THE SECTION 199A FINAL REGULATIONS – IMPORTANT CLARIFICATIONS, PART 2

Opportunities and Pitfalls

By Steve Beck

This article is the second of a two-part series discussing important provisions of the final regulations impacting the effect of the deduction provided under I.R.C. § 199A (the 199A deduction). The 199A deduction basically enables individuals, certain trusts and estates (collectively, "individuals") to deduct up to 20% of their combined qualified business income (QBI) from a domestic business operated as a pass-through (i.e., Subchapter K partnerships, Subchapter S Corporations, sole proprietorships and disregarded entities; collectively, "RPEs"). Note: The 199A deduction also allows a deduction in connection with qualified REIT dividends and qualified publicly traded partnership income. This article, however, focuses solely on the deductibility of 20% of QBI.

Final regulations were issued last year clarifying important issues regarding the applicability and effect of the 199A deduction (the 199A regulations). T.D. 9847 (February 12, 2019). The first article of this series focused on the important clarifications in the 199A regulations addressing whether an individual or RPE is engaged in a qualified trade or business (QTB), which is a prerequisite of qualifying for the 199A deduction. (See "The Section 199A Final Regulations – Important Clarifications, Part 1 - What is a Qualified Trade or Business," in the July/August 2019 issue of *Today's CPA* magazine.)

The first article focused on whether particular activities are eligible for the 199A deduction. In contrast, this second article addresses issues arising after the client's

eligibility for the 199A deduction has been established. Principally, this article discusses opportunities provided by the 199A regulations through which return preparers can help their clients maximize the amount of their 199A deductions. Additionally, this article mentions some pitfalls through which omissions by return preparers can result in reducing or eliminating the amounts of their clients' 199A deduction that otherwise would have been available.

The Wage Limitation

The 199A regulations provide opportunities for maximizing the amount of the 199A deduction under the wage limitation. As a quick recap, the amount of an individual's 199A deduction is generally equal to 20% of the aggregate amount of the individual's QBI from QTBs conducted by that individual (or an RPE in which the individual owns an interest). The amount of the 199A deduction, however, is reduced to the extent that 20% of QBI exceeds the amount allowable under the wage limitation.

The generally applicable wage limitation provides that the amount of the 199A deduction is reduced to the extent that 20% of QBI from a QTB exceeds the greater of: (a) 50% of the W-2 wages paid with respect to the QTB; or (b) the sum of: (i) 25% of the W-2 wages paid with respect to the QTB; plus (ii) 2.5% of the unadjusted basis immediately after acquisition (the UBIA) of all qualified property. I.R.C. §199A(b)(2). (The amount of W-2 wages taken into account for purposes of the 199A deduction is hereafter referred to as "W-2 wages.")

There are five requirements that must be satisfied to aggregate QTBs under the 199A regulations.

This generally applicable limitation is hereafter referred to as the "wage limitation" and it applies to individuals who: (i) are not engaged in a specified service trade or business (SSTB); and (ii) have an amount of taxable income of at least $207,500 (or $415,000 for married filing joint taxpayers, such amount, the "phase-out amount"). For individuals with taxable income less than the phase-out amount, a modified version of the wage limitation may apply. I.R.C. § 199A(b)(3)(B)(i).

General Rule – 199A Deduction Attributes Must be Calculated Separately for Each QTB

Thus, to calculate the amount of the 199A deduction available following application of the wage limitation, it is necessary to calculate that individual's share of QBI, W-2 wages and UBIA in connection with all of the QTBs conducted by that individual (or by an RPE in which that individual owns an interest).

The 199A regulations provide that the amount of an individual's or RPE's QBI generally must be calculated separately for each QTB conducted directly by that individual or RPE. Treas. Reg. § 1.199A-3(a). Similarly, the amount of W-2 wages and UBIA must be calculated separately for each QTB in which the individual or RPE is directly engaged. Treas. Reg. § 1.199A-2(a)(2), (3).

Aggregation – An Opportunity for Managing the Wage Limitation

Although individuals and RPEs are generally required to calculate their QBI, W-2 wages and UBIA separately for each QTB, the 199A regulations provide rules that permit individuals and RPEs to aggregate QTBs and treat the aggregate as a single QTB for purposes of applying the wage limitation. Treas. Reg. § 1.199A-4(b)(2). If an individual or RPE chooses to aggregate multiple QTBs, the QBI, W-2 wages and UBIA of those QTBs must be combined for purposes of applying the wage limitation. Id.

The aggregation rules in the 199A regulations are permissive. No individual or RPE is required to aggregate if they do not wish to do so. Treas. Reg. § 1.199A-4(a).

There are limits, however, to the extent to which QTBs can be aggregated under the 199A regulations. There are five requirements that must be satisfied in order to aggregate QTBs. If the requirements are satisfied, individuals and RPEs may aggregate (or not) to whatever extent they desire within the scope of those regulatory requirements. Id.

The five requirements (the aggregation requirements) that must be satisfied to aggregate QTBs under the 199A regulations are as follows. Treas. Reg. § 1.199A-4(b)(1).

First, the same person or group of persons must own, directly or indirectly, 50% or more of each QTB to be aggregated (the ownership requirement). Treas. Reg. § 1.199A-4(b)(1)(i). In the case of QTBs conducted by an S Corporation, the same person or group of persons must own at least 50% of the issued and outstanding shares of that S Corporation in order to aggregate those QTBs. Id.

In the case of QTBs conducted by a partnership, the same person or group of persons must own at least 50% of the capital or profits of the partnership. Id. For purposes of determining whether the same person or group of persons owns at least 50% of the QTB, an individual or RPE is attributed ownership from other related persons

under the standards of I.R.C. §§ 267(b) and 707(b). Treas. Reg. § 1.199A-4(b)(1)(i).

Second, the ownership requirement must be satisfied for a majority of the tax year, including the last day of the tax year, in which the items attributable to each QBT to be aggregated are included in income. Treas. Reg. § 1.199A-4(b)(1)(ii).

Third, all of the items attributable to each QTB to be aggregated must be reported on tax returns with the same tax year, not taking into account short tax years. Treas. Reg. § 1.199A-4(b)(1)(iii).

Fourth, none of the businesses to be aggregated may be an SSTB. Treas. Reg. § 1.199A-4(b)(1)(iv).

Lastly, the QTBs to be aggregated must satisfy at least two of the following factors, based on all the facts and circumstances. Treas. Reg § 1.199A-4(b)(1)(v). The first factor is satisfied if the QTBs provide products and services that are the same or customarily offered together (the similarity factor). Treas. Reg. § 1.199A-4(b)(1)(v)(A). The second factor is satisfied if the QTBs share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources or information technology resources (the sharing factor). The third factor is satisfied if the QTBs are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group; for example, supply chain interdependencies (the interdependency factor).

An individual may aggregate QTBs operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE. Treas. Reg. § 1.199A-4(b)(2)(i). Thus, if an RPE aggregates its QTBs, an individual owner of that RPE cannot segregate a QTB from those aggregated by the RPE. Id. An individual, however, may aggregate additional QTBs to those aggregated by the RPE as long as the aggregation requirements are otherwise satisfied. Id.

Similar rules apply to an RPE's ability to aggregate or segregate QTBs conducted by a lower-tier RPE. Treas. Reg. § 1.199A-4(b)(2)(ii). In addition, if the RPE chooses not to aggregate its QTBs, its owners are not required to follow the same methodology and can separately choose whether to aggregate their allocable shares of those QTBs conducted by the RPE. Id. If, however, an RPE chooses to aggregate multiple QTBs, that RPE must compute and report the QBI, W-2 wages and UBIA for the aggregated QTBs to its owners. Id.

The examples in Exhibits 1 and 2, adapted from the 199A regulations, illustrate the potential flexibility and restrictions posed by the aggregation requirements. In addition, the potential benefit of utilizing aggregation to increase the amount of the 199A deduction available under the wage limitation is illustrated by the examples in Exhibits 3 and 4, which are also adapted from the 199A regulations.

Exhibit 1: Example Based on Treas. Reg. § 1.199A-4(d)(8)

Gail owns 80% of the stock in S1, an S Corporation, and 80% of the capital and profits in LLC1 and LLC2, each of which is a partnership for federal tax purposes. LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1's widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. All of the entities share common advertising and management.

Gail owns more than 50% of the stock of S1 and more than 50% of the capital and profits in LLC1 and LLC2, and she, therefore, satisfies the ownership requirement. LLC1, LLC2 and S1 share significant centralized business elements and thus satisfy the sharing factor. LLC1, LLC2 and S1 are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group and thus satisfy the interdependency factor. Thus, Gail can treat the business operations of LLC1 and LLC2 as a single QTB for purposes of applying I.R.C. § 199A.

In addition, S1 is eligible to be included in the aggregated group, because it leases property to a QTB within the aggregated QTB and thus qualifies as a trade or business for purposes of the 199A deduction under the special rule of Treas. Reg. § 1.199A-1(b)(14) (discussed in the first article in this series).

Exhibit 2: Example Based on Treas. Reg. § 1.199A-4(d)(11)

Harvey, Joan, Kyle and Louise own interests in PRS1 and PRS2, each a partnership, and S1 and S2, each an S Corporation. Harvey owns 30%, Joan owns 20%, Kyle owns 5% and Louise owns 45% of each of the five entities. All of the entities satisfy two of the similarity, sharing and interdependency factors. For purposes of the 199A deduction, the taxpayers report the following aggregated QTBs:

- Harvey aggregates PRS1 and S1 together and aggregates PRS2 and S2 together;
- Joan aggregates PRS1, S1 and S2 together and reports PRS2 separately;
- Kyle aggregates PRS1 and PRS2 together and aggregates S1 and S2 together; and
- Louise aggregates S1, S2 and PRS2 together and reports PRS1 separately.

Harvey, Joan, Kyle and Louise together own a majority interest in PRS1, PRS2, S1 and S2, and they, therefore, satisfy the ownership requirement. In addition, each of the entities satisfies two of the similarity, sharing and interdependency factors. As a result, Harvey, Joan, Kyle and Louise are permitted to aggregate the QTBs of all the entities for purposes of calculating their 199A deductions.

Notably, each of the aggregation methods chosen by Harvey, Joan, Kyle and Louise are permitted, notwithstanding that they each opted to aggregate in a different manner. Thus, as shown in this example, owners of RPEs have extensive flexibility in determining their aggregation method and are not bound by the methods of other owners.

Exhibit 3: Example of Separate Calculation of 199A Attributes (Based on Treas. Reg. § 1.199A-1(d)(4)(vii)

Frida, an unmarried individual, owns as a sole proprietor 100% of three QTBs, Business X, Business Y and Business Z. None of the QTBs have any UBIA. Frida does not aggregate the QTBs for purposes of the 199A deduction.

For 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages. Business Y also generates $1 million of QBI but pays no W-2 wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages.

Frida also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, Frida's taxable income is $2,722,000. Because Frida's taxable income is above the phase-out amount, Frida's 199A deduction is subject to the wage limitation.

Frida did not aggregate her QTBs and thus the wage limitation must be applied separately to each QTB. None of the QTBs hold qualified property and, therefore, only the 50% of W-2 wages must be calculated.

Accordingly, Frida applies the wage limitation by determining the lesser of 20% of QBI and 50% of W-2 wages for each QTB. For Business X, the lesser of 20% of QBI ($1,000,000 x 20 percent = $200,000) and 50% of Business X's W-2 wages ($500,000 x 50% = $250,000) is $200,000. Business Y pays no W-2 wages. Thus, the lesser of 20% of Business Y's QBI ($1,000,000 x 20% = $200,000) and 50% of its W-2 wages (zero) is zero. For Business Z, the lesser of 20% of QBI ($2,000 x 20% = $400) and 50% of W-2 wages ($500,000 x 50% = $250,000) is $400. Thus, the total of the combined amounts available under the wage limitation for inclusion in the 199A deduction is $200,400 ($200,000 + 0 + 400).

Exhibit 4: Example Based on Treas. Reg. § 1.199A-1(d)(4)(viii)

This example assumes the same facts as in Exhibit 3, except that Frida aggregates Business X, Business Y and Business Z. Because Frida's taxable income is above the phase-out amount, Frida's 199A deduction is subject to the wage limitation. Because the QTBs are aggregated, the wage limitation is applied on an aggregated basis. None of the QTBs hold qualified property. Therefore, only 50% of the W-2 wages must be calculated. Frida applies the wage limitation by determining the lesser of: 20% of the QBI from the aggregated QTBs, which is $400,400 ($2,002,000 x 20%) and 50% of W-2 wages from the aggregated QTBs, which is $500,000 ($1,000,000 x 50%). Thus, the combined amount available under the wage limitation for inclusion in the 199A deduction is $400,400.

The examples in Exhibits 3 and 4 illustrate that, under the same facts, aggregation enabled Frida to virtually double the amount of her 199A deduction. This was because aggregation enabled her to devote excess available W-2 wages, primarily from Business Z, to enable QBI from the other QTBs to be available for the 199A deduction.

Aggregation - Potential Pitfalls Under the 199A Regulations

Aggregation, however, has its potential drawbacks. An aggregation method, once chosen, is generally binding on all subsequent years. Specifically, the 199A regulations provide that, once an individual or RPE chooses to aggregate two or more QTBs, the individual or RPE generally must report the aggregated QTBs consistently in all subsequent tax years. Treas. Reg. §§ 1.199A-4(c)(1), (3).

There are, however, limited exceptions through which an aggregation method may be modified. For example, an individual or RPE may add a newly created or newly acquired QTB to an existing aggregated QTB if the aggregation requirements are otherwise satisfied. Id. In addition, after choosing an aggregation method, if there is a significant change in facts and circumstances in a subsequent year such that the previously chosen method no longer satisfies the aggregation requirements, the

QTBs are no longer aggregated and the individual or RPE must reapply the aggregation requirements to determine a new permissible aggregation method. Id.

As a result of the binding nature of an aggregation method, taxpayers and their advisors need to consider carefully the long-term implications of a potential aggregation method. The methodology that may be advantageous in the first year may not continue to be optimal in the future.

Payroll Companies - An Alternative Potential Strategy for Managing the Wage Limitation

The 199A regulations contain a special rule through which a taxpayer's W-2 wages may also include wages actually paid by another person in certain circumstances. Specifically, in determining W-2 wages, an individual or RPE may take into account any wages paid by another person (the payroll company) and reported by that payroll company on Forms W-2 with the payroll company listed as employer in Box C of those Forms W-2, provided that the wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. Treas. Reg. § 1.199A-2(b)(2)(ii).

In this situation, the payroll company paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining the amount of the payroll company's W-2 wages. For purposes of this rule, a payroll company that can pay and report W-2 wages on behalf of, or with respect to, others can include, but are not limited to, certified professional employer organizations under I.R.C. § 7705, statutory employers under I.R.C. § 3401(d)(1) and agents under I.R.C. § 3504.

The use of a payroll company by commonly owned QTBs may enable the owners to allocate the W-2 wages where needed to maximize the amount of the 199A deduction available under the wage limitation. The payroll company can provide the workers to perform services on behalf of the affiliated QTBs. Each year, the services of those workers can be allocated among those affiliated QTBs and they can reimburse the payroll company for their proportionate shares of the wages paid to the workers.

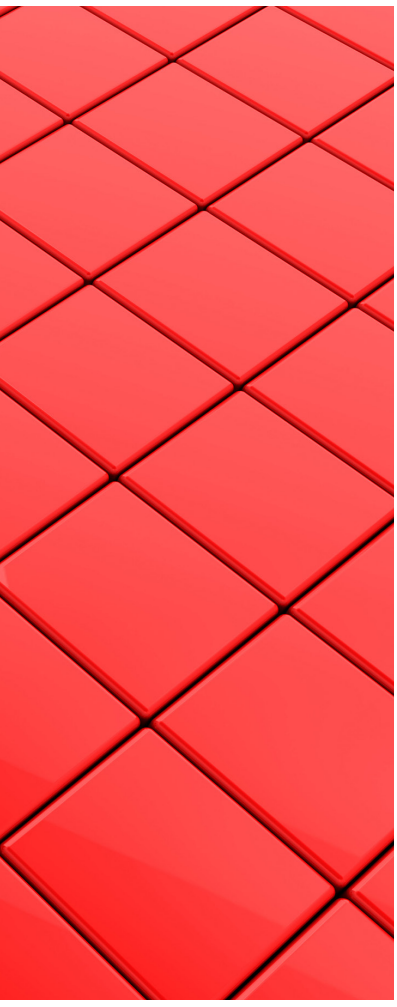
In this manner, the reimbursing QTB can get credit for the W-2 wages paid for the services allocated to that QTB. Of course, the workers' services and W-2 wages should be allocated among the affiliated QTBs consistently with how those QTBs' truly benefitted from those services.

Significantly, it may be possible to allocate the services differently among the affiliated QTBs' on a year-to-year basis if the manner in which the workers' services benefit the QTBs' changes on a yearly basis. In contrast, an aggregation method, once chosen, is binding on the taxpayer for all future years. Thus, the payroll company may provide affiliated QTBs with flexibility to manage the wage limitation in a manner not afforded by the aggregation method.

Additional Pitfalls Under the 199A Regulations

The 199A regulations impose annual disclosure requirements on individuals and RPEs in connection with their chosen method of aggregation. Individuals, for each tax year, must attach a statement to their returns identifying each business aggregated for purposes of I.R.C. § 199A. Treas. Reg. § 1.199A-4(c)(2)(i). The statement must contain:

- A description of each business;
- The name and EIN of each entity in which a business is operated;
- Information identifying any business that was formed, ceased operations, was acquired, or was disposed of during the tax year;
- Information identifying any aggregated business of an RPE in which the individual holds an ownership interest; and
- Such other information as the IRS Commissioner may require in forms, instructions or other published guidance. Id.



Additionally, RPEs must disclose similar information on the Schedules K-1 issued to their owners with regard to the RPE's chosen aggregation method. Treas. Reg. § 1.199A-4(c)(4)(i).

Significantly, if an individual or RPE fails to attach the required disclosure statement to the tax return or Schedule K-1, the IRS Commissioner may disaggregate the individual's or RPE's QTBs. Treas. Reg. § 1.199A-4(c)(2)(ii), (4)(ii). If the Commissioner disaggregates the individual's or RPE's QTBs, the individual or RPE cannot aggregate them for the subsequent three tax years. Id.

The 199A regulations also impose additional reporting requirements on RPEs. An RPE must separately identify and report on the Schedule K-1 issued to its owners for any business engaged in directly by the RPE: each owner's allocable share of QBI, W-2 wages and UBIA attributable to each such business, and whether any business of the RPE is an SSTB. Treas. Reg. § 1.199A-6(b)(3)(i). Further, an RPE must report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA or SSTB determinations reported to it by any lower-tier RPE in which the RPE owns a direct or indirect interest. Treas. Reg. § 1.199A-6(b)(3)(ii).

The consequences of an RPE's failure to comply with these reporting requirements may be dire for its owners. If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner any of the items required to be so reported, the owner's share (and the share of any upper-tier indirect owner) of the unreported item will be presumed to be zero. Treas. Reg. § 1.199A-6(b)(3)(iii).

Helpful Guidance and Potential Traps

The 199A regulations provide helpful guidance that is taxpayer beneficial. By introducing the aggregation and payroll company concepts, the 199A regulations provide taxpayers and their advisors helpful tools for maximizing the 199A deduction available under the wage limitation.

The 199A regulations, however, also provide potential traps for the unwary. The binding nature of the aggregation method chosen may result in a taxpayer being saddled with an unfavorable methodology if not initially chosen carefully.

In addition, an RPE's failure to disclose 199A attributes to an owner may eliminate that owner's ability to qualify for a 199A deduction that otherwise would have been available. For these reasons, the 199A regulations heighten the potential risk and reward for professionals advising their clients in connection with the 199A deduction.

ABOUT THE AUTHOR:
Steve Beck is a partner with Meadows Collier in Dallas. He is a board-certified tax attorney who practices in the areas of income tax and business planning, corporate, state tax planning and litigation, and real estate. You can reach him by phone at 214-744-3700 or by email at sbeck@meadowscollier.com.