FEATURE


# THE SECTION 199A FINAL REGULATIONS – IMPORTANT CLARIFICATIONS, PART 1

## WHAT IS A QUALIFIED TRADE OR BUSINESS?

By Steve Beck

I.R.C. § 199A 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). This deduction is hereafter referred to as the 199A deduction.

The basic effect of the 199A deduction is to reduce the maximum individual income tax rate on combined QBI of RPEs from 37% to 29.6% (i.e., 37%, multiplied by 80%). Therefore, it helps to partially bridge the gap between the maximum 37% income tax rate applying to individuals and the lower 21% income tax rate applying to corporations. The 199A deduction, however, applies only for tax years beginning after 2017 and before 2026.

*Today's CPA* included an article titled, "Pass-Through Entities Not Left Out of Tax Reform," in the May/June 2018 issue that discussed the 199A deduction based on the provisions of the Internal Revenue Code (I.R.C.), which was the only guidance available at the time of publication. That article noted many issues that remained outstanding at the time. Since then, the Treasury Department and Internal Revenue Service (collectively, Treasury) have issued final regulations (the 199A regulations), which clarify important issues regarding the 199A deduction. T.D. 9847 (Feb. 12, 2019).

This article is the first of a two-part series discussing important provisions of the 199A regulations. This article focuses 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 required to have any QBI eligible for the 199A deduction.

A second article will address the provisions in the 199A regulations that provide tax return preparers with opportunities for assisting their clients with maximizing the amount of the 199A deduction and potential pitfalls that could eliminate the amount of their clients' 199A deduction.

The QTB concept is important in determining whether a client is eligible for the 199A deduction. The amount of the 199A deduction is generally calculated based on 20% of the individual's QBI from a QTB. Thus, in order to have any QBI eligible for the 199A deduction, the individual (or RPE in which the individual owns an interest) must be engaged in a QTB.

A QTB is any trade or business, except for the trade or business of performing services as an employee and a specified service trade or business (an SSTB). I.R.C. § 199A(d)(1). Thus, there are three important concepts for determining whether an individual or RPE is engaged in a QTB:

- What is a trade or business for purposes of I.R.C. § 199A?
- What constitutes services as an employee?
- What constitutes an SSTB?

These three concepts are discussed in the following three sections of this article.

## What is a Trade or Business for Purposes of I.R.C. § 199A?

The term "trade or business" is not defined under I.R.C. § 199A. The 199A regulations, however, define a "trade or business" as an activity qualifying as such under I.R.C. § 162 (other than working as an employee). Treas. Reg. § 1.199A-1(b)(14). I.R.C. § 162 permits taxpayers to deduct all the ordinary and necessary expenses paid or incurred in carrying on trade or business that are reasonable in amount.

The Preamble to the 199A regulations (the Preamble) notes that the I.R.C. § 162 definition of trade or business is derived from a large body of existing case law. This case law provides that whether the activities of a taxpayer constitute a trade or business requires an examination of the facts and circumstances of the particular case. Higgins v. Comm'r, 312 U.S. 212, 217 (1941).

In addition, courts typically apply two factors in determining whether an activity rises to the level of a trade or business. First, the taxpayer's activities must be considerable, regular and continuous to constitute a trade or business. See Comm'r v. Groetzinger, 480 U.S. 23 (1987). Second, the taxpayer must enter into and carry on the activity with a good faith intention to derive a profit or with the belief that profit can be derived from the activity. See id.

**Courts typically apply two factors in determining whether an activity rises to the level of a trade or business.**

Significant questions have arisen regarding whether rental real estate activities qualify as a trade or business for purposes of the 199A deduction. In response, the Preamble notes that the relevant factors for determining whether a rental real estate activity constitutes an I.R.C. § 162 trade or business include the:

- Type of rented property (whether commercial or residential);
- Number of properties rented;
- Daily involvement of the owner or the owner's agents;
- Types and significance of any ancillary services provided under a lease; and
- Terms of the lease (e.g., a net lease, as opposed to a traditional lease, and a short-term or long-term lease).

In promulgating the 199A regulations, Treasury ultimately declined to provide any bright-line standard regarding whether a particular rental real estate activity is a trade or business for purposes of the 199A deduction. However, Treasury released Notice 2019-07, which contains a proposed Revenue Procedure detailing a proposed safe harbor (the safe harbor), under which an individual or RPE would be able to treat a rental real estate business as a trade or business solely for purposes of the 199A deduction.

### The Rental Real Estate Safe Harbor

The proposed Revenue Procedure would provide that a rental real estate activity that satisfies the standards of the safe harbor would be deemed to constitute a trade or business for purposes of the 199A deduction. Conversely, the standards of the proposed Revenue Procedure would not prohibit an individual or RPE engaged in rental real estate activities from qualifying for the 199A deduction in situations in which the safe harbor standards are not satisfied.

The safe harbor applies to a "rental real estate enterprise" (RREE), which is an interest in real property held for the production of rents. An RREE may consist of an interest in multiple properties. An individual or RPE relying on the safe harbor must hold the interest directly or through a disregarded entity.

Taxpayers must either treat each property held for the production of rents as a separate enterprise or all similar properties held for the production of rents (except for certain excluded properties) as a single enterprise. For purposes of the aforementioned treatment, commercial and residential real estate may not be part of the same enterprise, and taxpayers may not vary their treatment from year to year unless there has been a significant change in facts and circumstances.

The safe harbor provides that an RREE will be treated as a trade or business for purposes of the 199A deduction if the following three requirements are satisfied. First, the individual or RPE conducting the RREE must maintain separate books and records to reflect the income and expenses for each RREE.

Second, the RREE must involve at least a certain threshold of rental services for each year and the required frequency for satisfying that threshold varies depending on the tax year at issue. For tax years prior to 2023, at least 250 hours of "rental services" must be performed each year with respect to the RREE. In contrast, for tax years after 2022, the aforementioned standard of at least 250 hours of "rental services" must generally be satisfied in any three of the prior five consecutive tax years ending with the tax year at issue.

If, however, the RREE has been conducted for fewer than five years, the 250-hour threshold must be satisfied for each of the prior years in which the RREE has been conducted to satisfy the safe harbor for a tax year after 2022.

"Rental services" for purpose of the 250-hour threshold include:

- Advertising to rent or lease the real estate;
- Negotiating and executing leases;
- Verifying information contained in prospective tenant applications;
- Collection of rent;
- Daily operation, maintenance and repair of the property;
- Management of the real estate;
- Purchase of materials; and
- Supervision of employees and independent contractors.

These rental services may be performed by owners or by employees, agents and/or independent contractors of the owners. However, the following do not constitute "rental services" for purposes of the safe harbor:

- Financial or investment management activities, such as arranging financing;
- Procuring property;
- Studying and reviewing financial statements or reports on operations;
- Planning, managing or constructing long-term capital improvements; or
- Hours spent traveling to and from the real estate.

Third, the taxpayer or RPE must maintain contemporaneous records, including time reports, logs or similar documents, regarding the following:

- Hours of all services performed;
- Description of all services performed;
- Dates on which such services were performed; and
- Who performed the services.

The safe harbor also requires that these records must be made available for inspection at the request of the IRS. The safe harbor provides, however, that this contemporaneous records requirement is not applicable to taxable years beginning prior to Jan. 1, 2019.

Certain rental real estate arrangements are excluded from the safe harbor. These excluded arrangements consist of real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on the safe harbor) as a residence for any part of the year under I.R.C. § 280A and real estate rented or leased under a triple net lease. A triple net lease for this purpose includes a lease agreement that requires the tenant or lessee to pay (all or a portion of the) taxes, fees and insurance, and be responsible for maintenance activities for (all or a portion of) a property in addition to rent and utilities.

The safe harbor provides useful certainty for taxpayers who can document satisfaction of the 250-hour threshold. However, the documentation required under the safe harbor may impose additional administrative complexity on rental real estate businesses. For this reason, taxpayers who are confident they can establish that their rental real estate operations involve regular, continuous and considerable activities carried on for profit under the I.R.C. § 162 common law standards may choose to forego the additional documentation complexity that would be needed to obtain the protections of the safe harbor.

### Learn More About Section 199A

**To provide a more detailed review of the Section 199A regulations, TXCPA offers a number of CPE programs in this area. To learn more and register, go to the TXCPA website at tscpa.org and search on Section 199A regulations.**

### Common Control Rental Property

The 199A regulations also provide a special rule that enables an individual or RPE to treat certain rental or licensing of tangible or intangible property as a trade or business for purposes of I.R.C. § 199A, even though that activity would not otherwise rise to the level of an I.R.C. § 162 trade or business.

This special rule applies only if the property is rented or licensed to a trade or business that is subject to "common control." Treas. Reg. § 1.199A-1(b)(14). "Common control" for this purpose means that the same person or group of persons, directly or indirectly, owns 50% or more of the issued and outstanding shares of the corporation or capital and profits interests in the partnership. Treas. Reg. §1.199A-4(b)(1)(i).

Thus, under this principle, a rental activity that neither rises to the level of an I.R.C. § 162 trade or business nor qualifies under the safe harbor may still be treated as a QTB if the property is rented to a QTB that is controlled by the same person or group of persons. This special rule enables individuals to include rental income as QBI in situations in which the individuals own their operating


business in one entity and own the related real property used by that operating business in a separate entity for liability protection purposes.

## What is an Employee for Purposes of I.R.C. § 199A?

As mentioned previously, a QTB does not include the performance of services as an employee. Treas. Reg. § 1.199A-5(a)(3), (d)(1). Thus, no items of income, gain, loss and deduction from performing services as an employee constitute QBI. Treas. Reg. § 1.199A-5(d)(1). Accordingly, no individual may claim a 199A deduction for wage income, regardless of the amount of that individual's taxable income. Treas. Reg. § 1.199A-5(a)(3).

Whether wages are earned as an employee is determined based on the proper classification of the worker for federal employment tax purposes. Treas. Reg. §1.199A-5(d)(2). Thus, misclassification of a worker as an independent contractor is irrelevant.

In addition, an individual is presumed to be an employee for purposes of the 199A deduction if that individual was previously properly treated as an employee for federal employment tax purposes by the employer and that individual is subsequently treated as other than an employee by that employer with regard to the provision of substantially the same services directly or indirectly to that employer (or a related person). Treas. Reg. §1.199A-5(d)(3).

This presumption continues for three years after the individual is no longer treated as an employee and applies regardless of whether the individual provides services directly or indirectly through an entity. The presumption, however, may be rebutted upon a showing that, under federal tax common law standards, the individual is performing services in a capacity other than as an employee.

## What is an SSTB?

### SSTB Categories

An SSTB involves the performance of services in the following statutorily designated fields:

- Health;
- Law;
- Accounting;
- Actuarial science;
- Performing arts;
- Consulting;
- Athletics;
- Financial services; or
- Brokerage services.

An SSTB also involves the performance of services that consist of investing and investment management, trading and dealing in securities, partnership interests or commodities. I.R.C. §199A(d)(2)(B). All of the aforementioned fields of services that are explicitly listed as constituting an SSTB are hereafter referred to as the "listed categories."

In addition, an SSTB 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 owners or employees. I.R.C. §199A(d)(1). This "reputation or skill" category initially caused considerable concerns, but those concerns are significantly addressed by the 199A regulations, as discussed below.

The regulatory descriptions of the listed categories are relatively straightforward and thus are not discussed here. Instead, this article focuses on the meaning of the "consulting" and "reputation or skill" categories, because they have been the source of greater uncertainty.

### "Consulting"

"Consulting" means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Treas. Reg. §1.199A-5(b)(2)(vii). Consulting also includes providing advice and counsel regarding public advocacy or lobbying with the intention of influencing decisions made by governmental agencies or legislators.

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. For this purpose, 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. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided.

In addition, 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 a 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 199A regulations contain three examples distinguishing between situations that constitute consulting for purposes of the 199A deduction and those that do not. First, if a business advises clients regarding making their personnel structures more efficient, without providing any temporary workers to the clients or receiving compensation based on the client's use of temporary workers, that business involves consulting services for purposes of SSTB status. Treas. Reg. §1.199A-5(b)(3), Ex. 8.

**The 199A regulations contain three examples distinguishing between situations that constitute consulting for purposes of the 199A deduction and those that do not.**

Conversely, if the business merely involves providing temporary workers to clients for a fixed fee, that business may not involve consulting services, even if the temporary workers provide consulting advice to the clients. Treas. Reg. §1.199A-5(b)(3), Ex. 9.

Lastly, if a business involves licensing software to customers for a flat price, that business may not involve consulting services, even if the business involves advising customers regarding the particular software that may best fit the customers' needs. Treas. Reg. §1.199A-5(b)(3), Ex. 10.

### "Reputation or Skill"

In addition, an SSTB includes any trade or business in which the principal asset is the reputation or skill of one or more of its owners or employees. I.R.C. §199A(d)(1). This "reputation or skill" category initially caused a lot of concern that it would be interpreted broadly to cause a wide range of service businesses to be considered an SSTB even though they were not specifically identified by Congress. The 199A regulations alleviate these concerns.

The reputation or skill category means any trade or business that consists of any of the following activities (or any combination thereof):

- A trade or business in which a person receives fees, compensation or other income for endorsing products or services;
- 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; or
- Receiving fees, compensation or other income for appearing at an event or on radio, television or another media format. Treas. Reg. §1.199A-5(b)(2)(xiv).

For these purposes, a person is considered as "receiving fees, compensation or other income" if that person receives a partnership interest or S corporation stock and the corresponding allocable share of income, deduction, gain or loss from the partnership or S corporation. Treas. Reg. §1.199A-5(b)(2)(xiv)(D).

Notably, the 199A regulations provide that the reputation or skill category "means" (as opposed to "includes") the aforementioned personal likeness-type activities. Thus, the 199A regulations appear to limit the scope of the "reputation or skill" category to those specific personal likeness-type activities specifically described therein.

### Attribution of SSTB Status

The 199A regulations also contain a rule through which a trade or business that would ordinarily be eligible for QTB treatment is instead treated as an SSTB, but only to the extent that it provides goods or services to a commonly owned SSTB. Treas. Reg. §1.199A-5(c)(2). Common ownership for this purpose includes the direct or indirect ownership of 50% or more of both trades or businesses by related persons within the meaning of I.R.C. §§ 267(b) or 707(b).

The 199A regulations clarify that the treatment of the otherwise qualifying trade or business as an SSTB is only with respect to the related persons who comprise the common ownership interest in the two businesses. Thus, if a business is owned by two persons (Alison and Brenda), Alison owns more than 75% of the business and 100% of an SSTB, Brenda owns only 25% of the business and none of the SSTB, and the business derives all of its income from performing non-SSTB services for the SSTB, that business will be treated as an SSTB as to Alison, but not Brenda.

The 199A regulations contain an example illustrating a situation in which SSTB status is attributed to a non-SSTB business that derives its income from a commonly controlled SSTB. The example involves a partnership (Law Firm) that provides legal services to clients, owns its own office building and employs its own administrative staff. Law Firm divides into three partnerships. Partnership 1 performs legal services to clients. Partnership 2 owns the office building and rents the entire building to Partnership 1. Partnership 3 employs the administrative staff and through a contract with Partnership 1 provides administrative services to Partnership 1 in exchange for fees.

All three of the partnerships are owned by the same people (the original owners of Law Firm). Because Partnership 2 provides all of its property to Partnership 1, and Partnership 3 provides all of its services to Partnership 1, Partnerships 1, 2 and 3 would be treated as one SSTB for purposes of I.R.C. § 199A. Treas. Reg. § 1.199A-5(c)(2)(iii)(A).

If, however, Partnership 2 rents only 50% of the building to Partnership 1 and the other 50% is rented to unrelated third party tenants, only 50% of Partnership 2's leasing activity would be treated as an SSTB. The other 50% would be eligible for treatment as a QTB. Treas. Reg. § 1.199A-5(c)(2)(iii)(B).

## Claiming the 199A Deduction

The 199A regulations provide a great deal of additional clarity regarding the threshold issue of whether a client is engaged in a QTB and is, therefore, potentially eligible to claim the 199A deduction. Specifically, the 199A regulations provide a potential safe harbor that, if finalized, will provide taxpayers in the rental real estate business with protection in qualifying for the 199A deduction.

Once a client has satisfied the eligibility requirements for the 199A deduction, the next challenge is applying the 199A regulations in the manner that maximizes the amount of the client's 199A deduction. The next article in this series will discuss the manner in which the 199A regulations provide professionals with opportunities to assist their clients in doing so.


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# 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.

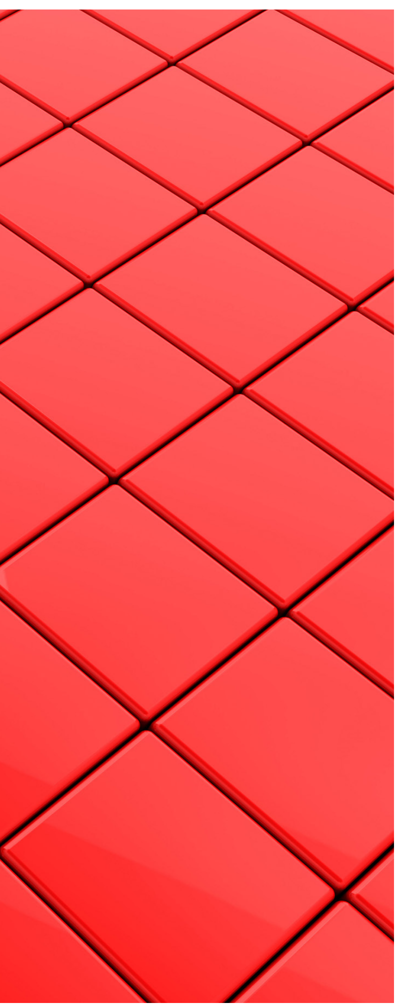
In this manner, the reimbursing QTB can get credit for the W-2 wages paid for the services allocated to that QTB. Of course, the workers' services and W-2 wages should be allocated among the affiliated QTBs consistently with how those QTBs' truly benefitted from those services.

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.

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