DEMYSTIFYING THE 20 PERCENT DEDUCTION FOR QUALIFIED BUSINESS INCOME UNDER SECTION 199A (PART 1)

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INTRODUCTION

The Tax Cuts and Jobs Act (TCJA) made significant changes to the Internal Revenue Code of 1986, as amended (Code). Two of the most significant changes made by the TCJA are the new 20 percent deduction from taxable income with respect to a qualified trade or business income (QBI), which, under Code Section 199A, is available to certain pass-through entities, trusts, estates and sole proprietorships, as well as the reduction of the tax rate applicable to C corporations to a flat 21 percent with the repeal of the corporate alternative minimum tax. Large corporations, however, are subject to a form of alternative minimum tax under Section 59A. The Section 199A deduction was designed to allow businesses in certain industry sectors, but clearly not all, to possibly obtain an effective federal income tax rate of 28.6 percent instead of 37 percent with respect to

all or a portion of its QBI. The Section 199A deduction is claimed at the individual taxpayer level, such as a shareholder in an S corporation, a partner in a partnership, or a sole proprietor. It is not available to a regular or C corporation. When the TCJA was enacted, owners of pass-through entities had to decide which one or more of their trades or businesses fell within the definition of a QBI — as per the legislative history and then the issuance of the Final Regulations — or if they were not qualified and would potentially be subject to the higher federal income tax rate.

The TCJA also introduced major reforms to the Code's international tax provisions, including the participation exemption on dividends received by a US shareholder with respect to a controlled foreign corporation (CFC), the repatriation of foreign accumulated earnings and profits under Section 965 applicable for taxable years of CFCs starting in 2017, and the global intangible low-taxed income (GILTI) under Section 951A, as well as the reduction in tax rates for US shareholders who are considered domestic corporations with respect to GILTI income and foreign-derived intangible income under Section 250. While the Section 199A deduction does not apply to foreign source income, US domestic corporations, including S corporations, as well as pass-through entities may be able to benefit from the international tax changes as well.[1]

Section 199A provides — effective for tax years beginning in 2018 through 2025 — a deduction of up to 20 percent of taxable income from a domestic QBI operated as a sole proprietorship or a pass-through entity, such as a partnership, S corporation, trust, or estate.[2] However, all that glitters — section 199A's 20 percent deduction from taxable income — is not gold. Section 199A: (i) does not apply to income from a non-qualified business; (ii) is subject to an annual limitation based on the individual taxpayer's pro rata share of the amount of W-2 wages paid with respect to the trade or business (W-2 wages), and/or (iii) does not apply to the unadjusted basis immediately after acquisition (UBIA) of qualified property held for use in the trade or business (UBIA of qualified property). Therefore, Section 199A may violate tax principles of fairness or what some refer to as principles of "horizontal equity" which means that taxpayers similarly situated should be subject to the same rules and limitations. It is clear that Section 199A suffers from Congressional bias. Particularly disadvantaged under Section 199A are service providers and their organizations such as lawyers, accountants, physicians, consultants, and other forms of non-qualified businesses referred to in Section 199A and the regulations as "specified service trades or businesses."

Taxpayers having taxable income for the year below a certain prescribed dollar amount may be able to claim the benefit of the Section 199A deduction even though the income is sourced from a "specified service trade or business." For 2018, the threshold amount for an individual was $157,500 and $315,000 for couples filing a joint return.[3] Where, for any tax year, the taxable income of a taxpayer is less than the sum of the threshold amount plus $50,000, $100,000 for married taxpayers filing a joint return, any specified service trade or business (SSTB) will still be treated as a qualified trade or business under Section 199A, but only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such SSTB will be taken into account in computing the QBI. The benefit from qualifying under Section 199A is quite clear: the reduction in the maximum rate of federal income tax from 37 percent to 29.6 percent on the taxpayer's QBI. For states that "piggy-back" their income tax base in general to the taxpayer's federal taxable income (plus certain modifications), the Section 199A deduction may have a corresponding benefit for state income tax purposes.[4]

Section 199A allows an individual taxpayer, including a trust or estate, a deduction from taxable income, i.e., after all other deductions and limitations have been taken into account, equal to 20 percent of the taxpayer's QBI, which includes the net amount of items of income, deduction, gain, and loss with respect to a QBI conducted by a partnership, S corporation or sole proprietorship. More particularly,

the Section 199A deduction is the lesser of the taxpayer's QBI or an amount equal to 20 percent of the excess, if any, of (i) the taxpayer's taxable income for the tax year over (ii) the taxpayer's net capital gain for such tax year.

This article will examine the application of Section 199A to many pass-through entities and sole proprietorships, specifically including S corporations and their shareholders, including trusts and estates. The QBI benefit only applies, with a major exception for individuals having taxable income below a threshold amount, to income from a "qualified trade or business" as compared with income from a "specified service trade or business." Additionally, the article will discuss new terms used in Section 199A, as well as the many unanswered questions and open issues under Section 199A that are primarily attributable to the speed at which the TCJA was drafted, revised, and passed into law, leaving little, if any, legislative history regarding the interpretation of Section 199A.

After having received comments from various industry groups, commentators, and academicians, the IRS issued proposed regulations on Section 199A on August 8, 2018 (the "Proposed Section 199A Regulations" or "Proposed Regulations"). After the comment period had run its course on January 18, 2019, the IRS issued final regulations (the "Section 199A Regulations" or as may also be referred to as the "Final Regulations" or "Regulations").[5]

The Final Regulations are comprised of various sections each providing applicable rules in the calculation of the Section 199A deduction. As will be discussed below, Treas. Reg. section 1.199A-1(b)(14) defines "trade or business" for purposes of Section 199A as a trade or business under Section 162 except the phrase does not include the trade or business of performing services as an employee. The Final Regulations provide that the determination of whether a trade or business exists for purposes of Section 199A is based on all relevant facts and circumstances. In addition, the IRS issued the Proposed Regulations in January 2019 on the treatment of previously suspended losses that constitute "qualified business income" and on the determination of the Section 199A deduction for taxpayers that hold interests in regulated investment companies (RICs), charitable remainder trusts, and split-interest trusts.[6] Under Treas. Reg. section 1.199A-2(b)(2)(iv)(A), the IRS was granted authority to issue guidance providing methods to calculate W-2 wages. Pursuant to such authority, the IRS, with the Final Regulations, simultaneously issued Revenue Procedure 2019-11,[7] which provides three methods for calculating W-2 wages per Section 199A(b)(4), including amounts treated as elective deferrals.[8]

OVERVIEW OF THE SECTION 199A FINAL REGULATIONS

The Section 199A Final Regulations address computational, definitional, and anti-abuse guidance and are generally favorable to taxpayers. The Section 199A Final Regulations contain six substantive areas. The operational rules for application of Section 199A are set forth in Treas. Reg. section 1.199A-1, and provide guidance on the computation of the deduction for individuals with taxable income at, below, or above the threshold amount ($315,000 for married taxpayers filing jointly and $157,500 for other taxpayers for 2018 returns), including application of Section 199A to taxpayers within the phase-in range above the threshold amount (between $315,000 and $415,000 for married taxpayers filing jointly and between $157,500 and $207,500 for other taxpayers, again for 2018).[9] Once a taxpayer's taxable income exceeds the fully phased-in amounts ($415,000 for married taxpayers filing jointly and $207,500 for other taxpayers), the wage and capital limitations fully apply to owners of qualified trades or businesses (QTBs), and owners of SSTBs are not eligible for the Section 199A deduction at all.[10] It is important to note that Section 199A only applies for taxable years beginning in 2018 through 2025. Unless extended or made permanent by Congress, Section 199A will expire after 2025.

Where an owner of a QTB is subject to the wage or capital investment limitations, the Section 199A deduction is limited to the greater of: (i) the taxpayer's allocable share of 50 percent of the W-2 wages

of the QTB; or (ii) the taxpayer's allocable share of 25 percent of the W-2 wages of the QTB plus 2.5 percent of the UBIA of the "qualified property" used in such trade or business. There is an overall limitation whereby an individual's Section 199A deduction may not exceed 20 percent of the amount by which the individual's taxable income exceeds such individual's net capital gain for the taxable year.[11] In other words, net capital gains are given a preferential tax rate, as are qualified dividends, and neither is part of the Section 199A matrix.

Wages and UBIA of qualified property

Treas. Reg. section 1.199A-2 sets forth rules for computing W-2 wages and the UBIA of qualified property. The determination of W-2 wages is required to be made for each trade or business or relevant pass-through entity (RPE) such as a partnership, limited liability company taxed as a partnership, or sole proprietorship, which directly conducts the trade or business (or aggregated trade or business).[12] For W-2 wages paid by an RPE, the RPE must determine and report on Schedules K-1 the W-2 wages for each trade or business (or aggregated trade or business) conducted by the RPE on its information return as well as with respect to the Forms K-1 that are issued to its shareholders or partners. The Final Regulations warn that "W-2 wages are presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business."[13] The calculation of W-2 wages paid is set forth in a three-step model in the Regulations. Included in this process are the important "aggregation rules" as discussed below in computing the wage and UBIA limitations.[14]

QBI, qualified real estate investment trust dividends, and qualified publicly traded partnership income

Section 199A also permits individuals and some trusts and estates (but not corporations) a deduction of up to 20 percent of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, including qualified REIT dividends and qualified PTP income earned through pass-through entities. Guidance on determining QBI, qualified REIT dividends, and qualified PTP income is set forth in Treas. Reg. section 1.199A-3.

The aggregation rules, including the aggregation election

The aggregation rule contained in Treas. Reg. section 1.199A-5 allows a taxpayer to aggregate separate trades or businesses (even if conducted as different legal entities) as if they were a single (qualified) trade or business, provided certain requirements are met. Aggregation is generally allowed based on a 50 percent common ownership test for the majority of the taxable year. It is elective. The reporting and record-keeping requirements of the aggregated QBIs can also be challenging.

On the other hand, where an RPE or individual taxpayer is engaged in more than one QTB, Treas. Reg. section 1.199A-6 requires an entity to separately report its QBI, W-2 wages, UBIA of qualified property, and its SSTB information for each trade or business engaged in by the entity. The Final Regulations apply a facts-and-circumstances test on whether a single entity is engaged in the conduct of multiple trades or businesses. The Treasury Department and the IRS also believe that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under Section 1.446-1(d). Section 1.446-1(d) explains that no trade or business is considered separate and distinct unless a complete and separable set of books and records is kept for that trade or business. Further, trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected.

Specified service trades or businesses

Income from an SSTB as well as its W-2 wages and UBIA are not taken into account in determining the deduction allowable under Section 199A. For instance, assume a real estate broker earns $2 million in brokerage commissions in 2021 as a sole

proprietor. She has no employees and uses a computer that is more than 10 years old. Let's assume her real estate brokerage income is QBI. Her Section 199A deduction is still $0 for such year. Her income is QBI but the W-2 wage limitation is $0 and the UBIA limitation is $0. She is taxed at 37 percent on her QBI income. Is that fair? Compare this result with a real estate brokerage firm operated as a flow-through or transparent entity, e.g., an S corporation. The employees hired by such S corporation generate fees and commissions of much greater amounts but its taxable income is still $2 million, and the shareholder or shareholders of the S corporation with QBI have payroll and/or UBIA. This makes a difference under Section 199A since the limitation allows 50 percent of the W-2 wages or 2.5 percent of UBIA, whichever is greater, to be the deductible amount under Section 199A to the shareholder or shareholders.

The Regulations provide detailed descriptions in applying the statutory language as to what is an SSTB and therefore what may not be a QBI. Treas. Reg. section 1.199A-5 sets forth definitions for the following enumerated professions: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. Treas. Reg. section 1.199A-5 also defines what constitutes investing and investment management, trading, and dealing in securities, partnership interests, or commodities.

What about the "star of the show" individual who generates goodwill for the QBI through her efforts and skills driving up business value and generating income? Well, such value added should be treated as part of the business and not separated out, correct? Section 1202(e)(3)(A) lists businesses which are "services" businesses and therefore not QBIs. That list contains: (i) health; (ii) law; (iii) accounting; (iv) the performing arts; (v) actuarial science; (vi) consulting; (vii) athletics; (viii) financial services; (ix) brokerage services as defined; and (x) a final "reputational" residual category which includes any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.[15] There was a fair amount of concern sourced from the professional community and commentators prior to the issuance of the Final Regulations contained in the Proposed Regulations section 1.199A-5(b)(2)(xiv), where the Service could "gin up," so to speak, a "reputation or skill" challenge to the owner or owners of relevant pass-through entities (RPEs) or sole proprietors who otherwise were clearly engaged in a qualified trade or business. The Final Regulations responded to the "noise" generated from the professional community and greatly limited the scope of the "reputation or skill" standard. The Final Regulations section 1.199A-5(b)(2)(xiv) provides that for purposes of Section 199A(d)(2), "reputation or skill" of an employee or owner means any trade or business that consists of any of the following or any combination thereof; to wit: (i) a trade or business in which a person receives fees, compensation, or other income for endorsing products or services; (ii) a trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; and (iii) receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

Pass-through entities, publicly traded partnerships, trusts and estates

RPEs, PTPs, and trusts and estates are addressed in Treas. Reg. section 1.199A-6. An RPE is a flow-through entity including a partnership, S corporation, even a trust or estate. A trust or estate is treated as an RPE to the extent that it passes through distributable net income that is comprised of QBI as well as W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income. The Treasury Department and the IRS declined to adopt the recommendation that would allow regulated investment companies (RICs) to be considered RPEs since RICs are C corporations and are not pass-through entities.

Section 199A anti-abuse rules

While it may be fair to evaluate the Section 199A Regulations as fair, those who may approach the edge of the Section 199A tax cliff must take into

account the anti-abuse rules in Section 199A. These anti-abuse provisions largely prohibit the so-called "crack-and-pack" strategy, which involves spinning-off a portion of an SSTB to a separate entity so that the spun-off entity can claim the Section 199A deduction as a QTB. The Final Regulations under Section 199A also provide an anti-abuse rule where a trust (or trusts) are used for a principal purpose of avoiding the, or using more than one, threshold amount, which is a species of the proscription of multiple trusts in certain instances. More specifically, Final Regulations issued under Section 643(f) grants the Secretary authority to treat two or more trusts as a single trust for purposes of Subchapter J if: (i) the trusts have substantially the same grantors and substantially the same primary beneficiaries and (ii) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1 of the Code. Section 643(f) further provides that, for these purposes, spouses are treated as a single person.

Fiscal-year taxpayers

The Final Regulations also address how to treat income received from a fiscal-year pass-through entity when part of the income received by an individual is received before January 1, 2018. The Section 199A Final Regulations allow an individual to take a deduction for all of the income received from a fiscal-year filer, which could include income earned by the pass-through entity in 2017.

Effective dates

The rules under the Final Regulations generally apply to tax years ending after the date the Final Regulations were published (January 18, 2019). However, taxpayers may rely on the Final Regulations in their entirety, or on the Proposed Regulations in their entirety, for taxable years ending in calendar year 2018. Additionally, the anti-abuse rule contained in Final Regulations section 1.199A-5(c)(2) regarding the so-called "crack-and-pack" strategy, as well as the rebuttable presumption treating former employees as employees set forth in Final Regulations section 1.199A-5(d)(3) apply to taxable years ending after December 22, 2017. Finally, the anti-abuse rule contained in Final Regulations section 199A-6(d)(3)(vii) regarding the anti-abuse rule for the creation of a trust to avoid exceeding the "threshold amount" applies to taxable years ending after December 22, 2017, and the anti-abuse rule contained in Treas. Reg. section 1.643(f)-1 regarding the treatment of multiple trusts applies to taxable years ending after August 16, 2018 (although the IRS expressed its opinion that the anti-abuse rule under Treas. Reg. section 1.643(f)-1 generally should be applicable prior to August 16, 2018).

OPERATIONAL RULES AND DEFINITIONS: TAKING A MUCH CLOSER LOOK AT SECTION 199A AND THE REGULATIONS

Treas. Reg. section 1.199A-1 provides operational rules for calculating the Section 199A qualified business income deduction and provides a number of definitions that apply for purposes of Section 199A and Treas. Reg. section 1.199A-1 through section 1.199A-6.[16]

There are important definitions or operative terms that must be understood and applied in accordance with Section 199A. Treas. Reg. section 1.199A-1(b)(1)-(16) sets forth a number of definitions under the Regulations. Among the most notable are:

- An "aggregated trade or business" means two or more businesses that have been aggregated pursuant to the aggregation rules of Treas. Reg. section 1.199A-4;
- The "applicable percentage" means, with respect to any taxable year, 100 percent reduced (but not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return);
- The "phase in-range" means a range of taxable income, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus $50,000 (or $100,000 in the case of a joint return);
- "QBI" means the net amount of qualified items of income, gain, deduction, and loss with

respect to any trade or business and is discussed in more detail below in connection with the provisions of Treas. Reg. section 1.199A-3(b);

- The term "reduction amount" means, with respect to any taxable year, the "excess amount" multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount bears to $50,000 (or $100,000 in the case of a joint return). In general, the excess amount is 20 percent of the QBI over the greater of 50 percent of W-2 wages or the sum of 25 percent of W-2 wages plus 2.5 percent of the UBIA of qualified property. The term W-2 wages means a trade or business's W-2 wages properly allocable to QBI is discussed in more detail in connection with Treas. Reg. section 1.199A-2(b);
- "RPE" means a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, Qualified REIT Dividends and/or Qualified PTP Income;
- An "SSTB" is defined as set forth in Treas. Reg. section 1.199A-5(b);
- The term "total QBI amount" means the net total QBI from all trades or businesses (including an individual's share of QBI from trades or businesses conducted by RPEs);
- Treas. Reg. section 1.199-1(b)(13) defines a "trade or business" for purposes of Section 199A as a "Section 162 Trade or Business" other than the trade or business of performing services as an employee.[17] Additionally, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a Section 162 Trade or Business will nevertheless be treated as a trade or business for purposes of Section 199A if the property is rented or licensed to a trade or business which is commonly controlled under Treas. Reg. section 1.199A-4(b)(1)(i), regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under the rules of Treas. Reg. section 1.199A-4. The trade or business requirement, and particularly its application to rental real estate, is discussed in more detail below;
- For purposes of Section 199A, "qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, which is used in the production of QBI sometime during the taxable year, and for which the depreciable period has not expired before the close of the taxable year.

Computation of Section 199A deduction for individuals with taxable income not exceeding threshold amount

Where an individual's taxable income does not exceed the applicable "threshold amount," such individual's Section 199A deduction is determined by adding 20 percent of the QBI amount (including QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends, and qualified PTP income from RPEs). That amount is then compared to 20 percent of the amount by which the individual's taxable income exceeds the individual's net capital gain for the taxable year, and the lesser of these two amounts is the individual's Section 199A deduction.[18]

Where a taxpayer's total QBI amount is less than zero, the portion of the individual's Section 199A deduction related to QBI is zero for the taxable year and the negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of Section 199A.[19] A similar rule and separate calculation applies where the combined amount of qualified REIT dividends and qualified PTP income is less than zero.[20]

Computation of the Section 199A deduction for individuals with taxable income above the threshold amount

In general

The Section 199A deduction is determined for individuals with taxable income for the taxable year

that exceeds the threshold amount by adding the QBI component and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income, and comparing such amount to 20 percent of the amount by which the individual's taxable income exceeds his or her net capital gain for the taxable year. The lesser of those two amounts is the individual's Section 199A deduction.[21]

Computational rules in determining Section 199A deduction

The QBI component is determined by applying the following computational rules in the following order, for an individual with taxable income for the taxable year that exceeds the threshold amount: (i) where the individual's taxable income is within the "phase-in range," then only the "applicable percentage" of QBI, W-2 wages, and UBIA amount for each SSTB is taken into account for purposes of determining the individual's Section 199A deduction; (ii) where the individual's taxable income exceeds the phase-in range, then the individual's Section 199A deduction is zero with respect to an SSTB.[22]

Consequence of aggregation election

When an individual chooses to aggregate trades or businesses under the rules of Treas. Reg. section 1.199A-4, the individual must combine the QBI, W-2 wages, and UBIA of qualified property of each trade or business within an aggregated trade or business *prior* to applying the "wage and capital limitations" (sometimes referred to as the W-2 wages and UBIA of qualified property limitations).[23] Treas. Reg. section 1.199A-4(b)(1) provides that trades or business may be aggregated only if an individual can demonstrate that: (i) the same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an "S" corporation, 50 percent or more of the issued and outstanding shares of stock of the corporation, or, in the case of such trades or businesses operated by a partnership, 50 percent or more of the capital or profits in the partnership (the ownership rule does not require that every person involved in the ownership determination own an interest in every trade or business, but rather, the rule is satisfied so long as one person or group of persons holds a 50 percent or more common ownership interest in each trade or business); (ii) the ownership described in (i) above exists for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income (the Final Regulations clarify that the "majority of the taxable year" must include the last day of the taxable year); (iii) all of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years; (iv) none of the trades or businesses to be aggregated are an SSTB; and (v) the trades or businesses to be aggregated satisfy at least two of the following factors based on all the facts and circumstances: (a) the trades or businesses provide products and services that are the same or customarily offered together; (b) the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or (c) the trades or businesses are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

Where an individual's QBI from *all* trades or businesses combined is less than zero, the QBI component is zero for the taxable year, such negative amount is treated as negative QBI from a separate trade or business in the succeeding year of the individual for purposes of Section 199A. It is important to note, however, that the W-2 wages and UBIA of qualified property from the trades or businesses which produced the negative QBI are *not* taken into account for purposes of computing the Section 199A deduction and are *not* carried over to the subsequent year.[24]

Qualified Business Income

Where a taxpayer is engaged in a Section 162 trade or business, the taxpayer must determine the QBI for each separate qualified trade or business. The term "QBI" generally means the net amount of "qualified items of income, gain, deduction and loss" with

respect to any "qualified trade or business" of the taxpayer. Qualified items of income, gain, deduction, and loss mean items of income, gain, deduction, and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States. However, in the case of a taxpayer who otherwise has QBI from sources within the Commonwealth of Puerto Rico, provided all of the income is taxable, the taxpayer's income from Puerto Rico will be included in determining the individual's QBI. The QBI component is the sum of such amounts determined for each trade or business. For each trade or business (including trades or businesses operated through RPEs), the individual must determine the lesser of (i) 20 percent of the QBI for that trade or business; or (ii) the greater of 50 percent of W-2 wages with respect to that trade or business, or the sum of 25 percent of W-2 wages with respect to such trade or business plus 2.5 percent of the UBIA of qualified property with respect to such trade or business.[25] However, in the case of a taxpayer who otherwise has QBI from sources within the Commonwealth of Puerto Rico, provided all of the income is taxable, the taxpayer's income from Puerto Rico will be included in determining the individual's QBI. Where an individual's taxable income is within the phase-in range and the amount determined under the wage and capital imitations is less than 20 percent of the QBI with respect to such trade or business, the QBI component for the trade or business will be reduced by the "reduction amount".[26] The Final Regulations clarify that for taxpayers with taxable income within the phase-in range, QBI from an SSTB must be reduced by the applicable percentage before the application of the netting and carryover rules described in Treas. Reg. section 1.199A-1(d)(2)(iii)(A).

Negative combined qualified REIT dividend/qualified PTP income

Where the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's section 199A deduction related to qualified REIT dividends and qualified PTP income will be zero for the taxable year, and the negative combined amount will be carried forward and used to offset the combined amount of REIT dividends/PTP income in the succeeding taxable year of the individual for purposes of Section 199A.[27]

Added operational rules

Effect of deduction

In the case of a partnership or S corporation, Section 199A is applied at the partner or shareholder level. The Section 199A deduction has *no* effect on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.[28]

Disregarded entities

An entity with a single owner that is treated as disregarded as an entity separate from its owner is disregarded for purposes of Section 199A and Treas. Reg. sections 1.199A-1 through 1.199A-6.[29]

Self-employment tax and net investment income

The Section 199A deduction does not reduce net earnings from self-employment under Section 1402 or the amount of net investment income under Section 1411.[30]

Coordination with alternative minimum tax

For purposes of determining alternative minimum taxable income under Section 55, the deduction allowed under Section 199A(a) for a taxable year is equal in amount to the deduction allowed under Section 199A(a) in determining regular taxable income for such taxable year. In other words, the Section 199A deduction is allowable for both regular tax and alternative minimum tax purposes.[31]

Imposition of accuracy-related penalty and underpayments

Section 6662(a) provides a penalty for an underpayment of tax required to be shown on a return. Under Section 6662(b)(2), the penalty applies to the portion of any underpayment that is attributable to a substantial understatement of income tax. A substantial understatement of income tax is defined

under Section 6662(d)(1) as an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return, or $5,000. Section 6662(d)(1)(C) sets forth a lower threshold to impose an accuracy-related penalty under Section 6662(d)(1)(A) by substituting five percent for 10 percent.[32] The purpose of lowering the percentage from 10 percent to five percent in order for the Section 6662(a) penalty to apply, was that Congress believed this would discourage taxpayers from "playing games" or manipulating the Section 199A deduction.

Reduction for income received from cooperatives

Treas. Reg. section 1.199A-1(e)(7) discusses the computation of the Section 199A deduction in the case of any trade or business of a patron of a specified agricultural or horticultural cooperative. The Section 199A deduction applicable to members of a cooperative is beyond the scope of this article.

Phase-in of wage and capital limitations

For taxpayers with taxable income between $157,500 and $207,500 ($157,500 plus $50,000), or with respect to married individuals filing jointly with taxable income between $315,000 and $415,000 ($315,000 plus $100,000)(for 2018), the wage and capital limitations are phased in. Specifically, if the wage and capital limit is less than 20 percent of the taxpayer's QBI with respect to the qualified trade or business, the taxpayer's deductible amount is determined by reducing 20 percent of QBI by the same proportion of the difference between 20 percent of the QBI and the wage and capital limit as the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 ($100,000 in the case of a joint return). Once the taxpayer has $207,500 of taxable income, or $415,000 of taxable income in the case of a married individual filing a joint return, the wage and capital limitations apply fully to the taxpayer.

Trade or business requirement, rental real estate, and QBI

In applying the QBI and SSTB rules, a trade or business under Section 162 (a "Section 162 Trade or Business") is defined as a trade or business other than the trade or business of performing services as an employee. There is no "bright line" test of when an activity constitutes a Section 162 Trade or Business.[33] It is a facts-and-circumstances test. The taxpayer asserting it, as an RPE in the trade or business of renting real property, has the burden of proof to establish by a preponderance of the evidence that it is so engaged in accordance with the case law and also, as to Section 199A, with respect to the statute and to Section 199A Regulations.

The Section 162 Trade or Business standard is difficult to apply to rental real estate activities. The Preamble to the Final Regulations provides that in determining whether a rental real estate activity is a Section 162 Trade or Business, relevant factors might include, but are not limited to: the type of rental property (commercial real property versus residential property); the number of properties rented; the owner's or the owner's agent's day-to-day involvement; the types and significance of any ancillary services provided under the lease; and the terms of the lease (for example, a net lease versus a traditional lease and short-term lease versus a long-term lease). In order to provide further clarity as to when a rental real estate activity constitutes a Section 162 Trade or Business the IRS issued Notice 2019-07,[34] which sets forth a safe harbor for when a rental activity will rise to the level of a Section 162 Trade or Business.

A leading case in this area is Curphey v. Comm'r.[35] The taxpayer, a dermatologist employed by a hospital, also owned and managed six rental properties. The year in issue was 1976. The taxpayer self-managed the rental properties. The petitioner treated the rental properties as a trade or business. The government sought to disallow the expenses as not being attributable to the carrying on of a trade or business by application of Section 280A (disallowaning certain expenses in connection with business use of home, rental, etc.) as well as Section 212 and the Supreme Court's decision in Higgins v. Comm'r.[36] While the Court accepted the government's argument with respect to the taxpayer's personal use of a unit, it found that the taxpayer's rental real estate activities constituted a trade or business. It acknowledged that in its decisions after Higgins, the Court has held that

the rental of even a single piece of real property for the production of income constitutes a trade or business.[37] The Court, in finding for the taxpayer, opined that the issue is to be resolved on all facts and circumstances where the scope of ownership and management activities are important. The facts in Curphey demonstrated that the taxpayer's activities were sufficiently regular, systematic, and continuous to place him in the business of rental real estate.[38]

The Preamble to the Final Regulations under Section 199A note the factors to be used in determining whether a rental real estate activity is a Section 162 trade or business. Such factors include: (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease). While the Final Regulations failed to adopt a bright line rule in response to many comments received, the IRS issued a safe harbor notice in Rev. Proc. 2019-38, 2019-42 IRB 942 (9/24/2019).[39]

Rev. Proc. 2019-38: Rental real estate safe harbor guidance

Revenue Procedure 2019-38, sets forth a safe harbor for when interests in rental real estate will be treated as a trade or business for purposes of Section 199A. Revenue Procedure 2019-38 generally follows an earlier IRS pronouncement, Notice 2019-07, which contained a proposed version of the safe harbor. Under Revenue Procedure 2019-38, a "rental real estate enterprise" under the safe harbor rule is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interest in multiple properties. The taxpayer or RPE must hold each interest directly or through an entity disregarded as an entity separate from its owner.

Taxpayers and RPEs may either treat each interest in "similar" property held for the production of rents as separate rental real estate enterprises or treat interests in all similar properties held for the production of rents as a single rental real estate enterprise. Properties held for the production of rents are treated as similar if they are part of the same rental real estate category. The two types of rental real estate categories for purposes of combining properties under the safe harbor into a single rental real estate enterprise are residential and commercial. Consequently, except for mixed-use property, which will be discussed below, commercial real estate held for the production of rents may only be part of the same rental real estate enterprise with other commercial real estate, and residential properties may only be a part of the same rental real estate enterprise with other residential properties. Revenue Procedure 2019-38 provides that an interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. A mixed-use property is defined as a single building that combines residential and commercial units. An interest in mixed-use property, if treated as a single rental real estate enterprise, may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property.

Once a taxpayer or RPE treats interests in similar commercial properties or similar residential properties as a single rental real estate enterprise under the safe harbor, the taxpayer or RPE must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when the taxpayer or RPE continues to rely on the safe harbor.

In qualifying a real estate activity under the Revenue Procedure 2019-38 safe harbor: (i) separate books and records must be maintained to reflect income and expenses for each rental real estate enterprise; (ii) at least 250 hours or more of "rental services" must be performed per year for the rental real estate enterprise; and (iii) the taxpayer must maintain contemporaneous records, including time reports or similar documents regarding hours of all services performed, a description of all services performed, the dates on which such services are performed, and who performed such services.

Property used as a personal residence and triple net leases

The Revenue Procedure 2019-38 safe harbor is unavailable for the rental of any residence that the taxpayer uses as a personal residence for more than 14 days during the year. Even more significantly, the Final Regulations provide that a taxpayer cannot use the safe harbor for any property rented on a "triple net lease" basis. Under Notice 2019-07, "[A] triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be *responsible* for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant." (emphasis added). Under Revenue Procedure 2019-38, "[A] triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to *pay* for maintenance activities for the property in addition to rent and utilities."(emphasis added). The significance of changing the definition from being responsible for maintenance activities to paying for maintenance activities is unclear. The definition still leaves the door open for other leases, such as where leases are restructured to provide that the lessor will pay for the real estate taxes and/or insurance on the property, to possibly be treated as triple net leases by the IRS, and thus not fall within the safe harbor.

Reporting requirements for rental real estate safe harbor

The taxpayer or RPE is required to attach a statement to a timely-filed original return (or the amended return for the 2018 taxable year only) for each taxable year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on the safe harbor may submit a single statement and the statement must list the required information separately for each rental real estate enterprise. The guidance sets forth the quality and quantity of information to be provided.

Rentals to a related party

The definition of a trade or business, solely for purposes of Section 199A, also includes the rental or licensing of tangible or intangible property to a related trade or business if the rental or licensing activity and the other trade or business are commonly controlled. The Final Regulations provide that the related-party rules under Sections 267(b) and 707(b) will be used to determine related parties for purposes of this special rule using a 50 percent or more relationship test. This rule, when its requirements are met, also allows taxpayers to aggregate their trades or businesses with the leasing or licensing of the associated rental or intangible property.

The Final Regulations also clarify that the special rule only applies to situations in which the related party is an individual or RPE, and as such, will not apply to a rental to a C corporation. 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, estate, or trust. Additionally, a trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income.

Determination of separate trades or businesses

The Final Regulations did not address the issue of whether a taxpayer is engaged in one trade or business or more than one trade or business when evaluating the separate and combined activities of the taxpayer or RPE. *However, the Preamble to the Final Regulations comments that no trade or business will be considered separate or distinct unless a complete separate set of books and records is kept for such trade or business*. The Preamble to the Final Regulations further notes that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under the Section 446 Regulations. That is a strong position to take, isn't it? In digging deeper, we know that Treas. Reg. section 1.446-1(d) does not provide guidance on when trades or businesses will be considered separate and distinct. Instead, it provides that a taxpayer can use different methods of

accounting for separate and distinct trades or businesses and specifies two circumstances in which trades or businesses will not be considered separate and distinct. Treas. Reg. section 1.446-1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete separate set of books and records is kept for such trade or business. Factors indicating whether a taxpayer is engaged in multiple trades or businesses with some or all being QTBs or SSTBs include: (i) separate books and records maintained for each purported business; (ii) separate facilities; (iii) operations in separate locations; (iv) separate workforce; (v) separate bank and investment accounts; (vi) operation of separate types of businesses or activities; (vii) whether the businesses are held out to the public as separate trades or businesses; and (viii) whether the operations are housed in separate legal entities.

Employee status is not a qualified business

A qualified trade or business means a trade or business *other than* an SSTB and *other than* the trade or business of being an employee. Treas. Reg. section 1.199A-5(d)(1) provides that the trade or business of performing services as an employee is not a trade or business under Section 199A. Can "former employees" be repositioned as independent contractors to qualify to some extent for the deduction available under Section 199A? Proposed Regulations section 1.199A-5(d)(3)(i) provided that solely for purposes of Section 199A(d)(1)(B), an individual who was correctly treated as an employee for federal employment tax purposes in rendering services and who was subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or related person), is nevertheless presumed to be in the trade or business of performing services as an employee with regard to such services. The Regulations state that this presumption will apply to the individual only if such individual was an employee of the entity during the three-year period prior to the date such individual was treated as other than an employee with respect to such entity. This presumption may be rebutted upon a showing by the individual that, under federal tax law, regulations, and principles (including common-law employee classifications rules), the individual is performing services in a capacity other than as an employee. The presumption also applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

Mechanics of Section 199A deduction

The deduction reduces a taxpayer's taxable income but not his or her adjusted gross income (i.e., it is a "below the line" deduction). However, the deduction is available whether one itemizes deductions or takes the standard deduction. Under Section 199A(c)(2), if the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount will be treated as a loss from a qualified trade or business in the succeeding taxable year. Consequently, even if such loss is used in computing taxable income in Year One, when you get to Year Two, that QBI loss carries over and reduces the QBI for Year Two solely for purposes of computing the 20 percent of QBI deduction. Additionally, under Section 172(d)(8), if a taxpayer has a Section 199A deduction in a year in which such taxpayer has a net operating loss, the taxpayer's net operating loss does *not* include the Section 199A deduction.

Determination of QBI in general

QBI must be determined and reported for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of Treas. Reg. section 1.199A-4. QBI means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer, provided the other requirements of Section 199A are satisfied: (i) gain or loss attributable to assets of a partnership giving rise to ordinary income under Section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and as such, is taken into account for purposes of computing QBI. The Section 199A Regulations provide that income attributable to a guaranteed payment for the use of capital (as well as for services) is

not considered to be attributable to a trade or business, and consequently is not taken into account for purposes of computing QBI. However, the partnership's deduction associated with the guaranteed payment for the use of capital will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes. Section 481 adjustments (whether positive or negative) will be taken into account for purposes of computing QBI to the extent that the requirements of Section 199A are otherwise satisfied, but only if the adjustment arises in taxable years after December 31, 2017. In general, losses or deductions which were previously disallowed (including under Sections 465, 469, 704(d) and 1366(d)), which are allowed in the taxable year are also taken into account for purposes of computing QBI for such taxable year. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 are *not* taken into account in a later taxable year for purposes of computing QBI. Still, such suspended losses may be used in computing taxable income in a manner that does not take Section 199A into account. The Final Regulations provide that any losses disallowed, suspended, or limited under the provisions of Section 465, 469, 704(d) and 1366(d), or any other similar provisions, whether such losses occur before or after January 1, 2018, shall be used, for purposes of Section 199A and the Regulations thereunder, in order from the oldest to the most recent on a FIFO (first-in, first-out) basis. Concurrently with the issuance of the Final Regulations, the Treasury Department and the IRS published Proposed Regulations under Section 199A that treat previously suspended losses as losses from a separate trade or business for purposes of Section 199A.[40]

Qualified items of income, gain, deduction, and loss

This term generally means items of gross income, gain, deduction, and loss to the extent that such items are effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the taxable year.[41] Treas. Reg. section 1.199A-3(b)(2)(ii) specifies that certain items are *not* taken into account as a qualified item of income, gain, deduction, or loss in computing QBI, including: (i) capital gains or losses; (ii) dividend income; (iii) interest income other than generated from a trade or business; (iv) commodities or currency gain or loss; (v) annuity payments not received in connection with a trade or busines; (vi) qualified REIT dividends or qualified PTP income; (vii) reasonable compensation received by a shareholder-employee of an S corporation. Note that the S corporation's deduction for such reasonable compensation will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes; (viii) a guaranteed payment under Section 707(c) received by a partner with respect to the trade or business. However, the partnership's deduction for such guaranteed payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible; and (ix) any Section 707(a) received by a partner for services rendered with respect to the trade or business. Again, however, the partnership's deduction for such payment will reduce QBI if the deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.

Deductions for wages paid

Expenses for all wages paid (or incurred in case of an accrual basis taxpayer) must be taken into account in computing QBI regardless of the application of the W-2 wage limitation.[42]

Computation of QBI for multiple trades or businesses

In the case of an individual or RPE directly conducting multiple trades or businesses, where such items of QBI are properly attributable to more than one of the trades or businesses, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a "reasonable method" based on all the facts and circumstances. The Section 199A Regulations provide that the individual or RPE may use a different reasonable method for different items of income, gain,

deduction, and loss, but that the chosen reasonable method for each item must be consistently applied from one taxable year to the next and must clearly reflect the income and expenses of each trade or business. The books and records maintained for a trade or business also must be consistent with any allocations of items of QBI thereunder.[43]

Qualified REIT dividends and PTP income

Treas. Reg. section 1.199A-3(c) sets forth the meanings of qualified REIT dividends and qualified PTP income, and provides that the rules applicable to the determination of QBI also applies to the determination of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP. The Proposed Regulations provide that a REIT dividend is not a qualified REIT dividend for purposes of Section 199A if the stock with respect to which it is received is held for fewer than 45 days, taking into account the principles of Sections 246(c)(3) and (4). The Final Regulations define the holding period for the REIT stock based on Section 246(c)(1)(A) — share(s) of REIT stock held by the taxpayer for more than 45 days during the 91-day period beginning on the date which is 45 days before the date on which such REIT share(s) becomes ex-dividend or to the extent the taxpayer is under an obligation (whether under a short sale obligation or otherwise) to make related payments with respect to positions in substantially similar or related property. Further guidance on this issue is to be provided by the Treasury Department and the IRS.

Wage and capital limitations

For businesses other than an SSTB (and for which the taxpayer's taxable income exceeds (for 2018) $207,500 ($157,500 + $50,000 phase-in amount), or $415,000 ($315,000 + $100,000 phase-in amount) if married filing jointly, the deductible amount for each qualified trade or business carried on by the S corporation, partnership, LLC or sole proprietorship is, as discussed above, the lesser of (i) 20 percent of the taxpayer's allocable share of QBI with respect to the qualified trade or business; or (ii) the greater of (a) the taxpayer's allocable share of 50 percent of the W-2 wages with respect to the qualified trade or business, or (b) the taxpayer's allocable share of the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of all "qualified property" (the "wage and capital limitations," sometimes referred to as the "W-2 and UBIA of qualified property limitations").

W-2 wages

For purposes of Section 199A, W-2 wages means amounts described in Sections 6051(a)(3) and (8) paid to employees by the taxpayer operating the QTB during the calendar year ending during such taxable year. W-2 wages includes the total amount of wages as defined in Section 3401(a) plus the total amount of "elective deferrals" (within the meaning of Section 402(g)(3)), the compensation deferred under Section 457, and the amount of designated Roth contributions (as defined in Section 402A). The employees of the individual or RPE are limited to employees of the individual or RPE as defined in Sections 3121(d)(1) and (2). For purposes of Section 199A, this includes officers of an S corporation and employees of an individual or RPE under common law. It is important to note, however, that W-2 wages do not include payments made to an independent contractor or management fees or guaranteed payments to a partner performing services for the partnership. This definition raises issues for employees employed by an affiliated management company that leases the employees to an *operating* business or businesses. The question is whether wages paid by the management company or other third party can be taken into account with respect to each qualified trade or business even though it is operated in a separate taxable entity. The Section 199A Regulations answer this question affirmatively so long as the individual or RPE is the common law employer of such employees.[44]

Section 199A wages do not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date, including extensions, for such return. Consequently, compliance with such reporting rules is necessary to get credit for the maximum amount of W-2 wages.

Allocable share of QBI, W-2 wages, and UBIA

If there is more than one owner of the pass-through entity, each owner is only entitled to their "allocable share" of QBI, W-2 wages, and UBIA of qualified property, such as the stock percentage ownership of a shareholder of an S corporation. For partnerships, where special allocations may be made under Section 704(b), a partner's allocable share of QBI and of W-2 wages will be equal to the amount of wages of the qualifying trade or business allocated to such partner by the partnership.[45]

Qualified property

For purposes of Section 199A, Section 199A(b)(6)(A) provides that "qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, which is used in the production of QBI *sometime* during the taxable year, and for which the depreciable period has not expired before the close of the taxable year. The "depreciable period" must be used as such term is defined in Section 199A(b)(6)(B). The depreciable period begins with the date that the qualified property was first placed in service by the taxpayer and ending on the later of: (i) the date that is 10 years after such date, or (ii) the last day of the last full year in the applicable recovery period that would apply to the property per Section 168 but without regard to Section 168(g). An RPE engaged in one or more qualified trades or businesses must also make this determination. Partners and shareholders in an S corporation are annually allocated their "allocable share" of the unadjusted basis of qualified property, which will be equal to his or her percentage ownership in the stock of the S corporation. However, with respect to partners of a partnership (including LLCs taxed as partnerships), the partner's allocable share of the unadjusted basis of qualified property will be equal to the percentage of Section 704(b) book depreciation allocated to such partner by the partnership.[46]

UBIA and Treas. Reg. § 1.199A-2

Treas. Reg. section 1.199A-2(a)(3) provides rules for the determination of UBIA of qualified property for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of Treas. Reg. section 1.199A-4. For qualified property held by an RPE, the amount of the UBIA held by a partnership is allocated to each partner based on share of book depreciation. For an S corporation, each shareholder's share of the UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation. If the UBIA of the qualified property is not determined and reported for each trade or business, the UBIA of such qualified property is presumed to be zero.

The operative term is "qualified property," which means, per Treas. Reg. section 1.199A-2(c)(1)(i), with respect to any trade or business of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation under Section 167(a) that is: held by, and available for use in, the trade or business at the close of the taxable year; used at any point during the taxable year in the trade or business's production of QBI; and has a depreciable period that has not ended before the close of the individual or RPE's taxable year.

UBIA is the taxpayer's cost basis on the placed-in-service date of the qualified property under Section 1012 or other applicable provisions of the Code. UBIA is determined without regard to basis adjustments required under Sections 1016(a)(2) or 1016(a)(3), any adjustments for tax credits or any adjustments for any portion of the cost basis that the individual or RPE has elected to treat as an expense. Additional first year depreciation including a 100 percent charge to basis under Section 168(k) is not taken into account. UBIA does reflect the reduction in basis for the percentage of the individual's or RPE's use of property for the taxable year other than in the trade or business. In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as *separate* qualified property first placed in service on the date such addition or improvement is placed in service, pursuant to Treas. Reg. section 1.199A-2(c)(1)(ii).[47]

Acquired depreciable property

Acquired depreciable 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 can demonstrate that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction.[48]

As to exchange or transferred basis transactions, clarify that additional first-year depreciation allowable under Section 168 will not affect the applicable recovery period for the qualified property. As mentioned, UBIA of qualified property is determined without regard to any adjustments described in Sections 1016(a)(2) or 1016(a)(3), any adjustments for tax credits claimed by the taxpayer, or any adjustments for any portion of basis for which the taxpayer has elected to treat as an expense — for example, under Section 179.

UBIA for exchanged and transferred qualified property

After much debate and commentary issued criticizing the Proposed Regulations, the Final Regulations provide that qualified property contributed to a partnership or S corporation in a non-recognition transaction should generally retain its UBIA on the date it was first placed in service by the contributing partner or shareholder. Fairness prevailed! Other special rules apply to like-kind exchanges under Section 1031 and involuntary conversions under Section 1033 as well as other exchange basis or transferred basis transactions including transfers of property described in accordance with Sections 332, 351, 361, 721, 731, or any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.[49]

UBIA of qualified property acquired from decedent

The Final Regulations provide that for qualified property acquired from a decedent and immediately placed in service, the UBIA of the property will generally be the fair market value at the date of the decedent's death under Section 1014. Additionally, the Final Regulations provide that a new depreciable period for property commences as of the date of the decedent's death.

Specified service trade or business and Treas. Reg. § 1.199A-5

Perhaps the most important issue in Section 199A is, based on all the facts and circumstances, to what extent a taxpayer or an RPE is engaged in an activity as an SSTB as compared with a QBI. Section 199A defines a "specified service trade or business" as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. It should be noted that engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

Since an SSTB includes both "consulting" businesses, brokerage businesses, and "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners," there were (and to a lesser degree, still are) unanswered questions and uncertainty as to whether certain businesses constitute an SSTB and thus a substantial amount of litigation was expected to ensue on this critical issue.

Fortunately, as will be discussed in more detail below, the Section 199A Regulations answer many of the questions by narrowly defining specified service trades or businesses, including a "catch all" for any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. As with other areas of Section 199A, even after issuance of the Section 199A Final Regulations, there are still a number of open issues dealing with the definition of a "qualified trade or business" versus a "specified service trade or business" and the effect each may

have on the other. Also, see the prior discussion on rental real estate as an SSTB or QBI and the administrative safe harbor rule.

Deduction allowed for specified service trade or business if taxable income is less than threshold amounts

Even though an SSTB is not a qualified trade or business, such business will nevertheless be eligible for the 20 percent QBI deduction provided that the taxpayer's taxable income is less than the threshold amounts of $315,000 in the case of married individuals filing joint returns and $157,500 for all other taxpayers.

Example

Specified Service Trade or Business with Taxable Income Below Threshold Amount

A is a partner in a law firm operated as an LLC taxed as a partnership. During 2018, A is married and has total taxable income of $300,000 with his wife. A's allocable share of the QBI of the law firm is $250,000, his allocable share of W-2 wages of the law firm is $60,000, and his allocable share of the unadjusted basis of the qualified property of the law firm is $40,000.

Even though A derives his income from a specified service trade or business, he will receive a deduction of $50,000 ($250,000 x 20 percent). Because A's taxable income is below the Threshold Amount of $315,000, the wage and labor limitation won't apply (the greater of $30,000 (50 percent of $60,000) or $16,000 (25 percent of $60,000 plus 2.5 percent of $40,000).

Phase-out of deduction for specified service trades or businesses

The ability of a taxpayer to take the deduction for 20 percent of QBI for a specified service trade or business is phased out for a taxpayer having taxable income between $315,000 and $415,000 in the case of married individuals filing joint returns, and between $157,500 and $207,500 for all other taxpayers. Specifically, a taxpayer with taxable income within the phase-out range takes into account only the "applicable percentage" of qualified items of income, gain, deduction, or loss, and of allowable W-2 wages. The "applicable percentage" with respect to any taxable year is 100 percent reduced by the percentage equal to the ratio of the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 (or $100,000 in the case of a joint return).[50]

Definitions of specified service trades or businesses under Treas. Reg. § 1.199A-5

Treas. Reg. section 1.199A-5 sets forth definitions for the following enumerated professions: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services and brokerage services. Treas. Reg. section 1.199A-5 also defines what constitutes investing in investment management, trading, and dealing in securities, partnership interests, or commodities. These trades or businesses, including any trade or business where the principal or asset of such trade or business is the reputation or skill of one or more of its employees or owners, are treated as "Listed SSTBs" under Treas. Reg. section 1.199A-5(b)(1). The Final Regulations are mostly taxpayer-friendly and side with the majority of commentators by narrowly defining what constitutes a Listed SSTB. Additionally, the Final Regulations (like the Proposed Regulations) set forth a narrow definition as to what is included as an SSTB where the principal asset of the trade or business is the reputation or skill of one or more of its employees or owners.

The Preamble to the Proposed Regulations states that Section 199A is a new Code provision intended to benefit a wide range of businesses and makes references to Section 1202(e)(3)(A), Section 448(d)(2), and Treas. Reg. section 1.448-1T(e)(4)(i), and provides that although the cross-referenced sections are not determinative on whether a particular trade or business is an SSTB, guidance can be taken from such sources. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting and provides that qualified personal service corporations generally are not subject to the prohibition

from using the cash method. The definition of an SSTB under Section 199A is substantially similar to the list of service trades or businesses provided in Section 448(d)(2)(A) and Treas. Reg. section 1.448-1T(e)(4)(i). The Preamble further provides that Section 448(d)(2) emphasizes that it is the direct provision of services by the employees of a trade or business, rather than the application of capital that is critical in determining whether a corporation is a "qualified personal service corporation". Consistent with the rules of statutory construction generally and also based on the legislative history of Section 199A, the Preamble to the Proposed Regulations provides that Treas. Reg. section 1.199A-5(b) draws upon the existing guidance under Section 448(d)(2) when appropriate for purposes of Section 199A and generally follows the guidance issued under Section 448(d)(2), with some modifications. The Preamble further provides that whether a service is performed in a qualifying field under Section 448(d)(2) is to be decided by examining all relevant indicia and is not determined by the characterization of a particular business under state licensing laws, and that this approach is also appropriate for Section 199A purposes. Although the Preamble extensively discusses Section 448 and the Regulations thereunder, as well as Section 1202, the Section 199A Regulations themselves contain no reference to Section 448.

The Final Regulations added two rules of general application with respect to SSTBs. First, the Final Regulations specify that the rules for determining whether a business is an SSTB within the meaning of Section 199(d)(2) applies solely for purposes of Section 199A, and thus, may not be taken into account for purposes of applying any other provision of law, except to the extent that such a provision expressly refers to Section 199A(d). Second, the Final Regulations include a hedging transaction rule that is applicable to any trade or business conducted by an individual or an RPE. The hedging transaction rule provides that income, deduction, gain, or loss from a hedging transaction entered into in the normal course of a trade or business is included as income, deduction, gain or loss from that trade or business. A hedging transaction for these purposes is defined in Treas. Reg. section 1.1221-2(b) and Treas. Reg. section 1.446-4. It is also important to note the exception in Section 199A as to the trade or business of performing services as an employee. Under Treas. Reg. section 1.199A-5(a)(3), the trade or business of performing services as an employee is not a trade or business for purposes of Section 199A. Therefore, no items of income, gain, deduction, or loss from the trade or business of performing services as an employee constitute QBI within the meaning of section 199A and Treas. Reg. section 1.199A-3. A taxpayer may not claim a Section 199A deduction for wage income, regardless of the amount of taxable income.

Services performed in the fields of health

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(ii) means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar health care professionals performing services in their capacity as such. Contrary to Section 448 and the statement in the Preamble to the Proposed Regulations discussed above, the Final Regulations drop the additional language contained in the Proposed Regulations that indicated that medical professionals were required to "provide medical services directly to a patient" in order to fall within the field of health. The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. As an example of an excluded service, the Section 199A Final Regulations provide that the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.[51]

The Preamble to the Final Regulations also addresses the sale of pharmaceuticals and medical devices by a retail pharmacy by providing that such activities are not by themselves a trade or business performing services in the field of health. However, the Final Regulations also provide an example of services provided by

a retail pharmacy through a pharmacist that do constitute performance of services in the field of health. The Preamble to the Final Regulations also discusses arguments made by commentators that veterinary medicine should not be considered an SSTB. Citing Revenue Ruling 91-30, 1991-1 C.B. 61, the IRS stated that it believed it was appropriate to continue the long-standing treatment of veterinary services as the performance of services in the field of health for purposes of Section 199A in the Final Regulations.

Services performed in the field of law

The SSTB for law is identified in Treas. Reg. section 1.199A-5(b)(2)(iii) as the performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators and similar professionals performing services in their capacity as such. The SSTB field of law category does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

Services performed in the field of accounting

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(iv) means the performance of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such. The field of accounting does not include, however, payment processing and billing analysis.

Services performed in the field of actuarial science

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(v) means the performance of services by individuals such as actuaries and similar professionals performing services in their capacity as such. However, the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial cost of risks or uncertainty of events.

Services performed in the field of performing arts

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(vi) means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Likewise, the performance of services in the field of performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

Services performed in the field of consulting

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(vii) means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting specifically includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses. The determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business, including the manner in which the taxpayer is compensated for the services provided. The performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of the trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate

payment for the consulting services. The Final Regulations also clarify that a business which assists other businesses in meeting their personnel needs by referring job applicants to them is not engaged in the performance of services in the field of consulting when the compensation for the business referring job applicants is based on whether the applicants accept employment positions with the businesses searching for employees. Additionally, Final Regulations section 1.199A-5(b)(2)(vii) provides that services within the fields of architecture and engineering are *not* treated as consulting services for purposes of Section 199A.

Services performed in the field of athletics

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(viii) means the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. Again, the performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Likewise, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.[52] The Preamble to the Proposed Section 199A Regulations provides that if a partnership owns a professional sports team, a partner's distributive share of income from the partnership's athletic trade or business is not QBI, regardless of whether the partner participates in the partnership's trade or business. Following the issuance of the Proposed Regulations, a number of commentators suggested that the definition of a trade or business involving the performance of services in the field of athletics should not include the trade or business of owing a professional sports team, since such owners are *not* directly performing athletic activities. The Final Regulations rejected the arguments of the commentators, stating that while team owners are not performing athletic services directly, that is not a requirement of Section 199A, which looks to whether there is income attributable to a trade or business involving the performance of services in a specified activity, and not simply to who performed the services.

Services performed in the field of financial services

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(vix) means the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings, and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities or similar services. This includes services provided by financial advisors, investments bankers, wealth planners and retirement advisors and other similar professionals performing services in their capacity as such. The Final Regulations also expressly provide that although the performance of services in the field of financial services does not include taking deposits or making loans (i.e., banking), it does include arranging lending transactions between a lender and borrower.

Banking

Banking as such is specifically excluded from the definition of an SSTB in Treas. Reg. section 1.199A-5(b)(2)(ix). There were a number of comments submitted to the Treasury Department and the IRS that traditional banking activities, such as the performance of services that consist of dealing in securities, should be excluded from the definition of an SSTB when performed by a bank. The Final Regulations continue to exclude taking deposits or making loans from the definition of an SSTB involving the performance of financial services and also exclude the origination of loans from the definition of dealing in securities for purposes of Section 199A. However, the IRS expressly stated that it did not believe that there is a broad exemption from the Listed SSTBs with respect to all services that may be performed by banks. This suggests that a subchapter

S bank should segregate specified service activities from the trade or business of banking and operate such specified service activities as an SSTB separate from its banking trade or business, either within the same legal entity or in a separate entity.

Services performed in the field of brokerage services

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(x) means the performance of services in which a person arranges transactions between a buyer and a seller with respect to securities — as defined in Section 475(c)(2) — for a commission or a fee. This would include services provided by stock brokers and similar professionals, but specifically excludes services provided by real estate agents and brokers or insurance agents or brokers.[53]

Meaning of services performed in the fields of investing and investment management

A Listed SSTB identified in Regulations section 1.199A-5(b)(2)(xi) means the performance of services that consist of investing and investment management involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The Final Regulations clarify that performance of services of investing and investment management does not include managing real property, including both direct and indirect management of real property through agents, employees, and independent contractors. The Preamble to the Final Regulations provides that commission-placed sales of insurance policies generally will not be considered the performance of services in the field of investing and investment management for purposes of Section 199A.

Provision of services in trading

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(xii) means the performance of services involving trading in securities, commodities, or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others or any combination thereof. A taxpayer such as a manufacturer or a farmer, who engages in hedging transactions as part of their trade or business of manufacturing or farming, is not considered to be engaged in a trade or business of trading commodities.

Provision of services in dealing

A Listed SSTB identified in Treas. Reg. section 1.199A-5(b)(2)(xiii) means the performance of services that consist of dealing in securities — regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions and securities with customers in the ordinary course of a trade or business. The Section 199A Regulations provide that the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is preforming services consisting of dealing in securities. The performance of services that consist of dealing in commodities means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions and commodities with customers in the ordinary course of a trade or business.[54] The Final Regulations clarify that the definition of dealing in commodities for purposes of Section 199A is limited to a trade or business that is dealing in financial instruments or otherwise does not engage in substantial activities with respect to physical commodities. In order to distinguish a trade or business that performs substantial activities with physical commodities from a trade or business that engages in a commodities trade or business by dealing or trading in financial instruments that are commodities, the Final Regulations adopt rules similar to the rules that apply to qualified active sales of commodities in Treas. Reg. section 1.954-2(f)(2)(iii). In general, those rules require a person to be engaged in the active conduct of a commodities business

as a producer, processor, merchant, or handler of commodities and to perform certain activities with respect to such commodities.

The performance of services that consist of dealing in partnership interests means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business, or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

Meaning of trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners

The Final Regulations take a very narrow view as to what is included as an SSTB where the principal asset of the business is the reputation or skill of one or more of its employees or owners. Specifically, Treas. Reg. section 1.199A-5(b)(2)(xiv) provides that the term "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners" means any trade or business that consists of the following (or any combination thereof): (i) a trade or business in which a person receives fees, compensation, or other income for endorsing products or services; (ii) a trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's likeness, name, signature, voice, trademark, or other symbol associated with the individual's identity; or (iii) the receipt of fees, compensation, or other income for appearing at an event or on radio, television, or another media format. The term "fees, compensation, or other income" includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain, or loss from the partnership, or the receipt of stock of an S corporation and the corresponding income, deduction, gain, or loss from the S corporation stock.

De minimus rule

For a trade or business with gross receipts of $25 million or less for the taxable year, a trade or business is *not* an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in an SSTB. For purposes of determining whether this 10 percent test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field.[55] For a trade or business with gross receipts of greater than $25 million for the taxable year, a trade or business is not an SSTB if less than five percent of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.[56] The Final Regulations retain the *de minimis* rule, and the Preamble to the Final Regulations makes it clear that trades or businesses with gross income from a specified service activity in excess of the *de minimus* threshold are considered to be SSTBs (a "cliff" approach). However, the Final Regulations add an example demonstrating a situation in which a trade or business has income from a specified service activity in excess of the *de minimus* threshold but is able to demonstrate that the entity separately conducts another trade or business, so that the separate trade or business is *not* tainted by the SSTB conducted by the entity.[57]

"Crack-and-pack" strategy

After Section 199A was enacted into law, the IRS announced its awareness that some taxpayers wanted to end-run the SSTB rules by separating what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the Section 199A deduction. The IRS felt that such a strategy was inconsistent with the purpose of Section 199A. In a slight change from the Proposed Regulations, Final Regulations section 1.199A-5(c)(2) removes the 80 percent rule contained in the Proposed Regulations, and simply provides that if a trade or business provides property or services to an SSTB and there is 50 percent or more common ownership of such trades or businesses, the portion of the trade or business providing property or services to the 50 percent or more commonly-owned SSTB will be treated as a separate SSTB *with respect to the related parties*. For example, a dentist owns a dental practice and an

office building. The dentist rents half of the building to the dental practice and half of the building to unrelated persons. Under these facts, the renting of half of the building to the dental practice would be treated as an SSTB. Fifty percent or more common ownership includes direct or indirect ownership by related parties within the meaning of Section 267(b) or Section 707(b). The Final Regulations clarify that the anti-abuse rule contained in Treas. Reg. section 1.199A-5(c)(2) only applies to those taxpayers who have 50 percent or more common ownership of each of the trades or businesses.

Overall limitation

In addition to the other limitations described above, the maximum amount of deduction available under new Section 199A (for all of a taxpayer's qualified trades or businesses) cannot exceed 20 percent of the excess of the taxpayer's taxable income less any capital gain for the taxable year. This overall limitation limits both the 20 percent "pass-through deduction" and the deduction equal to 20 percent of the taxpayer's qualified REIT dividends and PTP income for the year. In other words, after these two separate deduction limitations are calculated, they are then added together and subjected to the overall limitation. It should also be kept in mind that there are a number of items that may reduce a taxpayer's taxable income unrelated to QBI from a pass-through entity or sole proprietorship, which can result in a reduction of the QBI deduction. One common example would be the standard deduction available to taxpayers.

Notes

1 The international tax reforms introduced by the TCJA were extensive. First, Section 965 allows US taxpayers to achieve a repatriation tax rate of 15.5 percent on foreign accumulated earnings in the form of cash and cash equivalents, and eight percent on the excess foreign accumulated earnings and profits in the form of non-cash and non-cash equivalent assets. The tax on repatriation of foreign accumulated earnings can be elected to be paid over eight years in a series of back-end loaded payments with a special deferral rule for S corporations and their shareholders. In a related reform, Section 245A allows a non-taxable dividend from a 10 percent or more owned foreign subsidiary provided the US shareholder is a domestic corporation. Third, Congress has enacted a "US Patent Box"-type provision which favors US-based corporations doing business overseas directly or indirectly through a 10 percent or more owned foreign corporation. In particular, the TCJA provides domestic corporations with reduced rates of US income tax with respect to its foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) derived in taxable years beginning after 2017. As set forth in new section 250(a)(1), a domestic corporation is allowed a deduction an amount equal to the sum of: (i) 37.5 percent of its FDII for such taxable year; plus (ii) 50 percent of its GILTI which is included in gross income in accordance with section 951A for such taxable year plus the gross-up dividend amount under section 78 attributable to the GILTI inclusion under section 951A. The deduction amount effectively reduces the US corporate income tax to 13.125 percent with respect to FDII and 10.5 percent with respect to GILTI, which are subject to further adjustment for foreign taxes directly or indirectly paid or accrued. The tax outcomes under section 250 are reflective of the outcomes obtained by US multinationals receiving large royalty payments in low-tax countries such as Ireland, i.e., so called "patent boxes" filled with taxable income receipts from high tax jurisdictions but subject to far more favorable rates in the low-tax country where the royalty income is reportable. A fourth major change introduced in the TCJA with respect to the US international taxation of corporations (other than an S corporation, REIT, or real estate investment trust) is a base erosion "minimum" tax (BEATs). The BEATs prevents US companies from stripping earnings out of the US through deductible payments to foreign. The tax is structured as an alternative minimum tax (even though the corporate alternative minimum tax was repealed by the TCJA) that applies when a multinational company reduces its regular US tax liability to less than a specified percentage of its taxable income, after adding back deductible base eroding payments and a percentage of tax losses claimed that were carried from another year. The tax applies to deductible payments to foreign affiliates from domestic corporations, as well as on foreign corporations engaged in a US trade or business in computing the tax on their effectively connected income (ECI) of 10 percent (five percent for taxable years beginning in calendar year 2018) of the modified taxable income of such taxpayer over an amount equal to the regular tax liability (per section 26(b)) of the corporation for the taxable year reduced by certain credits. It is a provision of great complexity and will result in many multinational enterprises restructuring their supply chains. The threshold level for implicating the BEATs tax in a particular year is for companies with over $500 million in gross receipts. See August, The Proposed GILTI Regulations Under Section 951A, J. Corp. Tax'n (Mar/Apr 2019).

2 See Jerald David August, Understanding the Section 199A Deduction After the New Final Regulations: An IRS Perspective, VCAGO416 ALI-CLE 1 (April 16, 2019); John Cun-

ningham, Advising Clients Under Section 199A — A Revolutionary New Field of Tax and Legal Practice,The Practical Tax Lawyer, Vol. 32, No. 4, p. 43 (Summer 2018). Whitney House, Qualified Business Income Deductions In The Sharing Economy, 18 Colo. Tech. L. J. 453 (2020); Les Raatz, New Section 199A: Simplify Pass-Through Deduction Intricacy, Estate Planning, Vol. 45, No. 4, p. 16 (Thompson Reuters, April 2018).

3 For taxable years beginning in 2021, the threshold amount under Section 199(e)(2) is $329,800 for married filing joint returns, $164,925 for married filing separate returns, and $164,900 for all other returns. See Rev. Proc. 2020-45, §3.27. For 2020, the threshold amount was $326,600 for married filing joint returns, $163,300 for married filing separate returns and the same amount for single/head of household return. See Rev. Proc. 2019-44, §3.27. This article will set forth examples under the first operative year of Section 199A. The threshold amounts are indexed for inflation as provided in Section 199A(e)(2)(B), which adjusted amount is then phased out under the limitation under Section 199A(b)(3)(B). The dollar amounts for the phase-out of the threshold amount are not adjusted for inflation.

4 Many states have adopted federal adjusted gross income as a starting point in computing personal income taxes. Since the Section 199A deduction is taken from "taxable income", the application of Section 199A for state income tax purposes would have to be specifically provided by statute.

5 See also Notice 2019-07, which was concurrently issued with the Section 199A regulations and announced a proposed safe harbor whereby a rental real estate enterprise may be treated as a QBI for purposes of Section 199A. The rental real estate safe harbor was finalized on September 24, 2019 in Revenue Procedure 2019-38.

6 TD 9847, 84 FR 2952-01 (Feb. 8,2019).

7 2019 - _09_, I.R.B. 742__ (Jan. 19, 2019), mod'f'd by Rev. 2021-11, 2021-6 I.R.B. 833 (Jan. 14, 2021).

8 See also previously issued IRS Notice 2018-64.

9 See footnote 3 supra.

10 See Rev. Proc. 2018-57 (2019 inflation adjustments).

11 Treas. Reg. § 1.199A-1(d)(1).

12 See Treas. Reg. §1.199A-6, application of Section 199A to RPEs, PTPs, trusts and estates. See John Cunningham, Tax and Legal Practice Under Section 199A (With Client Questionnaire and Issues Checklist), The Practical Tax Lawyer, Vol. 34, No. 2, p. 9 (March 2020).

13 Treas. Reg. §1.199A-2(a)(2).

14 See Treas. Reg. §1.199A-2(b)(4). See also Rev. Proc. 2009-11.

15 Note that architecture and engineering, despite being listed in Section 1202(e)(3)(A) are excluded from being SSTBs somewhat artificially but nevertheless excluded.

16 For purposes of applying the rules of Regulations sections 1.199A-1 through 1.199A-6, the Section 199A Regulations provide that a reference to an "individual" includes a reference to a trust (other than a grantor trust) or an estate to the extent that the Section 199A deduction is determined by the trust or estate under the rules of Regulations section 1.199A-6.

17 See Groetzinger v. Commissioner, 480 U.S. 23 (1987).

18 Treas. Reg. § 1.199A-1(c)(1).

19 Treas. Reg. § 1.199A-1(c)(2)(i).

20 Treas. Reg. § 1.199A-1(c)(2)(ii).

21 Treas. Reg. section 1.199A-1(d)(1).

22 Treas. Reg. § 1.199A-1(d)(2)(i).

23 Treas. Reg. § 1.199A-1(d)(2)(ii).

24 Treas. Reg. § 1.199A-1(d)(2)(iii)(B).

25 However, in the case of a taxpayer who otherwise has QBI from sources within the Commonwealth of Puerto Rico, provided all of the income is taxable, the taxpayer's income from Puerto Rico will be included in determining the individual's QBI.

26 Treas. Reg. § 1.199A-1(d)(2)(iv)(B).

27 Treas. Reg. § 1.199A-1(d)(3).

28 Treas. Reg. § 1.199A-1(e)(1).

29 Treas. Reg. § 1.199A-1(e)(2).

30 Treas. Reg. § 1.199A-1(e)(3). *Income from Commonwealth of Puerto Rico*: If all of an individual's QBI is derived from sources within the Commonwealth of Puerto Rico and is taxable under Section 1 for a taxable year, then for purposes of determining the QBI of such individual for such taxable year, the term "United States" will include the Commonwealth of Puerto Rico. Treas. Reg. § 1.199A-1(e)(4).

31 Treas. Reg. § 1.199A-1(e)(5).

32 I.R.C. § 6662(d)(1)(C); Treas. Reg. § 1.199A-1(e)(6).

33 See, e.g., Comm'r v. Groetzinger, 480 U.S. 23 (1987) and Higgins v. Comm'r, 312 U.S. 212 (1941). Generally, in order to qualify as a Section 162 Trade or Business, the business must be conducted for income or profit and the activity must be engaged in on a regular, continuous, and substantial basis. Id.

34 See Note 1, supra.

35 73 T.C. 766 (1980).

36 312 U.S. 212 (1941).

37 See Fegan v. Comm'r, 71 T.C. 791, 814 (1979); Elek v. Comm'r, 30 T.C. 731 (1958), acq. 1958-2 C.B. 5; Lagreide v. Comm'r, 23 T.C. 508 (1954).

38 See also Alvary v. U.S., 302 F.2d 790 (2d Cir. 1962); Fackler v. Comm'r, 133 F.2d 509 (6th Cir. 1943), aff'g. 45 B.T.A. 708 (1941); and Bauer v. U.S., 144 Ct. Cl. 308 (1958). What should be the treatment of the lease of unimproved land under Section 199A? Trade or business? The government continues to adhere to its "all facts and circumstances" approach based on the Section 162 case law.

39 See Notice 2019-07, 2019-9 IRB 740.

40 REG-134652-18. See also I.R.C. §§651(1), 904(f).

41 Treas. Reg. § 1.199A-3(b)(2)(i).

42 Treas. Reg. § 1.199A-3(b)(4).

43 Treas. Reg. § 1.199A-3(b)(5).

44 See also I.R.C. §§ 6051(a)(3), 6501(a)(8); Rev. Proc. 2006-22.

45 See generally Treas. Reg. § 1.199A-2.

46 *Example — LLC Taxed as a Partnership in a Qualified Trade or Business with Income in Excess of Threshold Amount Plus Phase-In Amounts:*

A is a 30% owner of an LLC which has QBI of $3,000,000. The LLC paid wages of $1,000,000 and the LLC's unadjusted basis in qualified property is $200,000.

A's deduction will be equal to the lesser of:

1.

TOTAL QBI	ALLOCABLE SHARE (30%)	20% DEDUCTION
$3,000,000	$900,000	$180,000

and the greater of:

2(a).

TOTAL W-2 WAGES	ALLOCABLE SHARE (30%)	50% LIMITATION
$1,000,000	$300,000	$150,000

or

2(b).

TOTAL W-2 WAGES	ALLOCABLE SHARE (30%)	25% LIMITATION
$1,000,000	$300,000	$75,000

plus

UNADJUSTED BASIS	ALLOCABLE SHARE (30%)	2.5% LIMITATION
$200,000	$60,000	$1,500
TOTAL		**$76,500**

Thus, A is entitled to a deduction of $150,000.

47 Special rules apply under Sections 743(b) and 168 and are addressed in the Regulations. See Treas. Reg. § 1.743-1(j)(4)(i)(B).

48 Treas. Reg § 1.199A-2(c)(1)(iv).

49 See Treas. Reg. § 1.199A-2(c)(3).

50 As noted above, the threshold amounts will vary for each taxable year. For example, for 2019, as compared with the 2018 threshold amounts identified in the text, the phase-in range was $321,400 to $421,400 for joint filers, $160,725 to $210,725 for married filing separately and $160,700 to $210,700 for all other filing statuses.

51 See Treas. Reg. §§ 1.199A-5(b)(2)(ii).

52 Treas. Reg. § 1.199A-5(b)(2)(viii).

53 Treas. Reg. § 1.199A-5(b)(2)(x).

54 Treas. Reg. § 1.199A-5(b)(2)(xiii).

55 Treas. Reg. § 1.199A-5(c)(1)(i).

56 Treas. Reg. § 1.199A-5(c)(1)(ii).

57 See Treas. Reg. § 1.199A-5(c)(1)(iii)(B), Example 2.