends and PTP income are separately carved out, they also are excluded from QBI.[41]

To the extent a capital gain or loss is recharacterized as ordinary income, it is potentially includable in QBI if it relates to a qualified trade or

[34] I.R.C. § 199A(c)(1).
[35] I.R.C. § 199A(c)(3)(A)(i).
[36] I.R.C. § 199A(f)(1)(C).
[37] Treas. Reg. § 1.199A-3(b)(1)(v).
[38] Treas. Reg. § 1.199A-3(b)(1)(vi).
[39] Treas. Reg. § 1.199A-3(b)(1)(iii).
[40] I.R.C. § 199A(d)(3)(B).
[41] *See* I.R.C. § 199A(b)(1)(B).

business.[42] For example, capital gains of a partnership recharacterized as ordinary income under § 751 are considered attributable to the partnership's qualified business activities and are included in QBI.[43] Other examples include § 1231 gains recaptured as ordinary income under § 1245, etc., and § 1231 gains clawed back as ordinary income under the five-year lookback rule in § 1231(c). Certain other income items received from passthrough entities are similarly excluded. The simplest of these items are payments received by a partner from a partnership for services either as a guaranteed payment under § 707(c) or in a non-partner capacity under § 707(a).[44]

A more nuanced exclusion is reasonable compensation paid by an S corporation. The statute states that reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered to such qualified business does not constitute a qualified item of trade or business income.[45] This provision was included to ensure that salaries paid to an S corporation shareholder reduce the S corporation's QBI. While the statute does not refer to S corporations, the preamble to the 2018 Proposed Regulations states that the rule applies only to S corporations and is not extended to partnerships.[46] However, the statute fails to address what happens if a taxpayer reduces the compensation paid in order to make the qualified trade or business appear more profitable. The Treasury addressed this potential loophole in the preamble to the 2018 Proposed Regulations, stating: "The rule for reasonable compensation is merely a clarification that, even if an S corporation fails to pay a reasonable wage to its shareholder-employees, the shareholder-employees are nonetheless prevented from including an amount equal to reasonable compensation in QBI." [47]

Interestingly, the Treasury did not see the need to include this concept in the regulations. Based on commentary included in the preamble to the 2018 Proposed Regulations, the Treasury believes that case law setting forth minimum salary requirements to S corporation shareholders is sufficient to prevent abuse.[48]

E. *Qualified Trade or Business*

In order to accomplish the congressional objective of rewarding capital intensive businesses, rather than self-employed service businesses,

[42] Treas. Reg. § 1.199A-3(b)(2)(ii).
[43] Treas. Reg. § 1.199A-3(b)(1)(i).
[44] I.R.C. §§ 199A(d)(4)(B), 199A(d)(4)(C).
[45] I.R.C. § 199A(d)(4)(A).
[46] REG-107892-18, 83 Fed. Reg. 40,884, 40,893 (Aug. 16, 2018).
[47] *Id*. at 40,893.
[48] *Id*. For a more thorough discussion of reasonable compensation in the context of S corporation shareholders, *see* Tony Nitti, *S Corporation Shareholder Compensation: How Much Is Enough?* THE TAX ADVISER (July 31, 2011).

the definition of trade or business for purposes of § 199A had to be constrained. There are two types of trade or business activities that do not qualify.[49] The first is a "specified service trade or business" (SSTB), while the second is the trade or business of performing services as an employee. While it is possible for certain taxpayers with income below a threshold amount to treat a SSTB as a qualified trade or business, services performed in an employee capacity never qualify.[50]

Although the regulations define a trade or business within the context of § 162,[51] a precise definition of the term has historically been elusive as the term has unique meanings under various authorities. Furthermore, the courts have never established a uniform criteria for defining what constitutes a trade or business. In the preamble to the 2018 Proposed Regulations, the Treasury states that it believes "the definition of a trade or business under section 162 provides for administrable rules that are appropriate for the purposes of section 199A."[52] Therefore, it appears unlikely that we will see further guidance with respect to this matter. Furthermore, the final regulations modify the § 162 trade or business definition to treat certain rental activities as a trade or business for purposes of § 199A, including the rental or licensing of tangible or intangible property to a commonly controlled trade or business. [53]

In the preamble to the final regulations, the Treasury states that it is beyond the scope of the § 199A regulations to provide "bright line rules" to determine whether a rental real estate activity is a trade or business for purposes of § 162.[54] Due to ambiguities in existing authority and an overall lack of guidance, it can be especially difficult to determine whether certain other rental activities rise to the level of being a trade or business for purposes of § 162. Some common examples include:

- Ground rents are generally not treated as rising to the level of a trade or business, and the deductions associated with them are generally deductible under § 212 rather than § 162.[55]

[49] I.R.C. § 199A(d)(1); Treas. Reg. § 1.199A-5(a).
[50] The determination of whether a worker is an employee is based upon whether the worker is properly classified as an employee for tax purposes. Mischaracterization as an independent contractor by the employer has no consequences on the determination. Treas. Reg. § 1.199A-5(d)(2).
[51] Treas. Reg. § 1.199A-1(b)(14).
[52] REG-107892-18, 83 Fed. Reg. 40,884, 40,885 (Aug. 16, 2018).
[53] Treas. Reg. § 1.199A-1(b)(14).
[54] T.D. 9847, 84 Fed. Reg. 2,452, 2,955 (Feb. 8, 2019).
[55] Ground rents are generally considered portfolio income rather than trade or business income for purposes of § 469.

- Property subject to a net lease does not always rise to the level of a trade or business.[56]
- Property owned as tenants in common that is not reported as a partnership may not rise to the level of a trade or business. In order for the tenants in common to avoid filing a partnership tax return, § 761(a) requires that the activity not constitute a trade or business under § 162.
- Rental of a vacation home or a portion of a taxpayer's residence.

Concurrent with the release of the final regulations, the IRS released Notice 2019-7,[57] which provides notice of a proposed revenue procedure that sets forth a safe harbor for determining whether a real estate rental activity is a trade or business for purposes of § 199A. While the failure to meet the safe harbor requirements does not preclude a taxpayer from otherwise establishing that a rental real estate endeavor is a trade or business, it sets forth some important guidelines. Property subject to a triple net lease, and property used for any part of the year as a residence by the taxpayer (including an owner or beneficiary of an RPE that owns the property), do not qualify for safe harbor treatment.

In order to qualify for the safe harbor, three tests must be met: (1) separate books and records must be maintained to reflect the income and expenses for each rental real estate enterprise; (2) at least 250 hours must be spent annually (by the owner or the owner's agents) performing real estate services (e.g., advertising, negotiating leases, screening prospective tenants, daily operation of the property, maintenance, repair, property management); and (3) the real estate services must be contemporaneously documented for years beginning after 2018. In addition, the taxpayer is required to include on its tax return an attestation, signed under penalties of perjury, that the listed requirements were met.

F. *Relevant Passthrough Entity*

As described above, the § 199A computations are performed at the individual taxpayer level. When a taxpayer operates a business as a sole proprietor, owns a rental property individually, or conducts a business through a disregarded entity, the mechanical computations do not involve

[56] For a more detailed discussion of when net lease rentals are considered a trade or business, *see* https://ultimateestateplanner.com/2018/11/01/section-199a-triple-net-leases-considered-a-trade-or-business/. *See also* Marie Sapirie, *Rental Trades or Businesses and the Passthrough Deduction*, 161 TAX NOTES 671 (Nov. 5, 2018). Many of the points discussed in this article were also considered in the preamble to the final regulations. *See* TD 9847, 84 Fed. Reg. 2,452, 2,955 (Feb. 8, 2019).

[57] Notice 2019-7, 2019-9 I.R.B. 740.

obtaining information from another entity, because, for federal income tax purposes, a sole proprietorship is not considered as an entity distinct from its owner. However, when the taxpayer owns an interest in a qualified trade or business that is conducted by a regarded passthrough entity, the owner must receive sufficient information from that entity to enable each owner to properly compute his or her § 199A deduction.

Regulation § 1.199A-1(b)(10) coins a new term—"relevant passthrough entity" (RPE)—to describe certain passthrough entities. An RPE is defined as a partnership (other than a PTP) or an S corporation that is owned directly or indirectly by at least one individual, an estate, or a trust.[58] An estate or trust can itself be an RPE if it passes through § 199A attributes to a beneficiary.

The provisions of § 199A are applied at the partner or S corporation shareholder level.[59] Because the purpose of § 199A is to reduce the effective income tax rate on QBI, qualified REIT dividends, and qualified PTP income, the § 199A deduction has no effect on the adjusted basis of a partner or a shareholder's interest in the RPE.[60] Furthermore, since the rate of other taxes, including self-employment tax and net investment income tax, was not changed by the TCJA, deductions under § 199A do not apply for purposes of computing those taxes.[61] Finally, in order to minimize complexity when calculating the alternative minimum tax (AMT), the § 199A deduction that is allowable for regular tax purposes is the same amount allowed for AMT purposes.[62]

RPEs cannot ignore § 199A. The regulations prescribe computational and reporting rules to enable an RPE owner to compute his or her QBI deduction. Specifically, an RPE must undertake the following:

- Determine whether it is engaged in one or more trades or businesses.
- Determine whether any of its trades or businesses are SSTBs.
- Decide whether to aggregate any of its trades or businesses.
- Compute the QBI for each trade or business.

[58] Other entities that file Form 1065, U.S. Return of Partnership Income, including certain common trust funds and religious or apostolic organizations, are also treated as RPEs if they are owned, directly or indirectly, by at least one individual, trust, or estate. Treas. Reg. § 1.199A-1(b)(10).
[59] I.R.C. § 199A(f)(1)(A).
[60] Treas. Reg. § 1.199A-1(e)(1). Furthermore, § 199A has no effect on an S corporation's accumulated adjustment account. Presumably, it also does not affect a taxpayer's at-risk amount under § 465.
[61] I.R.C. § 199A(f)(3); Treas. Reg. § 1.199A-1(e)(3).
[62] I.R.C. § 199A(f)(2); Treas. Reg. § 1.199A-1(e)(5).

- Determine the amount of W-2 wages and UBIA of qualified property for each trade or business.
- Determine whether it has any qualified REIT dividends or qualified PTP income.
- Allocate the above items among its owners and report them on Schedules K-1.
- Notify owners of any items that are attributable to trades or businesses that are SSTBs.[63]

G. *Threshold Amount/Phase-in Range*

When the Senate considered replacing the House proposal of applying a lower tax rate to passthrough income with a regime prescribing a passthrough deduction, it proposed that lower income taxpayers be subject to a simplified set of rules.[64] The Senate also wanted to place limitations on deductions that apply to higher income taxpayers. The Senate proposed a complex set of rules containing multiple threshold and phase-in levels. In the final version of the bill, § 199A(b)(3) contains a unified threshold amount and phase-in range.

The threshold amount is based on the individual's taxable income, excluding the § 199A deduction.[65] For taxpayers who do not file a joint return, the threshold amount is $157,500 for years beginning before 2019.[66] For married taxpayers filing a joint return, the amount is increased to $315,000. For years beginning after 2018, the threshold amount is adjusted for changes to the consumer price index.[67] Taxpayers with taxable income less than the threshold amount are not subject to the Limitations.[68]

The rules are phased in when a taxpayer's taxable income exceeds the threshold amount, but does not exceed the threshold amount plus $50,000 ($100,000 for a joint return).[69] Once the upper limit of the phase-in range is reached, the Limitations apply. For taxpayers whose taxable income exceeds the upper limit of the phase-in range, the deductible amount is limited to the greater of (1) 50 percent of the W–2 wages with respect to the qualified trade or business or (2) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the UBIA of all qualified property.[70]

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[63] Treas. Reg. § 1.199A-6.
[64] H.R. Rep. No. 115-466, at 214-22 (2017) (Conf. Rep.).
[65] I.R.C. § 199A(e)(1).
[66] I.R.C. § 199A(e)(2)(A).
[67] I.R.C. § 199A(e)(2)(B).
[68] I.R.C. § 199A(b)(3).
[69] I.R.C. § 199A(b)(3)(B).
[70] I.R.C. § 199A(b)(2)(B).

For taxpayers whose taxable income falls within the phase-in range, a percentage of the QBI is subject to the Limitations. That "applicable percentage" is computed by taking the ratio of taxable income in excess of the threshold amount over the $50,000/$100,000 phase-in range.[71] The applicable percentage is also applied to the amount of W-2 wages and UBIA when calculating the Limitations.

To illustrate this concept, consider the following example:

> Todd, a single taxpayer, has taxable income of $177,500 and QBI of $100,000. Todd's threshold amount is $157,500 and his phase-in range is $50,000. His taxable income exceeds his threshold amount by $20,000, which is 40 percent of his phase in range. Therefore, 40 percent of his deductible amount is subject to the Limitations.

As discussed further below, similar rules apply when categorizing a SSTB as a qualified business.[72]

H. *W-2 Wages*

Generally, W-2 wages include wages paid to employees by the qualified trade or business in connection with that business.[73] The wages must be reported on a Form W-2 filed with the Social Security Administration no later than 60 days after the due date (including extensions).[74] The legislative history implies that the wages must be paid by, and the Forms W-2 filed, by the qualified business.[75]

Regulation § 1.199A-2(b)(2) addresses the situation where amounts are paid to workers by third party payors on behalf of their clients. In such a case, the third party payor prepares the Forms W-2 for those workers and is listed as the employer. Under the regulations, the qualified business is treated as the payor if it is the common law employer and can take into account the W-2 wages. If the third party payor is an individual or RPE, the qualified business may not include the wages when computing its own W-2 wage limitation.[76]

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[71] I.R.C. § 199A(b)(3)(B)(ii).
[72] I.R.C. § 199A(d)(3).
[73] I.R.C. §§ 199A(b)(4)(A), 199A(b)(4)(B).
[74] I.R.C. § 199A(b)(4)(C).
[75] H.R. Rep. No. 115-466, at 217-18 (2017) (Conf. Rep.).
[76] The preamble to the 2018 Proposed Regulations indicates that third party payors commonly include professional employer organizations, certified professional employer organizations, or agents under § 3504. REG-107892-18, 83 Fed. Reg. 40,884, 40,888 (Aug. 16, 2018). The IRS has also issued guidance with respect to determining the amount of W-2 wages paid by a trade or business. Rev. Proc. 2019-11, 2019-09 I.R.B. 742.

There are a few practical points to consider about Form W-2 reporting. Items that are improperly reported on a Form W-2, such as non-employee compensation properly reportable on Form 1099-MISC, should not be included in W-2 wages. Furthermore, if an employee is improperly treated as an independent contractor and that employee's compensation is not reported on a timely filed Form W-2, the compensation will not be included in W-2 wages. Similarly, it is a somewhat common, but incorrect, practice to treat partners as employees and report guaranteed payments under § 707(c) or payments under § 707(a) as wages on Form W-2.[77] Such amounts do not represent W-2 wages for purposes of the W-2 limitation.

In the context of an S corporation, taxpayers may seek to understate the amount of compensation paid to shareholders who are also employees. By doing so, the S corporation seeks to maximize the amount of QBI. However, if the S corporation's tax return is examined, the IRS may successfully maintain that some portion of the S corporation's QBI should be recharacterized as compensation. Since the additional compensation was not reported on a timely filed Form W-2, it will not qualify as W-2 wages.

The Limitations are computed by the individual owning the qualified trade or business. If the business is conducted by an RPE, the RPE must determine the amount of W-2 wages and allocate such wages among the owners of the business.[78] If an RPE conducts more than one qualified trade or business, it must allocate the W-2 wages to each trade or business. If the RPE fails to allocate and report such wages separately for each trade or business, the amount of W-2 wages paid is presumed to be zero.

Since W-2 wages are always reported to the government on a calendar year basis, RPEs having a taxable year other than a calendar year are required to report the W-2 wages for the calendar year ending within the fiscal year.[79] For example, *A* is a partner in *ABC* Partnership that has a June 30 year end. For the fiscal year ending June 30, 2020, *ABC* will consider the wages it paid to its employees for the calendar year ending December 31, 2019. Partnerships must allocate the W-2 wages limitation consistent with the allocation of related payroll expense.[80]

I. *Qualified Property*

The original intent of the House bill was to allow a lower tax rate on the portion of the passthrough business profits of an active trade or business

[77] Rev. Rul. 69-184, 1969-1 C.B. 256. The IRS concluded that a partner cannot also be an employee of the partnership.
[78] Treas. Reg. § 1.199A-2(a)(2).
[79] I.R.C. § 199A(b)(4)(A).
[80] I.R.C. § 199A(f)(1)(A)(iii).

that were attributable to capital.[81] The Senate version of the bill applied a limit based solely on W-2 wages.[82] When the bill was considered by the Conference Committee, the conferees agreed to modify the wage limit proposed by the Senate by including a limit incorporating a capital component.[83] Because Congress wanted to base the limitation on the amount invested by the owner in the business, the original unadjusted basis (rather than adjusted basis) of depreciable property was included in the base.

In order to be treated as qualified property with respect to a trade or business, an asset must meet three tests:

(1) It must be held by, and be available for use in, the qualified trade or business at the close of the taxable year. Thus, assets disposed of during the taxable year do not qualify.
(2) It must be used at any point during the taxable year in the production of QBI and must be placed in service for depreciation purposes in order to meet this requirement.
(3) The asset's depreciable period must not have ended before the close of the taxable year.[84]

The depreciable period generally ends on the later of (1) ten years after the placed in service date or (2) the last day of the last full year in the applicable recovery period that would apply under MACRS (without regard to ACRS).[85] The reference to ACRS refers to the depreciation system in effect from 1981 to 1986 (i.e., real property was depreciated over a 15- to 19-year period, depending on the nature of the real property and when it was placed in service). Generally, as of 2005, all ACRS property was fully depreciated and such property would otherwise not be qualified property. However, for purposes of applying this rule, the MACRS life is used to determine whether the depreciable period has ended. Since the MACRS lives for real property range from 27.5 to 39.5 years, many assets depreciated under ACRS will be qualified property.

The regulations add the term "unadjusted basis immediately after acquisition" (UBIA).[86] UBIA is generally the original cost basis of an asset determined under § 1012 principles When qualified property is held by an RPE, the RPE must determine and report UBIA separately for each trade or business conducted by the RPE. UBIA is presumed to be zero if not determined and reported separately for each trade or business.[87] As a

[81] H.R. Rep. No. 115-466, at 208-13 (2017) (Conf. Rep.).
[82] *Id.* at 217-18.
[83] *Id.* at 222-23.
[84] I.R.C. § 199A(b)(6)(A); Treas. Reg. § 1.199A-2(c)(1)(i)(C).
[85] I.R.C. § 199A(b)(6)(B).
[86] Treas. Reg. § 1.199A-2.
[87] Treas. Reg. § 1.199A-2(a)(3).

practical matter, this may require additional information from an RPE when preparing tax returns, particularly if the RPE has aggregated trade or business activities differently for purposes of § 465 or § 469.

Because individuals and RPEs commonly acquire assets in carryover basis transactions, the determination of UBIA may be complex for such assets. Pursuant to an anti-abuse rule in the regulations, the depreciable life of a carryover basis asset starts when the transferor placed it in service. When a portion of such asset's basis does not have a carryover basis (i.e., when boot is given), the depreciable life for that part of UBIA starts when the transferee placed the asset in service.[88]

The regulations deal with the UBIA of qualified property where assets were acquired in nonrecognition transactions. Several types of such transactions are addressed. Qualified property acquired in a transaction described in § 168(i)(7)(B) generally retains the UBIA of the transferor on the date the asset was first placed in service by such transferor.[89] This is consistent with the general scheme of §168(i)(7) in which the transferee owner "steps into the shoes" of the transferor. Transfers covered by § 168(i)(7) include those described in §§ 332, 351, 361, 721 and 731.[90]

The UBIA of qualified property acquired in a like-kind exchange pursuant to §1031 is generally the UBIA of the relinquished property.[91] If multiple assets are received in the exchange, the UBIA is apportioned among such properties based on their relative fair market values. To the extent boot is received, the UBIA of replacement qualified property is reduced by the amount of such boot.[92] Boot given is generally treated as a separate, newly acquired asset.[93] The rules for determining the UBIA of property acquired pursuant to an involuntary conversion under § 1033 are similar to those for like-kind exchanges.[94] The UBIA of inherited property is determined under § 1014 and is generally the fair market value on the decedent's date of death or the alternate valuation date. Capital improvements to an asset are generally treated as a separate asset.[95]

The Treasury was concerned about potential abuses where taxpayers temporarily acquire assets to artificially boost the UBIA of assets at the end of the taxable year. To address these concerns, the regulations state:

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[88] Treas. Reg. § 1.199A-2(c)(2)(iv).
[89] Treas. Reg. § 1.199A-2(c)(3)(iv).
[90] I.R.C. § 168(i)(7)(B).
[91] Treas. Reg. § 1.199A-2(c)(3)(ii).
[92] Treas. Reg. § 1.199A-2(c)(3)(ii)(A). For tax deferred exchanges, a further adjustment to UBIA is made by adjusting the amount of boot received to account for differences in value of the relinquished property on the date it was relinquished and its value on the date the replacement property was acquired. Treas. Reg. § 1.199A-2(c)(3)(ii)(B).
[93] Treas. Reg. § 1.199A-2(c)(3)(ii).
[94] Treas. Reg. § 1.199A-2(c)(3)(iii)(A). Note that Regulation § 1.199A-2(c)(3)(iii)(B) contains a similar adjustment for boot received.
[95] Treas. Reg. § 1.199A-2(c)(1)(ii).

> Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the section 199A deduction.[96]

When a partnership has a § 754 election in effect, it may adjust the basis of its assets in two situations:

(1) When a partnership interest is sold, exchanged, or inherited, the partnership may adjust the transferee partner's distributive share of the partnership's adjusted basis of its assets pursuant to § 743(b). While a detailed discussion of § 743(b) is beyond the scope of this paper, essentially the transferee partner's distributive share of the adjusted basis of partnership assets is marked to market.

(2) When assets are distributed to a partner that either (a) consist of cash exceeding that partner's adjusted basis of his partnership interest or (b) the partnership's basis of assets distributed in a liquidating distribution differ from the partner's basis of his partnership interest, the partnership adjusts the basis of its remaining assets under § 734(b) to account for the difference.

In the preamble to the 2018 Proposed Regulations, the Treasury indicated a concern that adjustments to basis under §§ 734(b) and 743(b) could result in an "inappropriate duplication of UBIA for qualified property."[97] Consequently, the 2018 Proposed Regulations provide that partnership basis adjustments under these sections are not treated as qualified property.[98] In response to this proposed regulation, several commentators expressed the view that this was an unfair result to the extent that such adjustments increase the basis of qualified property above its original UBIA.[99] In final regulations, the Treasury conceded inequities in the context of § 743(b) adjustments, but maintained that § 734(b)

[96] Treas. Reg. § 1.199A-2(c)(1)(iv).
[97] REG-107892-18, 83 Fed. Reg. 40,884, 40,889 (Aug. 16, 2018).
[98] Prop. Treas. Reg. § 1.199A-1(c)(1)(ii).
[99] REG-107892-18, 83 Fed Reg. 40,884, 40,889 (Aug. 16, 2018).

adjustments do not represent the acquisition of qualified property for § 199A purposes.[100]

As discussed in the preamble to the final regulations, Regulation § 1.199A-2(c)(2)(v) provides that basis adjustments are treated as qualifying property to the extent that the basis adjustment does not restore the basis of qualifying property that was reduced by prior depreciation.[101] This concept is best explained by example.

> *A* is a 50 percent partner in *AB* partnership. *AB* has a single asset, *X*, which is qualified property. *AB*'s UBIA in *X* is $100 and its adjusted basis in the asset is $80. (*AB* has claimed depreciation deductions of $20.) *X*'s fair market value is $140. *A* sells his partnership interest to *C* for $70. *AB* has a § 754 election in effect. In accordance with §743(b), *AB* records a basis adjustment to *X* of $30 (the excess of $70 over 50 percent of *AB*'s adjusted basis in *X*). The portion of the § 743(b) adjustment that is treated as UBIA is $20 (the excess of $70 over 50 percent of *AB*'s UBIA in *X*). This portion is referred to as an "excess § 743 basis adjustment" in Regulation § 1.199A-2(c)(2)(v).

A partnership must generally allocate UBIA consistently with how § 704(b) book depreciation is allocated.[102] An S corporation generally allocates UBIA among its shareholders pro rata based on the number of issued and outstanding shares on the last day of its taxable year.[103] Thus, an S corporation shareholder who sells or redeems his shares during the year will not be allocated any of the S corporation's UBIA.

J. *Aggregation of Multiple Trades or Businesses*

A critical component of the computation of the QBI deduction is dealing with taxpayers who carry on more than one trade or business. For those taxpayers, there are several questions that must be addressed. First, how are expenses allocated among those businesses? The second question is whether those businesses may be aggregated. Finally, can multiple entities be engaged in a single trade or business?

These issues are not unique to § 199A. They have been dealt with in the context of adopting accounting methods under § 446, determining the amount at risk under § 465, and determining the passive activity limitations

[100] TD 9847, 84 Fed. Reg. 2,952, 2,960 (Feb. 28, 2019).
[101] *Id*.
[102] Treas. Reg. § 1.199A-2(a)(3)(ii).
[103] Treas. Reg. § 1.199A-2(a)(3)(iii).

under § 469. Unfortunately, there is not a standard unified approach to dealing with these issues across multiple code sections.[104] For purposes of § 199A, the regulations require that a reasonable method of allocation be used and consistently applied from year to year.[105] Furthermore, the method used must clearly reflect the income of each trade or business.

Regulation §1.199A-4 allows, but does not require, grouping of trade or business activities. The proposed regulations did not allow grouping by RPEs and provided that only individuals could aggregate trade or business activities.[106] Because RPEs are allowed to aggregate for purposes of § 469 (and to a lesser extent § 465), many commentators complained about the administrative burden resulting from the inability to aggregate at the RPE level.[107] The Treasury relented in final regulations and agreed that aggregation should be allowed at the RPE level.[108]

In order to aggregate trades or businesses, an individual or RPE must demonstrate that the following conditions exist:

(1) The same person, or group of persons must directly, indirectly, or by attribution under § 267(b) or § 707(b) own at least a 50 percent interest in each business that is to be aggregated.

(2) Such ownership must exist for a majority of the taxable year, including the last day of the taxable year in which the items attributable to each trade or business to be aggregated are included in income.

(3) All items attributable to each trade or business to be aggregated must be reported on returns having the same taxable year.

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[104] For a further discussion of this topic, see Dinh Tran, *Can a trade or business include activities conducted in a different entity?* THE TAX ADVISER (July 1, 2018).

[105] Treas. Reg. § 1.199A-3(b)(5). In the preamble to the final regulations, the Treasury indicates that reasonable expense allocation methods may include direct tracing of expenditures or allocations based on gross income. However, the determination of whether a method is reasonable depends on the underlying facts and circumstances. T.D. 9847, 84 Fed. Reg. 2,952, 2,956-57 (Feb. 8, 2019).

[106] REG-107892-18, 83 Fed Reg. 40,884, 40,894 (Aug. 16, 2018).

[107] Unlike aggregation for purposes of determining limitations from passive activities under Proposed Regulation § 1.469-4(a), only individuals were allowed to aggregate or group trade or business activities for purposes of § 199A. This posed potential problems for some taxpayers. For example, if a § 469 activity is disaggregated, some of its components may not rise to the level of being a stand-alone trade or business. Consider a real estate portfolio that was aggregated for purposes of § 469 and contains individual net lease properties, each of which are not a trade or business on a stand-alone basis. Furthermore, from an administrative perspective, an RPE would have been required to separately disclose rental activities from each property on its Schedules K-1 which would have resulted in voluminous disclosures.

[108] T.D. 9847, 84 Fed. Reg. 2,952, 2,968 (Feb. 8, 2019).

(4) None of the businesses can be an SSTB.
(5) Two of the following three factors must be satisfied:
  (a) Products and services must be identical or customarily provided together.
  (b) Businesses share facilities or centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
  (c) Businesses are operated in coordination with or reliance upon the aggregated group (e.g., supply chain interdependence).[109]

Furthermore, when an individual or RPE aggregates trade or business activities, the following must be disclosed in the aggregator's tax return: (1) a description of each trade or business, (2) the name and EIN of each entity in which a trade or business is operated, (3) information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year, and (4) such other information as the Commissioner may require in forms, instructions, or other published guidance.[110] Failure to include such disclosure permits the IRS to disallow the aggregation.[111] Furthermore, any trades or businesses disaggregated by the IRS may not be reaggregated for the subsequent three years.

K. *Specified Service Trade or Business*

Congress sought to reduce the tax rate paid by businesses in the TCJA, but did not want to extend the rate reduction to businesses that provided personal services.[112] Personal services income was considered to be similar to wages, which do not constitute QBI. The House version of the TCJA provided that income from an SSTB would not qualify for the reduced rate unless it was capital intensive.[113] SSTBs included those types of businesses described in § 1202(e)(3)(A), plus certain investment businesses described in §§ 475(c)(2) and 475(e)(2).[114] The Conference Committee narrowed the definition to exclude engineers and architects.

[109] Treas. Reg. § 1.199A-4(b)(1).
[110] Treas. Reg. §§ 1.199A-4(c)(2)(i), 1.199A-4(c)(3)(i).
[111] Treas. Reg. §§ 1.199A-4(c)(2)(ii), 1.199A-4(c)(3)(ii).
[112] H.R. Rep. No. 115-409, at 134 (2017) (Conf. Rep.).
[113] *Id.* at 133-34.
[114] The services defined in § 1202(e)(3)(A) include services provided 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 the trade or business is the reputation or skill of one or more of its employees.

The final definition of SSTB is contained in § 199A(d)(2). Regulation § 1.199A-5(b) discusses each of the listed specified services in detail. The final version of the TCJA simplified the original House version by excluding an SSTB from the definition of a qualified trade or business.[115]

Regulation § 1.199A-5(b)(2) offers some additional exceptions to the definition of SSTB. Some of the more noteworthy exceptions are limiting brokerage services to securities broker dealers while excluding real estate and insurance agents and brokers.[116] There was some confusion about whether lending activities constituted an SSTB that provided financial services. Regulation § 1.199A-5(b)(2)(ix) clearly distinguishes lending activities from financial services and indicates that lending activities are not financial services.

The definition of SSTBs incorporates the statutory language of § 1203(e)(3)(A) which includes "any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees." For § 199A purposes, Regulation §1.199A-5(b)(2)(xiv) limits the application of this terminology. Such businesses are only considered to be SSTBs if they receive one of the following: (1) fees or other compensation for endorsing products or services, (2) royalties for use of an individual's image, signature, voice, etc., and (3) remuneration for appearances, including appearances in media.

The rules defining what constitutes an SSTB are somewhat arbitrary and practitioners should ensure that they have a thorough understanding of the taxpayer's trade or business before concluding whether or not the business is an SSTB. The SSTB rules do not apply to taxpayers whose taxable income is less than the threshold amount, and such rules are phased in for taxpayers whose taxable income is within the phase-in range.[117] However, once an individual's taxable income exceeds the upper limit of the phase-in range, if a trade or business is an SSTB, QBI, W-2 wages, and UBIA of qualifying property cannot be taken into account for purposes of computing the QBI deduction.[118]

When a trade or business engages in multiple activities, some of which are from specified services, Regulation § 1.199A-5(c)(1) contains two-pronged *de minimis* rules based on the gross receipts of the business. If the gross receipts of the trade or business are no more than $25 million, and the gross receipts from specified services are less than 10 percent of total gross receipts, the trade or business is not an SSTB. On the other hand, if

Securities broker dealers are defined in § 475(c)(2), while commodity broker dealers are defined in § 475(e)(2).

[115] I.R.C. § 199A(d)(1).

[116] Treas. Reg. § 1.199A-5(b)(2)(x).

[117] I.R.C. § 199A(d)(3).

[118] Treas. Reg. § 1.199A-5(b).

the gross receipts of the trade or business exceed $25 million, and the gross receipts from specified services are less than 5 percent of total gross receipts, the trade or business is not an SSTB. Trades or businesses with gross receipts approaching $25 million need to be aware that a relatively small amount of incremental gross receipts can have a large impact on the ability to claim a deduction under § 199A. It is quite common for a taxpayer to be affected by these rules.

For example, consider the case of David who conducts two trade or business activities. The first is a real estate brokerage business which is not an SSTB by virtue of Regulation § 1.199A-5(b)(2)(x). The second is an appraisal business that is either a consulting business providing professional advice or a financial services business providing valuation services and thus is an SSTB. Both businesses are located in the same office and share employees, supplies, etc. In 2018, David collected brokerage commissions of $2 million and appraisal fees of $500,000. David's total gross receipts were less than $25 million, but his receipts from the SSTB exceeded 10 percent of the total gross receipts. Consequently, *all* of his business activities constitute SSTB activities. It should be noted that, if David can reduce his taxable income below the threshold amount, the SSTB rules will not apply.[119]

As an anti-abuse measure, a rebuttable presumption is set forth in the regulations providing that a former employee providing substantially the same services in a different capacity is still an employee for § 199A purposes.[120] For example, consider an associate in a law firm who becomes a partner in that firm. In order to overcome the presumption that the partner is no longer an employee for purposes of § 199A, the partner presumably would have to demonstrate that his duties changed sufficiently from those

[119] Regulation § 1.199A-5(c)(iii) contains two examples of situations where a taxpayer conducts multiple trade or business activities, one of which is an SSTB. In the first example, the taxpayer sells lawn care and landscaping equipment and provides landscape design services which constitute an SSTB. Customers are invoiced separately and the two businesses have no common customers. The taxpayer maintains a single set of books and treats the businesses as a single trade or business for purposes of §§ 162 and 199A. Because the gross receipts from the landscape design exceed 10 percent of the total gross receipts, the entire business is treated as an SSTB. In the second example, the taxpayer provides veterinarian services (an SSTB) and develops and sells a line of organic dog food. Customers are separately invoiced. Each business has separate employees and separate books. The taxpayer treats the businesses as separate trades or businesses for purposes of §§ 162 and 199A. Despite the fact that the veterinarian business gross receipts exceed 10 percent of the combined gross receipts, the dog food business is not an SSTB. Based on these examples, for taxpayers seeking to avoid the *de minimis* rules, it seems important for multiple businesses owned by the same or related taxpayer(s) to maintain separate books and records and to treat the businesses as separate businesses for purposes of §§ 162 and 199A.

[120] Treas. Reg. § 1.199A-5(d)(3).

performed as an employee.[121] The presumption applies whether the former employee provides the services directly or through another entity.

Several examples in the regulations explain how these rules work.[122] In one example, a law firm associate who was an employee of the law firm left the firm. The associate subsequently contracted to provide substantially the same services to the law firm that he previously provided in his capacity as an employee. Even though the independent contractor relationship is otherwise respected for tax purposes, for purposes of § 199A, the income earned from the law firm by the former associate is not QBI.

A portion of a trade or business can be recharacterized as an SSTB under anti-abuse rules. Where the trade or business (1) has 50 percent common ownership with an SSTB and (2) provides property or services to that SSTB.[123] The income from services provided to the SSTB is recharacterized as coming from a separate SSTB.[124] Fifty percent or more common ownership includes direct or indirect ownership by related parties within the meaning of § 267(b) or § 707(b).

An example in the regulations illustrates the mechanics of the recharacterization rules.[125] In the example, the partners of a law firm own 60 percent of another partnership that owns the building occupied by the law firm. All the space in the building is leased to the law firm. Since the two partnerships have more than 50 percent common ownership and all the building is rented to the law firm, the rental partnership is recharacterized as an SSTB. If the facts are changed slightly, such that the law firm only occupies 70 percent of the space in the building and the remaining 30 percent is leased to unrelated third party tenants, then only the rents received from the law firm are recharacterized as an SSTB.

L. *Penalties*

Congress was concerned with potential taxpayer abuses in connection with the QBI deduction. Consequently, the substantial understatement penalty thresholds under § 6662(d)(1) were lowered by separately defining a substantial understatement of tax if the understatement pertains to an overstatement of the deduction allowed under § 199A. The normal threshold is an understatement that exceeds the greater of 10 percent of the amount of tax required to be shown on the return or $5,000. For

[121] *See* Regulation § 1.199A-5(d)(3)(iii)(C) for an example that adds the concept of a "career milestone" for an employee who become a partner in the firm he works for. Apparently, achieving a career milestone may be sufficient to rebut the presumption.
[122] Treas. Reg. § 1.199A-5(d)(3)(iii).
[123] Treas. Reg. § 1.199A-5(c)(2)(i).
[124] Treas. Reg. § 1.199A-5(c)(2)(ii).
[125] Treas. Reg. § 1.199A-5(c)(2)(iii).

understatements of tax resulting from the disallowance of deductions under § 199A, the 10 percent threshold is reduced to 5 percent.[126]

CONCLUSION

Implementing the qualified business deduction is challenging. In the preamble to the final regulations, the Treasury estimated that 25 million hours would be spent annually by affected taxpayers complying with these provisions.[127] The IRS has not finalized any forms on which to compute the QBI deduction. The only place where the deduction appears on an IRS form is on Form 1040, Line 9, where it instructs taxpayers to "see instructions." The printed IRS Instructions to the 2018 Form 1040 were released on December 17, 2018, and are 117 pages in length.[128] Less than three pages of these instructions are devoted to the amount reported on Line 9. The instructions include a one-page "simplified" worksheet with 17 lines, but they fail to provide all the information necessary to properly complete several lines on the worksheet.[129] The instructions fail to discuss matters such as SSTBs, trade or business aggregation, or any disclosure requirements, and refer readers to the section in Publication 535 entitled "Determination of your qualified trades or businesses."[130]

In terms of complexity, the rules of § 199A are reminiscent of the passive activity limitations under § 469 that were enacted as part of the Tax Reform Act of 1986. Because of the complexity of § 469, it took many years to establish sufficient guidance to administer those rules. It is possible that it will take a comparable period of time for the framework of the rules under § 199A to evolve. Perhaps § 199A will expire before its evolution is complete.

[126] I.R.C. § 6662(d)(1)(C).
[127] T.D. 9847, 84 Fed. Reg. 2,952, 2,952 (Feb. 8, 2019).
[128] *See* https://www.irs.gov/pub/irs-pdf/i1040gi.pdf.
[129] On February 13, 2019, the IRS released a draft of Form 8995, which will replace the worksheet in the 2019 tax returns. The draft form is available at https://www.irs.gov/pub/irs-dft/f8995--dft.pdf.
[130] *See* IRS Publication 535, Business Expenses (Jan. 25, 2019), at 50.