GETTING THE 411 ON IRC 199A: JUST THE FACTS, MA'AM*

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I. INTRODUCTION

Income taxes are a pervasive part of our lives, and the year 2013 brought significant changes regarding income taxes. In that year, the net investment income tax, enacted as part of the Health Care and Education Reconciliation Act of 2010, P.L. 111-152, 124 Stat. 1029 (2010), became effective and imposes a 3.8% income tax on passive income of individuals, trusts, and estates. In addition, with the passing of the American Taxpayer Relief Act of 2012, P.L. 112-24, 126 Stat. 2313 (2013) ("ATRA 2012"), the highest tax bracket for estate, gift, and generation-skipping transfer ("GST") tax purposes went from 35% to 40%, making the spread between these tax rates and the highest income tax rate virtually nil. Estate planners and their clients began to have a new focus on the role of income taxes as part of estate planning.

Five years later, with the enactment of the Tax Cut and Jobs Act of 2017, P.L. 115-97, 131 Stat. 2054 (2018) ("TCJA 2017") on December 22, 2017,[1] new Section 199A is part of the Code (the "Code")[2], and provides a potential deduction of up to 20 percent of the qualified business income of a domestic business operated as a sole proprietorship or through a partnership or S corporation.[3] In addition to this new deduction, TCJA 2017 reduced the highest federal income tax rate for individuals, trusts, and estates on ordinary income from 39.6% to 37%,[4] and reduced the highest federal income tax rate for C corporations from 35% to 21%.[5] Certain provisions of TCJA 2017 are "permanent," or at least as permanent as tax laws can be, while others expire. The Section 199A deduction is one of the TCJA 2017 items that expire. For now, it applies only for the tax years 2018 through 2025. IRC § 199A(i).

At what seems to be lightning speed, the Treasury and IRS issued proposed Treasury regulations related to Section 199A on August 8, 2018. Interestingly, as part of this same issuance, proposed Treasury regulations were issued regarding Section 643(f) of the Code. *See* 83 Fed. Reg. 40,884 (Aug. 16, 2018). When issuing the regulations, the IRS and Treasury invited comments, and groups, such as The American College of Trust and Estate Counsel ("ACTEC") and the American Institute of Certified Public Accountants ("AICPA") submitted extensive, substantive comments. ACTEC's comments are attached as Exhibit A. A hearing was held on the proposed regulations on October 16, 2018. A draft of the final Treasury regulations was released on January 18, 2019, and the final regulations were published on February 8, 2019 at 84 Fed. Reg. 2952.[6]

It is essential for estate planners to have a fundamental understanding of the income tax issues that are important to their clients. To be clear, this paper is not an "all things Section 199A" paper. It does not answer every question out there about Section 199A, and instead, it is intended to provide an overview of the basics of the Section 199A deduction. This paper is designed to give a breakdown of Section 199A and the Treasury regulations related to that

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[1] The technical name of the Act is "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018", but "AAPRPTIIVCRBFY 2018" seems to be a remarkably unhelpful acronym. Some have suggested "the Act Formerly known as TCJA 2017," or perhaps its abbreviation, "AFKATCJA."

[2] References herein to "Section(s)" or to "Code" are to the Internal Revenue Code of 1986, as amended. References herein to § are to relevant sections of the final Treasury regulations, and to the "Preamble" are references to the preamble to the final regulations, unless otherwise noted.

[3] As part of TCJA 2017, Section 199 was repealed. Certain of the provisions of former Section 199 were used as models for provisions of Section 199A.

[4] IRC § 1. In the last quarter of each year, the IRS issues a Revenue Procedure that provides the inflation-adjusted numbers for a variety of items. Revenue Procedure 2016-55, 2016-45 IRB 707 was issued on October 25, 2016 and provides the tax rate tables for taxpayers for the year 2017. Although a Revenue Procedure was issued on October 19, 2017 to provide the tax rate tables for 2018, the enactment of TCJA 2017 overrode that Revenue Procedure and published new tables as part of the Act. For years after 2018, income tax brackets will be adjusted by Chained CPI. Certain other inflation-adjusted numbers that require the application of Chained CPI, such as the exclusion amounts for transfer tax purposes, also required an official update by the IRS. On March 2, 2018, the IRS issued an updated Revenue Procedure establishing many 2018 inflation-adjusted figures using the Chained CPI method. Rev. Proc. 2018-18, 2018-10 IRB 392.

[5] IRC § 11(b).

[6] This paper was originally submitted on November 12, 2018 as part of the materials for the 53rd Annual Heckerling Institute on Estate Planning, but has been updated to incorporate the final regulations related to Sections 199A and 643(f).

section and Section 643(f) of the Code. The regulations provide numerous examples, and a conscious decision was made to not restate those examples but leave it to the reader to refer to the regulations in that respect. Lastly, certain specialty provisions of Section 199A, namely the provisions related to specified agricultural or horticultural cooperatives, are not covered and are left to someone more scholarly on those areas.

II. THE 199A OVERVIEW

As noted above, the Section 199A deduction is based on the "qualified business income" of noncorporate domestic businesses, i.e. pass-through entities, which include sole proprietorships, partnerships, and S corporations, although the deduction is subject to various limitations. Although partnerships are often termed "taxpayers," they are pass-through entities that never pay tax. Instead, partnerships report income and expenses on an IRS Form 1065, "U.S. Return of Partnership Income," and then provide a Schedule K-1 to each partner who then reports the information provided on the K-1 on the partner's individual income tax return. A corporation that elects to be taxed as an S corporation under Subchapter S of the Code reports its income and expenses similarly, instead filing an IRS Form 1120S, "U.S. Income Tax Return for an S Corporation," and then providing a Schedule K-1 to each shareholder who then reports the information provided on the K-1 on the shareholder's individual income tax return.

Until tax years beginning after December 31, 2025, the Section 199A deduction may be taken by "individuals" and by non-grantor trusts and estates. The Section 199A deduction is a deduction for income tax purposes only. IRC § 199A(f)(3). For taxpayers whose taxable income exceeds a statutorily-defined amount or "threshold amount," the deduction may be limited, or even lost, based upon the type of business, the amount of wages paid by the business, or the unadjusted basis of assets used in the business. Like all income tax deductions, Section 199A is a matter of legislative grace, so while a limitation on or loss of the deduction may feel like a penalty, it is not.

Note that partnerships, S corporations, and similar pass-through entities do not take the deduction themselves. Rather, they are required to provide owners of the entities with relevant information so that the owners can compute their individual available Section 199A deduction. Separate recordkeeping for items that apply solely for purposes of Section 199A will be needed. Moreover, the limitations based upon taxable income apply at the owner and not the entity level, and in the case of partnerships and S corporations, Section 199A is applied at the partner or shareholder level, not at the entity level. If the owner of an entity happens to be an estate or trust, the deduction may be further passed through, in whole or in part, to the beneficiaries of the estate or trust. In that case, limitations based upon taxable income may apply at the beneficiary level to the extent items are passed through to them.

As noted above, in addition to reducing the highest federal income tax rate for individuals, trusts, and estates on ordinary income to 37%, TCJA 2017 also brought with it a reduction in the top corporate tax rate, reducing it to 21%.[7] Loosely speaking, the Section 199A deduction can be thought of as a way to bring the tax rate for individuals who have income derived from pass-through entities a little more on par with the tax rate applicable to income earned by C corporations. How so? Because if we start with the highest individual income tax rate of 37% and allow a deduction of 20%, the effective tax rate becomes 29.6% [.37 x (1-.2) = .296]. For individual taxpayers in the 32% bracket, after taking into account the 20% deduction, the effective tax rate becomes 25.6% [.32 x (1-.2) = .256].

Here's the skinny: A taxpayer, other than a corporation, is allowed a deduction equal to the lesser of either the taxpayer's combined qualified business income ("QBI") or twenty percent (20%) of the excess of the taxpayer's taxable income less the taxpayer's net capital gain for the taxable year. The deduction may be illustrated as:

$$\boldsymbol{Section\ 199A\ deduction} = < \left(combined\ QBI\ amount\ or\ 20\%\ (taxable\ income - net\ capital\ gain)\right)$$

The formula appears simple but much goes into that formula, at least as far as what comprises the combined QBI amount. The definition of the combined QBI amount is tricky because, although the structure starts out the same for all taxpayers, several modifications are made as you keep reading the statute. Essentially, you learn that taxpayers can fall into one of three strata. Stratum I is for those taxpayers who fall at or below the Section 199A threshold amount, Stratum II is for those taxpayers who fall above the threshold amount but within the added Section 199A phase-in range, and Stratum III is for those taxpayers who fall above the threshold amount plus the phase-in range. Add to that the possibility that a taxpayer may be involved in something called a "specified service trade or business," and if so, the strata can become rockier or even crumble away.

As one can begin to see even in this overview, Section 199A has its own vocabulary. Understanding Section 199A necessitates becoming familiar with its language. Overall, even at more than 4,300 words, Code Section 199A itself

[7] IRC § 11(b).

is somewhat skeletal with much of the meat on its bones provided in the Treasury regulations, which are organized in a helpful structure. The Treasury regulations are organized in six parts:

§ 1.199A-1 = Operational rules

§ 1.199A-2 = Determining W-2 wages and unadjusted basis immediately after acquisition of qualified property

§ 1.199A-3 = Determining qualified business income, qualified real estate investment trust dividends, and qualified publicly traded partnership income

§ 1.199A-4 = Aggregation rules

§ 1.199A-5 = Specified service trade or business and the trade or business of performing services as an employee

§ 1.199A-6 = Special rules for relevant pass-through entities, publicly traded partnerships, trusts, and estates

In addition to the foregoing regulations, § 1.643(f)-1 was issued in an attempt to address perceived anti-avoidance rules for multiple trusts, although the final Treasury regulations are vastly different than as proposed.

Article IV of the paper provides a running list of what I call "Section 199A Rules of Thumb," and Article V discusses the mechanics of Section 199A. In both of those articles, I reference Section 199A terms with the assumption that the reader understands the vocabulary. If you believe you do, feel free to move on to those articles! If not, Article III can serve as a guide.

So, how about that 199A vocabulary?

III. THE 199A VOCABULARY

Section 199A of the Code introduces new terms or puts a spin on old terms. To understand the Section 199A deduction, it is helpful to have a good grasp of the terms as used in the statute and Treasury regulations. Most of these terms are discussed in more detail in context of their use relative to the Section 199A deduction, but an overview of the vocabulary is a helpful predicate to the discussion that follows. The new terms[8] are as follows:

A. Aggregated trades or businesses

Aggregated trades or businesses are two or more trades or businesses (not necessarily two or more entities) that have been aggregated at the election of an individual or a relevant pass-through entity ("RPE") pursuant to § 1.199A-4. If an election to aggregate is made, the individual can treat those aggregated trades or businesses as a single trade or business in applying the limitations imposed on the determination of the QBI component under § 1.199A-1(d)(2)(iv). Because those limitations do not apply to individuals whose taxable income is below the threshold amount (so-called Stratum I individuals), this term is not important for those individuals. Note that the final Treasury regulations broaden the ability to aggregate such that not only can aggregation be done by individual owners, it can be done by RPEs as well. Treas. Reg. § 1.199A-4(b).

B. Alternative limitation

For individuals whose taxable income is above the threshold amount (so-called Stratum II and III individuals), the QBI component of the Section 199A deduction is subject to limitations. For these individuals, the QBI component is limited to the lesser of two amounts for each qualified trade or business, with the second amount being the greater of two amounts. This "greater of" calculation is the greater of: (1) 50% of W-2 wages with respect to each qualified trade or business, or (2) the sum of 25% of W-2 wages with respect to each qualified trade or business plus 2.5% of UBIA of qualified property, the latter portion of this calculation seeming to favor real estate companies. IRC § 199A(b)(2)(B);. Treas. Reg. § 1.199A-1(d)(2)(iv). Although not found in Section 199A or its related Treasury regulations, the Preamble to the proposed regulations terms this "greater of" calculation as the "alternative limitation," which is a handy moniker that will be used in this paper.[9] Some commentator refers to item (1) of the calculation as the "wage limitation"

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[8] Many of the terms of or rules for Section 199A involve one or more formulae, and the relevant formula is set out with the relevant vocabulary term. In addition, a summary of the formulae presented in the order of application for the three Strata of taxpayers is included as Exhibit C.

[9] The Preamble does not include this reference and instead references the "W-2 wage limitation" or "W-2 wage and UBIA of qualified property limitation." I prefer the shorthand "alternative limitation" to refer to both.

and item (2) of the calculation as the "capital limitation," although this latter calculation is composed of a percentage of both W-2 wages and UBIA of qualified property.

If the alternative limitation must be tested, the formula for this portion of the QBI component for each trade or business is:

$$\boldsymbol{Alternative\ limitation} => \left[50\%\ (W-2\ wages)\, or\ \left(25\%\ (W-2\ wages) + 2.5\%\ (UBIA\ of\ qualified\ property)\right)\right]$$

Taking into account the alternative limitation, an individual's QBI component for each trade or business may be limited to the lesser of twenty percent (20%) of QBI or the alternative limitation. Treas. Reg. § 1.199A-1(d)(2).

C. Applicable percentage

Applicable percentage is important for individuals who fall within the phase-in limit (Stratum II individuals) and who are allocated items from an SSTB. It is the percentage applied to an individual's share of any QBI, W-2 wages, and UBIA of qualified property from an SSTB for purposes of determining any reduction to the individual's Section 199A deduction. IRC § 199A(d)(3). As long as an individual's taxable income falls within the phase-in limit, the applicable percentage applies to all of the individual's share of QBI, W-2 wages, and UBIA of qualified property from each SSTB. IRC § 199A(d)(3); Treas. Reg. § 1.199A-1(d)(2)(i). If an individual's taxable income exceeds the phase-in limit (Stratum III individuals), the applicable percentage can be ignored because all QBI, W-2 wages, and UBIA of qualified property from an SSTB are disregarded and none of those amounts can be used to calculate the individual's Section 199A deduction. IRC § 199A(d)(1), Treas. Reg. § 1.199A-1(d)(2)(i). If the applicable percentage applies, the formula is:

$$\boldsymbol{Applicable\ percentage} = 100\% - \frac{(Taxable\ income - threshold\ amount)}{\$50{,}000\ (single\ filer), or\ \$100{,}000\ (joint\ filer)}$$

D. Combined qualified business income amount, or combined QBI amount

"Combined qualified business income amount" or "combined QBI amount" is one of the fundamental elements of the Section 199A deduction, serving as one of the limitations or caps for the deduction. IRC § 199A(a). Note that when reading the Preamble and the Treasury regulations, the term "total QBI" is also used. However, "total" QBI does not include aggregate qualified REIT dividends and qualified PTP income and should not be confused with the combined QBI amount.

Section 199A(b) of the Code addresses the definition of the combined QBI amount by formula. The formula to determine the combined QBI amount for each taxable year of an individual is composed of two parts and may be illustrated in its simplest form as follows:

$$\boldsymbol{Combined\ QBI\ amount} = QBI\ component + 20\%\ (aggregate\ qualified\ REIT\ dividends\ and\ qualified\ PTP\ income)$$

As shown in the formula, two elements must be known in order to determine the combined QBI amount. First, the QBI component must be calculated. Second, twenty percent (20%) of aggregate qualified REIT dividends and qualified PTP income must be calculated. Determining the QBI component involves determining the "deductible amount" for each qualified trade or business of an individual, as further detailed in Section 199A(b)(2) of the Code and § 1.199A-1(d)(2)(iv). When learning the definition of the deductible amount, one learns this number involves a calculation of twenty percent (20%) of QBI, which relates to the notion that the Section 199A deduction is a potential 20% deduction for qualified business income from pass-through entities. In addition, for some individuals (i.e., those above the threshold amount), it may be further limited by W-2 wages and UBIA of qualified property, or because the trade or business is an SSTB.

As noted in the definitions of QBI, qualified REIT dividends, and qualified PTP income, each of these items may be negative in a taxable year. If so, regardless of whether an individual has taxable income above or below the threshold amount, either of the two elements comprising the combined QBI amount may be negative. In other words, the QBI component and/or the aggregate qualified PTP income and REIT dividends may be negative. For purposes of determining the combined QBI amount, the number to use in the formula for either negative element will be zero while the negative number itself, i.e. negative total QBI amount or negative aggregate qualified REIT dividends and qualified PTP income, will carry forward to the next year to offset any positive QBI or positive aggregate qualified REIT dividends and qualified PTP income, respectively. Treas. Reg. §§ 1.199A-1(c)(2)(i), (c)(2)(ii), (d)(2)(iii)(B), (d)(3)(iii). Although individuals whose taxable income exceeds the threshold amount are subject to the alternative limitation related to W-2 wages or W-2 wages and UBIA of qualified property, only any negative total QBI amount will carry forward; W-2 wages or UBIA of qualified property related to the trades or businesses that produced negative QBI will not carry forward. Treas. Reg. § 1.199A-1(d)(2)(iii).

E. Depreciable period

For calculations based on a trade or business's qualified property for purposes of the Section 199A deduction, only qualified property for which the depreciable period has not ended before the close of the taxable year is considered. Treas. Reg. § 1.199A-2(c)(1). Although subject to many qualifying factors, as a starting point, the depreciable period begins on the date the individual or relevant pass-through entity ("RPE") first places the property in service and ends on the later of (a) the date that is 10 years after that date, or (b) the last day of the last full year in the property's class life based on the applicable recovery period under the accelerated cost recovery system of Section 168(c) of the Code. IRC § 199A(b)(6)(B); Treas. Reg. § 1.199A-2(c)(2). Any additional first-year depreciation under Code Section 168 that would apply for other purposes of the Code does not apply for Section 199A purposes. Treas. Reg. § 1.199A-2(c)(2)(ii). Because there may be a mismatch between the depreciable period for Section 199A purposes and depreciation for other income tax purposes, trades and businesses will need to separately track each. Also, note that what is being tracked is the depreciable period on the placed in service date, not depreciation itself, meaning the depreciable period is a factor of time and does not affect the value or basis of the property. Keeping in mind that once the depreciable period ends, the property is no longer qualified property, so it may be important to determine if options are available to restart the depreciable period. The "many qualifying factors" mentioned above are discussed in further detail below in Article V.I.3.

F. Excess amount

The "excess amount" applies only if (i) an individual's taxable income falls within the phase-in range (Stratum II individuals), and (ii) the 20% portion of the QBI component is the greater of the two limitation amounts determined under the QBI component formula. The excess amount is a component of the reduction amount, which serves to further reduce the individual's QBI component, and may be illustrated as:

$$\boldsymbol{Excess\ amount} = 20\%\ (QBI) - > \left[50\%\ (W\text{–}2\ wages)\ or\ \left(25\%\ (W\text{–}2\ wages) + 2.5\%\ (UBIA\ of\ qualified\ property)\right)\right]$$

IRC § 199A(b)(3)(B)(iii); Treas. Reg. § 1.199A-1(b)(9).

G. Individual

According to Code Section 199A, the Section 199A deduction is available to taxpayers "other than a corporation," although "corporation" in this context does not include S corporations. IRC §§ 199A(a), (f)(1)(A). In reality, because pass-through entities such as partnerships and S corporations do not pay tax, it is the individual owners of those entities that may be entitled to the deduction. Although the term "individual" is not used in Section 199A itself to describe who is entitled to the Section 199A deduction, it is used throughout the Treasury regulations to describe who is entitled to the deduction. Section 1.199A-1(a)(2) clarifies that, for purposes of the Treasury regulations, an individual includes an estate or a trust (other than a grantor trust) to the extent the estate or trust determines whether it may have a Section 199A deduction. This paper will use "individual" rather than "taxpayer" when discussing who may be entitled to a Section 199A deduction.

In the final regulations, Treasury and the IRS included a special rule defining disregarded entities. Specifically, if an entity has a single owner and is treated as a disregarded entity under any other provision of the Code, it will be treated as a disregarded entity for all purposes of Section 199A and the regulations. Treas. Reg. § 1.199A-1(e)(2). Presumably, if Revenue Procedure 2002-69 applies whereby an entity is treated as disregarded because it is owned solely by a husband and wife as community property under applicable law, even though the entity technically has two owners, the entity will be treated as disregarded for Section 199A purposes. Rev. Proc. 2002-69, 2002-2 CB 831.

H. Phase-in limit, amount, or range

For individuals whose taxable income falls within a certain range above the threshold amount, or phase-in range (i.e., our so-called, Stratum II individuals), limitations are placed on those individual's Section 199A deduction. The phase-in range falls between the threshold amount plus $50,000 for individuals who are single filers, estates, and trusts, or plus $100,000 for individuals who are joint filers. IRC § 199A(b)(3); Treas. Reg. § 1.199A-1(b)(4). Therefore, taking into account the threshold amount, the top end of the phase-in range for 2018 is $207,500 for single filers, estates, and trusts, and $415,000 for joint filers, and for 2019 is $210,700 for single filers, estate, and trusts, and $421,400 for joint filers.

If an individual's taxable income is within the phase-in limit, a ratio is used to reduce the 20% of QBI calculation based upon each trade's or business's W-2 wages, UBIA of qualified property, and SSTB status. IRC § 199A(b)(2), (3)(A); Treas. Reg. § 1.199A-1(c). These are our so-called Stratum II individuals. For Stratum II individuals, the Section 199A deduction may be limited, or reduced, because for these individuals, the reduction amount will be applied to the QBI portion of the QBI component for each trade or business if it is greater than the alternative limitation, and the applicable percentage will be applied to an individual's share of any QBI, W-2 wages, and UBIA of qualified property from an SSTB. IRC § 199A(b)(3); Treas. Reg. §§ 1.199A-1(b)(9), (d)(2)(iv).

I. Qualified business income, or QBI

Qualified business income, or QBI, is the "net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business" of an individual.[10] IRC § 199A(c)(1); Treas. Reg. §§ 1.199A-1(b)(5), -3(b). QBI is determined and reported by the individual or RPE that directly conducts a trade or business, and is determined prior to applying the aggregation rules of § 1.199A-4. Treas. Reg. § 1.199A-3(a).

QBI is what Code Section 199A is mainly about! In addition to what may be thought of as typical income, gain, deduction, and loss of a trade or business, it includes the following four categories:

- gain or loss attributable to transactions involving unrealized receivables or inventory of a partnership that result in ordinary income under Section 751(a) or (b) of the Code and that are attributable to the partnership's trades or businesses, so-called "hot assets." Treas. Reg. § 1.199A-3(b)(1)(i).
- adjustments under Section 481 of the Code that occur in tax years after December 31, 2017 for changes in method of accounting. Treas. Reg. § 1.199A-3(b)(1)(iii).
- previously disallowed losses or deductions that are allowed in a later year, applied in order from the oldest to the most recent on a first-in, first-out basis, as long as the disallowance arose in a taxable year beginning January 1, 2018 or after. Treas. Reg. § 1.199A-3(b)(1)(iv).
- net operating losses disallowed under Section 461(l) of the Code; otherwise, net operating losses are not included. Treas. Reg. § 1.199A-3(b)(1)(v).[11]

Several exceptions are placed on the general definition. Although these exceptions are discussed in more detail below in the definition of "qualified items of income, gain, deduction, and loss," a few words on the exceptions are merited. QBI must be effectively connected with an active U.S. trade or business[12]. IRC §§ 199A(c)(1), (3)(A)(i); Treas. Reg. § 1.199A-3(b). It does not include such things as qualified REIT dividends or qualified PTP income, reasonable compensation paid by a qualified trade or businesses to an individual for services rendered to the trade or business (although limited to the context of S corporations by the regulations), guaranteed payments described in Code Section 707(c) paid to a partner for services rendered to the trade or business, and payments paid to a partner for services rendered in a capacity other

[10] Note that QBI does not take into account credits, in contrast to the general pass-through rules applicable to partnerships and S corporations. *See, e.g.,* IRC §§ 704, 1366.

[11] Under TCJA 2017, for taxpayers other than C corporations, Code Section 461(l) disallows any "excess business loss" incurred in tax years beginning after December 31, 2018 and before January 1, 2026. IRC § 461(l)(1). An "excess business loss" is the excess of a taxpayer's aggregate deductions for the tax year attributable to trades or businesses of the taxpayer, less the sum of the taxpayer's aggregate gross income or gain for the tax year which is attributable to those trades or businesses, plus $250,000 ($500,000 for taxpayers filing a joint return). IRC § 461(l)(3)(A). The additional amounts are subject to adjustment for inflation. IRC § 461(l)(3)(B). For Section 199A purposes, excess business losses are included in QBI; net operating losses that are not disallowed under Section 461(l) are not included in QBI. Treas. Reg. § 1.199A-3(b)(1)(v). Thus, for 2018, QBI includes only net operating losses in excess of $250,000 ($500,000 for joint filers), and in 2019, includes only net operating losses in excess of $255,000 ($510,000 for joint filers). *See* Rev. Proc. 2018-57, 2018-49 IRB 827, § 3.32.

[12] If an individual's QBI comes from sources in Puerto Rico and all of it is taxable under chapter 1 of the Code, then for purposes of determining QBI, Puerto Rico is considered a U.S. trade or business. IRC § 199A(f)(1)(C); Treas. Reg. § 1.199A-3(b)(3).

than as a partner (regardless of whether the partner is an individual or an RPE). IRC §§ 199A(c)(1), (c)(4), 707; Treas. Reg. §§ 1.199A-1(b)(5), -3(b)(1)(ii), -3(b)(2).

In the case of reasonable compensation paid to a shareholder from an S corporation or a guaranteed payment or payment to a partner for service rendered in a capacity other than a partner, the S corporation's or partnership's deduction for the respective payment will reduce QBI if the payment is properly allocable to the trade or business and is deductible for federal income tax purposes. Treas. Reg. §§ 1.199A-3(b)(2)(ii)(H), (I), (J). Note that § 1.199A-3(b)(2)(ii)(H) limits the exclusion of reasonable compensation from QBI to that paid by an S corporation and does not exclude reasonable compensation paid by a partnership. Citing Revenue Rulings 74-44, 1974 CB 287 and 69-184, 1969-1 CB 256 in the Preamble to the proposed regulations, Treasury and the IRS determined that the exclusion is best kept to S corporations since they are subject to rules mandating the payment of reasonable compensation whereas partnerships are not. In other words, no rules mandate the payment of reasonable compensation, or even a guaranteed payment, to a partner. In addition, applying the rule to partnerships would violate the principle that a partner can never be an employee of a partnership. Although the reasoning was not kept in the Preamble, the insight is helpful.

Because QBI must be connected to a qualified trade or business, what constitutes a qualified trade or business is important. For example, as noted below in the definition of that term, the trade or business of performing services as an employee is excluded from the definition of a trade or business, and by doing so, it means that wage income received by an employee will never be QBI. In addition, if an individual's taxable income is above the threshold amount plus the phase-in limit (a Stratum III individual), an SSTB is not a qualified trade or business and any of the individual's share of QBI from an SSTB is ignored. Treas. Reg. § 1.199A-1(d)(2)(i).

In determining the Section 199A deduction for a nongrantor trust or an estate, QBI is to be allocated each year among the trust or estate and its beneficiaries in the same way as DNI is allocated for the year. Treas. Reg. § 1.199A-6(d)(3)(ii). In determining DNI for Section 199A purposes, the separate share rule of Section 663(c) is taken into account, but the Section 199A deduction is not. *Id*.

Because QBI is the net amount of defined items from a trade or business, it may be negative in a taxable year. If so, regardless of whether an individual has taxable income above or below the threshold amount, negative QBI from one trade or business will offset any positive QBI from another trade or business or be added to any other negative QBI for another trade or business to determine the individual's net total QBI amount. Treas. Reg. §§ 1.199A-1(c)(2)(i), (d)(2)(iii). If an individual ends up with a negative total QBI amount, the individual's QBI for that year is zero, and the negative total QBI amount is treated essentially as a loss coming from a separate trade or business and carries forward for Section 199A purposes as negative QBI to the following year for use in calculating the individual's potential Section 199A deduction in that following year. IRC § 199A(c)(2); Treas. Reg. §§ 1.199A-1(c)(2)(i), (d)(2)(iii)(B). Note, although individuals whose taxable income exceeds the threshold amount are subject to the alternative limitation related to W-2 wages or W-2 wages and UBIA of qualified property, only any negative total QBI amount will carry forward; W-2 wages or UBIA of qualified property related to the trades or businesses that produced negative QBI will not carry forward. Treas. Reg. § 1.199A-1(d)(2)(iii).

Regardless of whether an individual has taxable income above or below the threshold amount, if the individual has QBI from multiple trades or businesses, and has negative QBI from some trades or businesses but overall positive QBI from all trades or businesses, an allocation of the negative QBI is made. The individual must determine the relative amounts of positive QBI from the trades or businesses that produced positive QBI and then apportion and offset the negative QBI against the positive QBI in the same proportions. Treas. Reg. §§ 1.199A-1(c)(2)(i), (d)(2)(iii)(A). For individuals whose taxable income exceeds the threshold amount, once the allocation is made, the resulting QBI for each trade or business is added together and twenty percent (20%) of that amount is then compared to the alternative limitation to determine which is the lesser amount, to then determine the combined QBI amount. Treas. Reg. § 1.199A-1(d)(2)(iv).

J. Qualified items of income, gain, deduction, and loss

QBI includes net amounts of qualified items of income, gain, deduction, and loss. IRC §§ 199A(c)(1), (3)(A); Treas. Reg. §§ 1.199A-3(b)(1), (2). To be qualified, the items must be effectively connected with the conduct of a trade or business in the United States and be included or allowed in determining taxable income. *Id*. The rules set forth in Code Section 864(c) determine whether income, gain, deduction, or loss are effectively connected with the United States. IRC § 199A(c)(3)(A)(i).

Section 199A(c)(3)(B), supplemented by § 1.199A-3(b)(2)(ii), provides a laundry list of ten categories of items that are not qualified items of income, gain, deduction, or loss. These include:

- short-term and long-term capital gains and losses, or any other item treated as such, such as Section 1231 gains and losses;
- dividends or their equivalents[13];
- interest income unless that income is properly allocable to a trade or business[14];
- gains or losses from foreign commodities transactions or foreign currency gains;
- notional principal contracts unless qualifying under Section 1221(a)(7);
- annuity amounts that are not received in connection with a trade or business;
- qualified REIT dividends or PTP income as defined in Section 199A;
- reasonable compensation paid from an S corporation to a shareholder;
- guaranteed payments under Section 707(c) paid to a partner for services rendered to the trade or business, regardless of whether the partner is an individual or an RPE, and because the partner may be an RPE, if a guaranteed payment is paid from a lower-tier partnership to an upper-tier partnership, it will retain its character as a guaranteed payment, and not be included in QBI of a partner in either tier; and
- payments paid to a partner under Section 707(a) for services rendered in a capacity other than as a partner, regardless of whether the partner is an individual or an RPE, and because the partner may be an RPE, if the payment is from a lower-tier partnership to an upper-tier partnership, it will retain its character, and not be included in QBI at either tier.

As noted in the definition of QBI, in the case of reasonable compensation paid to a shareholder from an S corporation or a guaranteed payment or payment to a partner for service rendered in a capacity other than a partner, the S corporation's or partnership's deduction for the respective payment will reduce QBI if the payment is properly allocable to the trade or business and is deductible for federal income tax purposes. Treas. Reg. §§ 1.199A-3(b)(2)(ii)(H), (I), (J).

Note that many of the excluded items are also described as foreign personal holding company income in Code Section 954(c).

K. QBI component

As noted in the definition of QBI, the determination of an individual's QBI component is further detailed in Section 199A(b)(2) of the Code and § 1.199A-1(d)(2). The term QBI component is not found in Section 199A but was coined in the proposed Treasury regulations and kept in the final regulations. Treas. Reg. §§ 1.199A-1(b)(5), (6). The QBI component applies for all individuals who may qualify for a Section 199A deduction,[15] and it involves a formula. It is the first calculation an individual makes to determine the combined QBI amount, which is the maximum Section 199A deduction that an individual may receive.

If an individual's taxable income is above the threshold amount, the individual must determine the lesser of two amounts for each qualified trade or business, with the latter of these amounts determined as the greater of two amounts.[16] Written out, for each qualified trade or business, the individual must determine (1) 20% of QBI, (2) 50% of W-2 wages, and (3) 25% of W-2 wages plus 2.5% of UBIA of qualified property. Treas. Reg. § 1.199A-1(d)(2)(iv). (Importantly, if an individual's taxable income falls below the threshold amount, only the QBI portion of the QBI component must be determined. Treas. Reg. § 1.199A-1(c).) The individual then compares the greater of (2) and (3) to (1), and the lesser of those two comparisons determines the

[13] Other than certain patronage dividends from farmers' cooperatives.

[14] If interest income is attributable to an investment in working capital, reserves, or similar accounts, then it is not properly allocable to a trade or business. Treas. Reg. § 1.199A-3(b)(2)(ii)(C).

[15] Of course, if an individual has no taxable income from a qualified trade or business but has qualified REIT dividends and/or PTP income, then the QBI component of the Section 199A deduction becomes irrelevant in that the QBI component will be zero and the combined QBI will be based solely on the qualified REIT dividends and qualified PTP income. The QBI component from any SSTB is also irrelevant for individuals whose only trades or businesses are SSTBs and their taxable income is greater than the threshold amount plus the phase-in limit.

[16] The taxpayer must also determine 20% of any qualified REIT dividends and qualified PTP income, but these items are the non QBI component of the combined QBI amount.

individual's QBI component. For an individual whose taxable income exceeds the threshold amount (but ignoring formulas for further limitations that may apply to individuals in the phase-in range, such as the reduction amount), the QBI component formula may be illustrated as:

$$\boldsymbol{QBI\ component} = <20\%\ (QBI)\ or\ > \left[50\%\ (W\text{–}2\ wages)\ or\ \left(25\%\ (W\text{–}2\ wages) + 2.5\%\ (UBIA\ of\ qualified\ property)\right)\right]$$

Note that the calculation of the QBI component may result in the lesser amount being an amount that does not include any QBI and only includes W-2 wages or W-2 wages and UBIA of qualified property. Again, importantly, if an individual's taxable income falls below the threshold amount, the W-2 wage and UBIA of qualified property limitations in the above formula can be ignored, and only 20 percent of QBI needs to be calculated.

As noted in the definition of QBI, because QBI is the net amount of defined items from a qualified trade or business, it may be negative in a taxable year. If so, regardless of whether an individual has taxable income above or below the threshold amount, negative QBI from one trade or business will offset any positive QBI from another trade or business or be added to any other negative QBI from another trade or business to determine the individual's net total QBI amount. Treas. Reg. §§ 1.199A-1(c)(2)(i), (d)(2)(iii). If an individual ends up with a negative total QBI amount, the individual's QBI for that year is zero, and the negative QBI amount is treated essentially as a loss coming from a separate trade or business and carries forward for Section 199A purposes as negative QBI to the following year for use in calculating the individual's potential Section 199A deduction in that following year. IRC § 199A(c)(2); Treas. Reg. §§ 1.199A-1(c)(2)(i), (d)(2)(iii)(B). In addition, for purposes of the above formula, regardless of whether any W-2 wages or UBIA of qualified property is allocated to an individual, the "lesser of" amount will be QBI since it will be zero, and therefore, the QBI component will be zero. Note, although individuals whose taxable income exceeds the threshold amount are subject to the alternative limitation related to W-2 wages or W-2 wages and UBIA of qualified property, only any negative total QBI amount will carry forward; W-2 wages or UBIA of qualified property related to the trades or businesses that produced negative QBI will not carry forward. Treas. Reg. § 1.199A-1(d)(2)(iii).

L. Qualified property

For individuals whose taxable income is above the threshold amount, calculations that involve qualified property become relevant, because the UBIA of qualified property can serve to limit the individual's Section 199A deduction. For purposes of Section 199A, qualified property includes only a trade or business's tangible property subject to depreciation under Section 167(a) of the Code. IRC § 199A(b)(6)(A); Treas. Reg. § 1.199A-2(c)(1)(i). Therefore, for real property, only improvements are included as qualified property, and not the underlying land itself. Treas. Reg. § 1.167(a)-2.

Section 199A(b)(6) provides that qualified property must be held by, and available for use in, the qualified trade or business at the close of the taxable year[17], be used at any point during the taxable year in the production of QBI, and for which the depreciable period for the property has not ended before the close of the taxable year. IRC § 199A(b)(6)(A); Treas. Reg. § 1.199A-2(c)(1)(i). To avoid taxpayers gaming the system by acquiring property at the end of the taxable year in an attempt to maximize a Section 199A deduction by lessening the effect of the alternative limitation on individuals, and then quickly disposing of the property, the Treasury regulations impose a holding period as an anti-abuse provision, as further discussed below in Article V.I.3.

If qualified property is already placed in service and improvements are later made, the improvements are treated as separate qualified property placed in service as of the date the improvement is first placed in service, and such date sets the beginning of the depreciable period for those improvements. Treas. Reg. §§ 1.199A-2(c)(1)(ii), (c)(2). In other words, the improvements are somewhat treated like a separate asset. Treasury and the IRS had noted in the Preamble to the proposed regulations that in doing so, rules similar to Code Section 168(i)(6) were being adopted.

[17] Based on the proposed regulations, I had made the comment that presumably this refers to the trades or business's taxable year, not the individual's taxable year**.** In the Preamble, Treasury and the IRS clarified that UBIA of qualified property is measured at the trade or business level, so if the property is owned by an RPE, the RPE's applicable year applies. Furthermore, if a taxpayer transfers an interest in the RPE prior to the close of the RPE's tax year, the taxpayer will not be entitled to a share of the UBIA from the RPE with respect to the transferred interest.

Improvements become qualified property, but what about special partnership basis adjustments, such as Section 754 adjustments? Although proposed § 1.199A-2(c)(1)(iii) provided "[b]asis adjustments under sections 734(b) and 743(b) are not treated as qualified property," the final regulations reversed this initial position, as further discussed below.

Therefore, for qualified property, trades or businesses will need to track several things, including each property's placed in service date, depreciable period, and UBIA. Additional nuances regarding qualified property are discussed below.

M. Qualified publicly traded partnership (PTP) income

The combined QBI amount includes twenty percent (20%) of an individual's qualified PTP income in a taxable year, aggregated with twenty percent (20%) of qualified REIT dividends, either of which may be earned directly or indirectly through an RPE. IRC § 199A(b)(1)(B); Treas. Reg. § 1.199A-3(c). Because qualified PTP income is included in the second element of the combined QBI amount, it is not also included in QBI. IRC § 199A(c)(1).

Keeping in line with the point that the Section 199A deduction relates to a deduction for income from pass-through entities, qualified PTP income is the sum of the net amount of an individual's share of income, gain, deduction, and loss from a PTP, as defined in Section 7704 and not taxed as a corporation, plus any gain or loss attributable to transactions involving unrealized receivables or inventory of a partnership that result in ordinary income under Section 751(a) or (b) of the Code and that are attributable to the partnership's trades or businesses. IRC § 199A(e)(4); Treas. Reg. § 1.199A-3(c)(3)(i).

In determining the Section 199A deduction for a nongrantor trust or estate, qualified PTP income is to be allocated each year among the trust or estate and its beneficiaries in the same way as DNI is allocated for the year. Treas. Reg. § 1.199A-6(d)(3)(ii). In determining DNI for Section 199A purposes, the separate share rule of Section 663(c) is taken into account, but the Section 199A deduction is not. *Id*.

If an individual's qualified PTP income is negative, it is netted against any positive qualified REIT dividends or added to any negative qualified REIT dividends to determine the aggregate qualified REIT dividends and qualified PTP income. If the combined number is negative, the deduction related to qualified REIT dividends and qualified PTP income is zero, and that negative number carries forward to succeeding taxable years for Section 199A purposes as negative combined qualified REIT dividends and qualified PTP income, to be netted against aggregate qualified PTP income and qualified REIT dividends in following years. Treas. Reg. § 1.199A-1(c)(2)(ii), (d)(3). Therefore, negative combined qualified REIT dividends and qualified PTP income are not netted against any positive QBI, and no negative Section 199A deduction can result.

N. Qualified real estate investment trust (REIT) dividends

The combined QBI amount includes twenty percent (20%) of an individual's qualified REIT dividends in a taxable year, aggregated with twenty percent (20%) of qualified PTP income, either of which may be earned directly or indirectly through an RPE. IRC § 199A(b)(1)(B); Treas. Reg. § 1.199A-3(c). Because qualified REIT dividends are included in the second element of the combined QBI amount, they are not also included in QBI. IRC § 199A(c)(1). A qualified REIT dividend includes any REIT dividend received in the taxable year that is not a capital gain dividend and is not qualified dividend income. IRC § 199A(e)(3); Treas. Reg. § 1.199A-3(c)(2)(A). In addition, in order to be a qualified REIT dividend, the REIT stock has a holding period for Section 199A purposes that tracks Code Section 246(c). Specifically, (1) the REIT dividend must be from REIT stock held for more than 45 days (after taking into account certain holding period rules set forth in Section 246 of the Code) during the 91-day period beginning 45 days before the date the stock becomes ex-dividend, and (2) the shareholder cannot be obligated to make payments with respect to substantially similar or related property. Treas. Reg. § 1.199A-3(c)(2)(ii)(B). The holding period was established as an anti-abuse rule and applies to taxable years ending after December 22, 2017. Treas. Reg. § 1.199A-3(e)(2)(i).

In determining the Section 199A deduction for a nongrantor trust or estate, qualified REIT dividends are to be allocated each year among the trust or estate and its beneficiaries in the same way as DNI is allocated for the year. Treas. Reg. § 1.199A-6(d)(3)(ii). In determining DNI for Section 199A purposes, the separate share rule of Section 663(c) is taken into account, but the Section 199A deduction is not. *Id*.

If an individual's qualified REIT dividends are negative, they are netted against any positive qualified PTP income or added to any negative qualified PTP income to determine the aggregate qualified REIT dividends and qualified PTP income. If the combined number is negative, the deduction related to qualified REIT dividends and qualified PTP income is zero and that negative number carries forward to succeeding taxable years for Section 199A purposes as negative combined qualified REIT dividends and qualified PTP income, to be netted against aggregate qualified REIT dividends and qualified PTP income in following years. Treas. Reg. §§ 1.199A-1(c)(2)(ii), (d)(3)(iii). Therefore, negative combined qualified REIT dividends and qualified PTP income are not netted against any positive QBI, and no negative Section 199A deduction can result.

O. Qualified trade or business

Remember that a qualified trade or business is pivotal for most parts of the deduction because QBI, W-2 wages, and qualified property all have to be associated with a qualified trade or business. In order to qualify for the Section 199A deduction, Section 199A(d) of the Code defines a qualified trade or business by stating what it is not, but be careful, the definition doesn't stop there. Section 199A(d) begins by stating that a qualified trade or business is a trade or business other than an SSTB or the trade or business of performing services as an employee. Further reading of that section shows that not all SSTBs fail to qualify as a qualified trade or business. Specifically, if an individual's taxable income in a taxable year is less than the threshold amount, an SSTB is a qualified trade or business. IRC § 199A(d)(3). If an individual's taxable income exceeds the threshold amount but is within the phase-in limit, an SSTB will also qualify as a qualified trade or business, but the individual's QBI, W-2 wages, and UBIA of qualified property allocable to the SSTB will be reduced. *Id*. If an individual's taxable income is more than the threshold amount plus the phase-in limit, that's when an SSTB does not qualify as a qualified trade or business and all of an individual's QBI, W-2 wages, and UBIA of qualified property allocable to the SSTB will be eliminated. Treas. Reg. § 1.199A-1(d)(2)(i).

By excluding the trade or business of performing services as an employee from the definition of a qualified trade or business, wage income received by an employee will never be QBI.

Although the term "qualified trade or business" is defined in Code Section 199A, the term "trade or business" is not, but the Treasury regulations shed some light on the term. Section 1.199A-1(b)(14) provides that a trade or business is a Code Section 162 trade or business, with two caveats. First, consistent with the Code Section 199A definition of a qualified trade or business, a trade or business does not include the trade or business of providing services as an employee. Second, in contrast to Section 162, rental activity, described as the rental or licensing of tangible or intangible property, will be a trade or business for Section 199A purposes, if the property is rented or licensed to a trade or business conducted by the individual or RPE and that meets the common control requirements of § 1.199A-4(b)(1), regardless of whether the rental activity and the trade or business are aggregated for Section 199A purposes. Treas. Reg. § 1.199A-1(b)(14). Therefore, rental activity that meets these requirements will be a trade or business for Section 199A purposes, even if the rental activity does not meet the requirements of Code Section 162.

By making reference to Code Section 162, for a trade or business other than rental activity as further qualified in the Treasury regulations, the trade or business must be one that has a profit motive and for which activities are regular, extensive, and continuous. As noted in the Preamble, Treasury and the IRS settled on Code Section 162 as the general measure due to taxpayers' familiarity with its standard and that appears to be the most practical for taxpayers and the IRS. Treasury and the IRS declined to adopt strict guidelines for what constitutes separate trades or businesses within an entity, but stated in the Preamble that they believe in order for multiple trades or businesses to exist, in general, different methods of accounting could be used for each, and in referencing § 1.446-1(d), complete and separable sets of books and records are kept for each. However, trades or businesses will not be considered separate if by using different methods of accounting, an artificial shifting of profits and losses occurs between the businesses.

Treasury and the IRS had noted in the Preamble to the proposed regulations that the reference to Code Section 162 was supplemented with rental activity for Section 199A purposes in recognition of the common business model of segregating rental businesses from operating businesses. A question was raised as to whether real estate rented pursuant to a triple net lease would be a qualified trade or business, with its owner potentially entitled to a Section 199A deduction, due to the facts set forth in two examples in the proposed regulations. *See* Treas. Prop. Reg. § 1.199A-1(d)(4)(iv), Exs. 1, 2. In response, Treasury and the IRS revised the examples and the IRS issued Notice 2019-7, 2019-9 IRB 740 to clarify that a "standard" triple net lease arrangement does not automatically qualify as a trade or business and does not meet the safe harbor provided in the Notice.

Notice 2019-7 was issued to preview a proposed revenue procedure creating a safe harbor for individuals and RPEs to determine if a rental real estate enterprise will be treated as a trade or business for Section 199A purposes. Several conditions are required for a real estate enterprise to be treated as a trade or business. The enterprise must be an interest in real property held for the production of rents, and the individual or RPE must hold the interest directly or through a disregarded entity. Furthermore, commercial and residential real property may not be part of the same enterprise. The enterprise may include an interest in multiple properties and a taxpayer may choose to treat each property as a separate enterprise or similar properties as a single enterprise. In addition, real estate used by the taxpayer for any part of a year as a residence is specifically excluded as is all real estate rented or lease pursuant to a triple net lease. In order for the enterprise to fit within the safe harbor, for the relevant taxable year, several requirements must be met: (1) separate books and records must be maintained for each enterprise; (2) for tax years prior to January 1, 2023, 250 or more hours of "rental services" must be performed per year for each enterprise and after that time, 250 or more hours must be spent on each enterprise in three of the five consecutive years that end with the taxable year at issue; (3) and the taxpayer must maintain records showing the dates, hours and description of all services performed, as well as who performed the services, with the records available for inspection. "Rental services" are defined to include advertising the rental or leasing, negotiating and executing leases; verifying information in rental applications, collecting rent; daily operating, maintaining, and repairing the property; managing the real estate; purchasing materials; and supervising employees and independent contractors. However, the rental services do not include such things as financial and investment management activities, work related to long-term capital improvements, or time spent traveling to and from the real estate. In order to qualify for the safe harbor, a taxpayer or RPE must include a statement that the safe harbor requirements have been satisfied, signed under penalty of perjury by a person with personal knowledge, on a return either claiming a Section 199A deduction or passing through Section 199A items.

It is important to remember that the requirements for a trade or business to "qualified" are for the trade or business itself and do not relate to the participation of the individual in the trade or business. In other words, there is no requirement that an individual have an active role in the trade or business, but rather, the individual may be a passive owner.

P. Reduction amount

The reduction amount applies only if (i) an individual's taxable income falls within the phase-in range (Stratum II individuals), and (ii) the 20% of QBI portion of the QBI component is the greater of the two limitation amounts determined under the QBI component formula. IRC § 199A(b)(3); Treas. Reg. § 1.199A-1(b)(9). If the reduction amount applies, it serves to further reduce the individual's QBI component, so that the individual's QBI component is equal to 20% of QBI reduced by the reduction amount. In effect, it serves to reduce the QBI element of combined QBI in proportion to how much the individual is within the phase-in range. The reduction amount reduces the 20% of QBI portion of the QBI component by a percentage of the amount by which 20% of QBI exceeds the alternative limitation. The percentage is the amount of the individual's income that exceeds the threshold amount divided by the phase-out amount. Treas. Reg. § 1.199A-1(d)(2)(iv)(B). For an SSTB, the reduction amount is applied after the applicable percentage has been taken into account. Treas. Reg. § 1.199A-1(d)(2).

The reduction amount is based on a ratio and may be illustrated as:

$$\boldsymbol{Reduction\ amount} = Excess\ amount\ \times \frac{(Taxable\ income - threshold\ amount)}{\$50{,}000\ (single\ filer), or\ \$100{,}000\ (joint\ filer)}$$

Q. Relevant pass-through entity (RPE)

A relevant pass-through entity ("RPE") is a term found in the Treasury regulations and refers to a pass-through entity that either operates a trade or business or passes through the qualified items of income, gain, loss, or deduction from lower-tier RPEs to an individual. An RPE is "a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly by at least one individual, estate, or trust." Treas. Reg. § 1.199A-1(b)(10). An estate or trust may also be an RPE, but only "to the extent it passes through QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income." *Id*. The final regulations expanded the definition of an RPE by providing that it includes other pass-through entities if the entity files a partnership income tax return (Form 1065) and is owned, directly or indirectly, by at least one individual, trust, or estate. *Id*. In short (with the exception of trusts and estates, which may be "individuals" in part and RPEs in part), an RPE is the entity that generates and passes through Section 199A items, as opposed to the individuals that may take the Section 199A deduction. Therefore, an RPE includes a sole proprietorship, partnership, S corporation, and in certain circumstances, a trust, or an estate.

R. Specified service trade or business (SSTB)

Keep in mind that an SSTB may or may not be a qualified trade or business for Section 199A purposes. As long as an individual's taxable income is less than the threshold amount (a Stratum I individual), an SSTB is a qualified trade or business, although limitations on the Section 199A deduction for items allocated to an individual from an SSTB occur if the individual's taxable income is above the threshold amount and within the additional phase-in amount (a Stratum II individual). IRC § 199A(d)(3); Treas. Reg. §§ 1.199A-1(d), -5(a)(2).

Section 199A(d)(2) defines an SSTB to include (i) for the most part, the qualified trades or businesses described in Code Section 1202(e)(3)(A), although as noted below, Section 199A(d)(2) excepts out those trades or businesses involving engineering and architecture, (ii) any trade or business described in Section 1202(e)(3)(A) if the term "employees" was substituted for "employees or owners," and (iii) any trade or business that involves services consisting of investing and investment management; trading; or dealing in securities, partnership interests, or commodities.

Because the definition of SSTBs in Code Section 199A(d)(2) left much to be desired, an entire section of the Treasury regulations is devoted to what constitutes an SSTB. Specifically, § 1.199A-5(b)(1) sets forth a laundry list with more detailed descriptions of each in § 1.199A-5(b)(2). The laundry list from Code Section 1202(e)(3)(A), as further described in § 1.199A-5(b)(2) solely for Section 199A purposes and which notably does not include engineering and architecture[18], includes the performance of services in the following fields:

- Health;
- Law,
- Accounting,
- Actuarial science,
- Performing arts,
- Consulting,
- Athletics,
- Financial services,
- Brokerage services,
- Investing and management,
- Trading,
- Dealing in securities, partnership interests, or commodities, and
- Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.

Although Section 1202 and its related Treasury regulations do not describe what constitutes the foregoing trades or businesses, § 1.199A-5(b)(2) does provide a description of each. For the most part, the descriptions are what one might expect (if not broader than what one might expect when factoring in that trades or businesses include fields of a particular service), but in some cases the descriptions have some surprising features. For example, although the field of health gives examples and states that it must directly relate to a medical service field, it does not include health clubs or health spas, presumably even if a physician orders a patient to use those services as therapy. Treas. Reg. § 1.199A-5(b)(2)(ii). Notably, the final regulations deleted language from the proposed regulations that stated services had to be provided directly to a patient. In multiple instances in the Preamble, Treasury and the IRS maintain that determining whether a particular field meets a definition is a facts and circumstances test, and in the case of health, the Preamble provides that proximity to a client is not a necessary component. In addition, in defining the meaning of "consulting," § 1.199A-5(b)(2)(vii), provides that consulting does not include services that are "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" and the services are not paid for separately. As another example, the field of brokerage services includes stock brokers but does not include real estate or life insurance agents and brokers. Treas. Reg. § 1.199A-5(b)(2)(x). An example of where Treasury and the IRS decided to elaborate on what constitutes, or does not constitute, a particular field of service is the field of "dealing," specifically dealing in commodities. The final regulations go to great lengths to except out a producer, processor, merchant, or handler of commodities as opposed to someone who deals in financial instruments that are commodities. Treas. Reg. § 1.199A-5(b)(2)(xiii).

One of the most surprising descriptions, because of its narrow construction, is for the trade or business where the principal asset is the reputation or skill of one of more of its employees or owners. For this field, the regulation limits its application to persons who receive some type of income for endorsing products or services; license or receive some type of income for the use of their image, likeness, name, signature, voice,

[18] We were somewhat confused in our firm as to why we wouldn't qualify as architects and/or engineers, since we design and engineer plans every day – then we realized we were specifically targeted in § 1.199A-5(b)(2)(iii).

trademark, or any other symbols associated with the individual's identity (think, the singer Prince); or receives personal appearance fees. Treas. Reg. § 1.199A-5(b)(2)(xiv).

In addition to the descriptions provided in § 1.199A-5(b)(2) for each category, several examples are provided in § 1.199A-5(b)(3), many of which were vastly revised from those in the proposed regulations. Upon closer inspection of the regulations, however, one sees that although the descriptions are helpful, their application may be difficult in practice in certain circumstances. When analyzing each field and determining whether a particular trade or business might fall into one or more categories, it will be prudent to review not only the final regulations and the examples given, but the Preamble as well.

The regulations provide additional rules for SSTBs, one a de minimis rule and the other being anti-abuse rules. The de minimis rule attempts to give relief to trades or businesses that have an SSTB as a somewhat incidental part of the trade or business, but if the de minimis rule is not met, the entire trade or business will be an SSTB. Pursuant to this rule, if a trade or business has gross receipts of $25 million dollars or less and less than ten percent (10%) of its gross receipts are attributable to an SSTB, the trade or business will not be an SSTB. Treas. Reg. § 1.199A-5(c)(1)(i). If the gross receipts are more than $25 million and less than five percent (5%) of the gross receipts are attributable to an SSTB, the trade or business will not be an SSTB. Treas. Reg. § 1.199A-5(c)(1)(ii). These calculations are made prior to applying the aggregation rules of § 1.199A-4. Treas. Reg. §§ 1.199A-4(a), (b)(1)(iv). Furthermore, any activity performed that is incidental to the actual performance of the specific field of service will be considered part of the performance of a service in that field. Treas. Reg. § 1.199A-5(c)(1)(i).

After the enactment of Section 199A, much talk ensued of possible ways to circumvent the SSTB rules by segregating or splitting off portions of a trade or business so that after the restructuring, the portion of the trade or business that would be treated as an SSTB would be isolated, thereby opening up the non-SSTB portion to a potential Section 199A deduction. Anti-abuse rules designed to combat these strategies are discussed in Article V.I.2.

S. Threshold amount

At its most fundamental level, the threshold amount, which is measured against an individual's taxable income, serves to determine whether an individual will receive the full Section 199A deduction or whether the deduction will be reduced in whole or in part by various limitations imposed by the Code and Treasury regulations. That is, whether an individual's taxable income is equal to or less than the threshold amount or exceeds the threshold amount determines whether an individual will be in Stratum I, or when coupled with the phase-in range, whether the individual will be in Stratum II or III.

The threshold amount is defined to be "$157,500 (200 percent of such amount in the case of a joint return)." IRC § 199A(e)(2)(A); Treas. Reg. § 1.199A-1(b)(12). Consequently, for 2018, the threshold amount is $157,500 for a taxpayer filing a single return, or $315,000 for taxpayers filing a joint return.[19] Treas. Reg. § 1.199A-1(b)(12). The threshold amount is adjusted for inflation after 2018.[20] IRC § 199A(e)(2)(B); Treas. Reg. § 1.199A-1(b)(12). For 2019, the threshold amount is $160,700 for single filers and $321,400 for married, filing jointly. Rev. Proc. 2018-57, 2018-49 IRB 827. The threshold limits for single filers applies to trusts and estates. Note that although the Treasury regulations give dollar figures for single and married, filing joint filers and indicate that both figures are inflation adjusted, the statute provides that the threshold amount for a joint return is 200% of the amount for a single return. If the proposed, and now final, regulations had been followed, the 2019 threshold amount for joint returns would have been $321,450 instead of $321,400 (which is 200% of the threshold amount for a single filer). Maybe the language in the proposed, and now final, regulations is why for married, filing separately, the threshold amount is $160,725 in 2019.

[19] Note that these amounts are equal to the upper income threshold amounts for the 24% ordinary income tax brackets for single filers and joint filers, respectively, or where the crossover from the 24% to the 32% brackets occurs. For income tax imposed on ordinary income, individuals, trusts, and estates share most of the same income tax brackets, including the highest bracket of 37%, although the brackets for trusts and estates are much more compressed. For trusts and estates, the highest income tax bracket of 37% is reached at $12,500 of ordinary income, so no correlation to the threshold amount and tax brackets exists for them.

[20] Prior to TCJA 2017, inflation was measured by changes to the Consumer Price Index ("CPI"), published by the U.S. Bureau of Labor Statistics. TCJA 2017 modified the index to the "Chained Consumer Price Index," ("C-CPI-U" or "Chained CPI"), which generally grows more slowly than CPI. Although many of the provisions related to individuals in TCJA 2017 are only effective for years 2018-2025, Chained CPI as the method of inflation adjustment is "permanent."

In brief, how does the threshold apply?

If an individual's taxable income falls at or below the threshold amount, the Section 199A deduction is simply equal to twenty percent (20%) of the individual's QBI for all qualified trades or businesses (which include SSTBs) plus 20% of the individual's aggregate qualified REIT dividends and PTP income for the year, or if less, 20% of the individual's taxable income less net capital gains. IRC §§ 199A(b)(2), (3)(A); Treas. Reg. § 1.199A-1(c). These are our so-called Stratum I individuals.

If an individual's taxable income is above the threshold amount plus the phase-in limit, the Section 199A deduction is subject to further limitations based upon the W-2 wages and UBIA of qualified property of each trade or business of the individual, but everything related to an SSTB is ignored. IRC §§ 199A(b)(2), (d); Treas. Reg. § 1.199A-1(d). These are our so-called Stratum III individuals.

If an individual's taxable income is within the phase-in limit, one percentage reduces the QBI, W-2 wages, and UBIA of qualified property from any SSTBs, and a separate ratio may reduce the 20% of QBI calculation based upon the individual's taxable income, threshold amount, and QBI, W-2 wages, and UBIA of qualified property for each qualified trade or business. IRC §§ 199A(b)(2), (3), (d)(3); Treas. Reg. §§ 1.199A-1(d)(2)(i), (iv). These are our so-called Stratum II individuals.

T. Total QBI amount

Total QBI amount is the "net total QBI from all trades or businesses." Treas. Reg. § 1.199A-1(b)(13). After netting all QBI allocated in a taxable year to an individual from all qualified trades or businesses, including from a trade or business conducted by an RPE, the individual's total QBI amount may be negative. If so, regardless of whether an individual has taxable income above or below the threshold amount, the individual's QBI for that year is zero, and the negative QBI amount is treated essentially as a loss coming from a separate trade or business and carries forward as negative QBI to succeeding years for use in calculating the individual's potential Section 199A deduction in following years. IRC § 199A(c)(2); Treas. Reg. § 1.199A-1(c)(2)(i). Note, although individuals whose taxable income exceeds the threshold amount are subject to the alternative limitation related to W-2 wages or W-2 wages and UBIA of qualified property, only any negative total QBI amount will carry forward; W-2 wages or UBIA of qualified property related to the trades or businesses that produced negative QBI will not carry forward. Treas. Reg. § 1.199A-1(d)(2)(iii).

U. Unadjusted basis immediately after acquisition (UBIA) of qualified property

An individual's share of UBIA of qualified property serves as a potential limitation on that individual's Section 199A deduction, or in some instances, a higher amount of UBIA of qualified property may curb the limitation. IRC §§ 199A(b)(2), (3)(A); Treas. Reg. § 1.199A-1(d). It only applies if the individual's taxable income is above the threshold amount, and regardless of whether that income is above the threshold amount plus the phase-in limit (a Stratum II or III individual). *Id*. If an individual's taxable income is below the threshold amount (a Stratum I individual), the individual's share of UBIA of qualified property can be ignored because it will not be used to impose any limitation on that individual's Section 199A deduction. IRC § 199A(b)(3)(A); Treas. Reg. § 1.199A-1(c)(1). If an individual's taxable income is above the threshold amount plus the phase-in limit (a Stratum III individual), any of the individual's share of UBIA of qualified property from an SSTB is ignored. Treas. Reg. § 1.199A-1(d)(2)(i).

Qualified property is defined separately herein. The key for UBIA of qualified property is that this it is *unadjusted* basis immediately after acquisition, which for most purposes will be its original cost basis. Code Section 199A does not define UBIA, so we must go to § 1.199A-2(c)(3) for a definition. UBIA is defined, subject to later exceptions, as "the basis on the placed in service date of the property as determined under section 1012 or other applicable sections of chapter 1. . . ." Treas. Reg. § 1.199A-2(c)(3)(i). ACTEC requested in its comments clarification that a Code Section 1014 basis adjustment would be recognized for this purpose, and § 1.199A-2(c)(3)(v) was added confirming that UBIA of qualified property would generally be the fair market value on a decedent's date of death with a new depreciable period beginning on that date.

Because the regulations incorporate other rules, such as Subchapter C (relating to corporations) and Subchapter K (relating to partnerships), in non-recognition transfers, the transferor's adjusted basis in qualified property will carry over to the transferee as new unadjusted basis. Because the basis is unadjusted, the regulations specify that UBIA is determined without taking into account any adjustments for depreciation or tax credits, or for any basis adjustments for which the individual or an RPE has elected to expense, such as Section 179 expenses and bonus depreciation. Treas. Reg. § 1.199A-2(c)(3)(i). Therefore, if Section 179 expenses or bonus depreciation are taken, neither will affect, i.e. lower, UBIA of qualified property.

Allocation of UBIA of qualified property differs, however, if the property is held by a partnership or S corporation. A partnership allocates UBIA of qualified property to each partner in the same way it allocates depreciation under § 1.704-1(b)(2)(iv)(g) on the last day of the taxable year. Treas. Reg. § 1.199A-2(a)(3)(ii). An S corporation allocates UBIA of qualified property to each shareholder based on the number of shares of stock held by the shareholder on the last day of the taxable year over all issues and outstanding shares. Treas. Reg. § 1.199A-2(a)(3)(iii).

Reversing the position taken in the proposed regulations, the final regulations provide that certain special partnership basis adjustments, such as Section 754 adjustments are also taken into account. The Treasury regulations address this issue not by directly referencing Section 754, but by stating that excess Section 743(b) basis adjustments are treated as qualified property. Treas. Reg. § 1.199A-2(c)(1)(iii). In its comments, ACTEC had urged Treasury and the IRS to reconsider the opinion in the proposed regulations, providing rationale for the same, so that as for other purposes, the basis adjustments could attempt to eliminate the differences in inside and outside basis that occur with partnerships. The final regulations adopt this recommendation in defining an excess 743(b) basis adjustments as "an amount that would represent the partner's section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§ 1.743-1(b) and 1.755-1, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property." Treas. Reg. § 1.199A-2(a)(3)(iv)(B).

Also, note that the basis does not adjust from year to year because of the depreciable period. Instead, the depreciable period, which is a matter of time, is a factor that will determine whether property will even be considered qualified property.

Therefore, for qualified property and basis, the placed in service dates are important and must be tracked for Section 199A purposes. We also know from the definition of qualified property that its depreciable period will need to be tracked for these purposes as well. Keep in mind too that improvements to qualified property will result in the improvements being treated as separate qualified property with separate UBIA to be tracked for that property. On the flip side, the Section 199A deduction does not affect the basis of a partner's interest in a partnership or a shareholder's stock in an S corporation. Treas. Reg. § 1.199A-1(e)(1).

V. W-2 wages

An individual's share of a trade's or business's W-2 wages serves as a potential limitation on that individual's Section 199A deduction, or in some instances, a higher amount of W-2 wages may curb the limitation. IRC §§ 199A(b)(2), (3)(A); Treas. Reg. § 1.199A-1(d). The wage limitation only applies if the individual's taxable income is above the threshold amount (a Stratum II or III individual), regardless of whether the income is within the phase-in limit or exceeds the threshold amount plus the phase-in amount. *Id*. If an individual's taxable income is below the threshold amount (a Stratum I individual), the individual's share of W-2 wages can be ignored because they will not be used to impose any limitation on that individual's Section 199A deduction. IRC § 199A(b)(3)(A); Treas. Reg. § 1.199A-1(c)(1). If an individual's taxable income is above the threshold amount plus the phase-in limit (a Stratum III individual), all of the individual's share of W-2 wages from an SSTB are ignored. Treas. Reg. § 1.199A-1(d)(2)(i).

W-2 wages include amounts paid to an employee during a calendar year that ends in the relevant taxable year, including all wages, elective deferrals, and deferred compensation, including Roth contributions.[21] IRC §§ 199A(b)(4)(A), 402(g)(3), 402A, 457, 3401(a); Treas. Reg. § 1.199A-2(b)(2). Such amounts must be allocable to QBI, and must be properly included on a return filed with the Social Security Administration on or before the 60th day after the due date of the return, including any extensions. IRC §§ 199A(b)(4)(A), (B); Treas. Reg. § 1.199A-2(b)(2)(iii). Because reasonable compensation paid to an S corporation shareholder is wages, such reasonable compensation would be W-2 wages for Section 199A purposes. If W-2 wages are not determined and reported for each trade or business, or aggregated trade or business, they are presumed to be zero. Treas. Reg. § 1.199A-2(a)(2). In order to show that W-2 wages are allocable to QBI, a corresponding wage expense must be taken when calculating QBI. Treas. Reg. § 1.199A-2(b)(4). Furthermore, the individual or RPE that directly conducts a trade or business determines the W-2 wages for that trade or business or aggregated trade or business. Treas. Reg. § 1.199A-2(a)(2).

[21] TCJA 2017 repealed Section 199 of the Code but as stated in the Preamble to both the proposed and final regulations, that section served as the starting point for the definition of W-2 wages for purposes of Section 199A, as well as serving as the starting point for several other provisions of Section 199A and the Treasury regulations thereunder.

IV. THE 199A RULES OF THUMB

Not concluding that it's an exclusive list, but a running list of basic Section 199A rules of thumb are:

A. All Individuals

1. Section 199A is not yet "permanent." In planning with Section 199A, remember that as the law stands now, it expires in 2025.

2. Section 199A applies to pass-through entities effectively connected to a U.S. trade or business. It doesn't apply to C corporations and it doesn't apply to foreign trades or businesses. Regardless, Section 199A should not be the only factor to consider in relation to ownership and entity structure. (A topic reserved for another paper.)

3. To have a Section 199A deduction, an individual must have positive taxable income. If an individual has no taxable income in excess of net capital gains (regardless of the individual's combined QBI amount), then Section 199A is ignored. Why? Because the Section 199A deduction is the "lesser of" either that calculation or combined QBI, if an individual has zero taxable income in excess of net capital gains (which includes qualified dividend income) or negative taxable income, there can be no Section 199A deduction.

4. Taxable income influences the Section 199A deduction. For Section 199A purposes, an individual's taxable income determines the threshold amount, and thus, whether the individual falls in Stratum I, II, or III. Taxable income also influences a myriad of other Section 199A items. Because it is taxable income that counts, an individual's tax-exempt income is ignored, and the standard deduction or itemized deductions will lower an individual's taxable income for Section 199A purposes.

5. An individual's taxable income less capital gains serves as a cap on the Section 199A deduction. If an individual has taxable income in excess of net capital gains (which includes qualified dividend income), you have to know if the individual has a positive combined QBI amount, and if the individual does, you also have to know the amount of the individual's taxable income less net capital gains. Even if an individual has a positive combined QBI amount, the Section 199A deduction may be reduced, if 20% of the individual's taxable income less net capital gains is less than the combined QBI amount. This amount serves to limit, or cap, the Section 199A deduction.

6. Don't forget about qualified REIT dividends and qualified PTP income. Even if an individual has no QBI component, the individual's qualified REIT dividends and PTP income may result in a Section 199A deduction because these items are a separate part of the combined QBI amount. If an individual has no QBI (or even negative QBI) but has qualified REIT dividends and PTP income, the individual may still have a Section 199A deduction. But, if a Stratum III individual receives PTP income from an SSTB, even that PTP income will not be qualified PTP income for Section 199A purposes.

7. Negative QBI and negative aggregate REIT dividends and PTP income will stick with an individual. Any negative QBI, and any negative aggregate qualified REIT dividends and qualified PTP income, are carried forward to the next taxable year, with negative QBI netted against the next year's QBI, and negative aggregate qualified REIT dividends and qualified PTP income netted against the next year's aggregate qualified REIT dividends and qualified PTP income.

8. All Stratum I individuals and those Stratum III individuals who only have allocations from SSTBs have it the easiest. Stratum I because "everything counts" and Stratum III because "nothing counts" regarding allocated amounts. See the rest of this paper for more on these notions!

9. Be aware of the 2/7ths Rule. If you know that W-2 wages will exceed 2/7ths of gross QBI (so QBI before any wage expense is taken), the alternative limitation will never apply because 20% of QBI will always be the lesser portion of the QBI component. UBIA of qualified property also won't matter because the 20% of net QBI portion of the QBI component will always be the lesser amount. If W-2 wages don't exceed 2/7ths of gross QBI, the alternative limitation may apply and even if there are no W-2 wages, UBIA may still give a 199A deduction!

B. Stratum I Individuals – Taxable Income At or Below the Threshold Amount

If an individual's taxable income is at or below the threshold amount, whether or not the individual has income from an SSTB doesn't matter and W-2 wages and UBIA of qualified property don't matter. The individual's entire combined QBI amount counts, regardless of whether any trade or business is an SSTB. You don't have to do any calculations based on W-2 wages or UBIA of qualified property. To determine a

Stratum I individual's Section 199A deduction, you only have to calculate twenty percent (20%) of QBI and twenty percent (20%) of aggregate qualified REIT dividends and qualified PTP income, combine the two results to get the combined QBI amount and then see if that amount, or 20% of the individual's taxable income less net capital gains, is the lesser amount. IRC §§ 199A(a), (b)(1), (2), (3)(A), (d)(3); Treas. Reg. § 1.199A-1(c).

C. Stratum II Individuals - Taxable Income Exceeds the Threshold Amount But is Within the Phase-in Limit

If an individual's taxable income is above the threshold amount but below the threshold amount *plus* the phase-in limit (so within the phase-in range), QBI from SSTBs matter separately from QBI allocated to the individual from other qualified trades or businesses, W-2 wages and UBIA of qualified property from SSTBs matter, and W-2 wages and UBIA of qualified property from all qualified trades or businesses matter. For each SSTB, you'll have to apply the applicable percentage to the individual's allocated QBI, W-2 wages, and UBIA of qualified property. For each qualified trade or business, including SSTBs, you have to calculate 20% of QBI, determine whether that amount exceeds the alternative limitation, and if so, you'll also have to calculate the reduction amount for that trade or business. The reduction amount is based on an individual's taxable income, threshold amount, and for each qualified trade or business, the allocated QBI, W-2 wages and UBIA of qualified property, and serves to reduce the individual's 20% of QBI for the respective trade or business. The resulting calculations give you the QBI component for each qualified trade or business, and adding them together, give you the total QBI amount. To determine a Stratum II individual's Section 199A deduction, you have to combine the total QBI amount and twenty percent (20%) of aggregate qualified REIT dividends and qualified PTP income, and then see if that amount, or 20% of the individual's taxable income less net capital gains, is the lesser amount. IRC §§ 199A(a), (b)(1), (2), (3)(B), (d)(3); Treas. Reg. §§ 1.199A-1(b)(9), (d)(1), (2)(i), (iv). Keep in mind that if any of a Stratum II individual's PTP income is from a PTP that is an SSTB, then only the applicable percentage of that PTP income is taken into account for Section 199A purposes. Treas. Reg. § 1.199A-1(d)(3)(ii).

Even though these are rules of thumb, because the calculations related to the Section 199A deduction for Stratum II individuals are so complicated, further rules of thumb related to the phase-in amount, coupled with an example, are helpful:

> All amounts allocated from an SSTB will get a "haircut." The haircut, or applicable percentage, is equal to the percent that the Stratum II individual is through the phase-out amount. For example, for a single individual, the phase-out amount is $50,000. If the individual's 2018 taxable income is $172,500, the individual is 30% through the phase-out amount ($172,500 - $157,500)/$50,000 = 30%. As a result, all QBI, W-2 wages, and UBIA of qualified property from an SSTB will be reduced by 30%.
>
> For every qualified trade or business to which the alternative limitation does not apply (i.e., because 20% of QBI is less than the alternative limitation), you can ignore computing the excess amount and the reduction amount. However, for every qualified trade or business to which the alternative limitation applies (i.e., because 20% of QBI exceeds the alternative limitation) and including SSTBs that have already had a "haircut," the alternative limitation is phased in by the percent that the Stratum II individual's taxable income is through the phase-in amount. For example, for a single individual, the phase-out amount is $50,000. If the individual's 2018 taxable income is $172,500, the individual is 30% through the phase-out amount ($172,500 - $157,500)/$50,000 = 30%. As a result, if 20% of QBI exceeds the alternative limitation, then the QBI deduction will be reduced by 30% of the difference between 20% of QBI and the amount of the alternative limitation.

D. Stratum III Individuals – Taxable Income Exceeds the Threshold Amount Plus the Phase-in Limit

If an individual's taxable income is above the threshold amount *plus* the phase-in limit, anything allocated to the individual from an SSTB is disregarded. In other words, you can ignore anything allocated to the individual from an SSTB. For each other qualified trade or business, you'll need to know the QBI, W-2 wages, and UBIA of qualified property allocated to the individual. An individual's QBI component for each of those trades or businesses will simply be the lesser of 20% of QBI or the alternative limitation, and adding the results together gives you the total QBI amount. To determine a Stratum III individual's Section 199A deduction, you have to combine the total QBI amount and twenty percent (20%) of aggregate qualified REIT dividends and qualified PTP income, and then see if that combined amount, or 20% of the individual's taxable income less net capital gains, is the lesser amount. IRC §§ 199A(a), (b)(1), (2), (d)(1); Treas. Reg. §§ 1.199A-1(d)(1), (2)(i), (iv). Keep in mind that if any of a Stratum III individual's PTP income is from a

PTP that is an SSTB, none of that PTP income will be taken into account for Section 199A purposes. Treas. Reg. § 1.199A-1(d)(3)(ii).

V. THE 199A MECHANICS

If an individual's taxable income exceeds the threshold amount, special computational rules are used to determine the QBI component, and can change the component depending on factors such as whether the individual is within the phase-in range, has income from an SSTB, or elects to aggregate trades or businesses. If an individual's taxable income exceeds the threshold amount but does not exceed the threshold amount plus the phase-in limit, special rules apply to (i) reduce items flowing through from SSTBs, and (ii) reduce the 20% of QBI element of the Section 199A deduction for each trade or business where that element exceeds the alternative limitation. If an individual's taxable income exceeds the threshold amount plus the phase-in limit, the limits measured by W-2 wages or UBIA of qualified property apply in full, and QBI from an SSTB is completely disregarded and cannot be taken into account for purposes of the individual's Section 199A deduction.

In the case of partnerships and S corporations, Section 199A is applied at the partner or shareholder level, not at the entity level. Treas. Reg. § 1.199A-1(e)(1).

A. Gathering and Reporting Information Needed by Individuals for the Section 199A Deduction

Pass-through entities will need to establish methods to track the various Section 199A items for each trade or business of that entity so that required reporting can be made to the owners, or in the case of a trust or an estate that will be treated as an RPE, to its beneficiaries. In essence, the responsibility of gathering, determining, and reporting the information related to trades or businesses that individuals need to calculate their Section 199A deduction starts at the entity level. The following discussion addresses the requirements related to RPEs and PTPs. The requirements as they relate to trusts and estates are discussed later, along with other special rules that relate to trusts and estates, although keep in mind that the following requirements would be applicable to a trust or an estate treated as an RPE.

1. Responsibilities of RPEs

Section § 1.199A-6(b) provides the general rule that an RPE is responsible for determining and reporting the information related to its trades or businesses that its owners need for Section 199A purposes, regardless of whether any of the owners are eligible for the deduction. The regulation sets forth four steps for an RPE to follow. First, the RPE must determine if it is engaged in one or more trades or businesses, and which, if any, of those are SSTBs. Second, the RPE must determine the QBI for each separate trade or business that the RPE engages in directly. Third, the RPE must determine the W-2 wages and UBIA of qualified property for each separate trade or business that the RPE engages in directly. Fourth, the RPE must determine the amount of any qualified REIT dividends the RPE earns directly or indirectly through another RPE and the net amount of qualified PTP income the RPE earns directly or indirectly through investments in PTPs. Treas. Reg. § 1.199A-6(b)(2). If an RPE chooses to aggregate trades or businesses, the RPE may follow these steps to determine the items for the aggregated trades or businesses. *Id*.

Once the RPE completes the foregoing steps, the RPE must report the relevant information on Schedules K-1 or attachments thereto. Specifically, if an RPE engages in a trade or business directly, Schedules K-1 for each trade or business issued to its owners must show each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property from the trade or business (or aggregated trade or business) and which, if any, trades or businesses are SSTBs. Treas. Reg. § 1.199A-6(b)(3)(i). On an attachment to the K-1, the RPE must also show each of these items reported to it by another RPE and each owner's share of any qualified REIT dividends or qualified PTP income, whether received directly or through another RPE. Treas. Reg. § 1.199A-6(b)(3)(ii). Failure to separately identify or report an item to an owner results in the presumption of that owner's share of positive QBI, W-2 wages, and/or UBIA of qualified property to be zero. Treas. Reg. § 1.199A-6(b)(3)(iii). As written, the proposed regulations read that even the failure to report one of these items would result in all of the items being zero. Thankfully, this harsh result was revised in the final regulations so that it only applies to the relevant item that is not reported. The final regulations gave further relief by providing that if the statute of limitations is still open, the information can be reported on an amended or late-filed return. Treas. Reg. § 1.199A-6(b)(3)(ii).

2. Responsibilities of PTPs

Section § 1.199A-6(c)(1) provides the general rule that each PTP must determine the QBI for each trade or business in which the PTP is engaged in directly, and which, if any, of those are SSTBs.

Each PTP must also determine any qualified REIT dividends or qualified PTP income or loss that the PTP receives from an RPE, REIT, or another PTP. Treas. Reg. § 1.199A-6(c)(2). Each PTP is then responsible for separately identifying and reporting the foregoing information on Schedules K-1 to its partners. *Id*.

B. Calculating an Individual's Taxable Income

For individuals, so many pieces of the Section 199A puzzle feed off of an individual's taxable income. Therefore, from an individual's standpoint, first things first, calculate taxable income. The Code generally provides that for individuals who itemize deductions, taxable income is gross income less the deductions allowed under Chapter 1 of the Code other than the standard deduction, and for those who do not itemize deductions, taxable income is an individual's adjusted gross income less the standard deduction, personal exemption[22], and Section 199A deduction. IRC § 63. In either event, however, for all purposes of applying Section 199A, the Section 199A deduction is not taken into account in calculating taxable income; in other words, for Section 199A purposes, taxable income is computed the same as for other purposes of Chapter 1, except the Section 199A deduction is not taken. IRC § 199A(e)(1). Once the Section 199A taxable income is calculated, whether the individual is below the threshold amount, above the threshold but within the phase-in range, etc. will be known, and thus, it will be known whether the individual is in Stratum I, II, or III. For individuals who itemize deductions, this means that deductions, such as the charitable or state and local tax deductions, will lower taxable income for purposes of the Section 199A deduction. Other things that drive down taxable income, such as making retirement plan contributions and investing for tax-exempt income, will also influence the calculation. A copy of the 2018 Qualified Business Income Deduction—Simplified Worksheet from the instructions for the 2018 IRS Form 1040, which only applies for Stratum I individuals, is attached as Exhibit B.

Remember that the Section 199A deduction applies to reduce income taxes only. It does nothing to reduce an individual's net earnings from self-employment or net investment income. Treas. Reg. § 1.199A-1(e)(3). Therefore, these amounts must be calculated without regard to any Section 199A deduction, and in evaluating entity structures in light of income taxes, should not be forgotten as additional factors.

C. Stratum I Individuals – Taxable Income At or Below the Threshold Amount

1. Compute QBI for Each Qualified Trade or Business

Stratum I individuals, like every individual who is allocated items of QBI, begin determining the QBI component of the Section 199A deduction by computing all net amounts of qualified items of income, gain, deduction, and loss from each qualified trade or business. IRC §§ 199A(c)(1), (3)(A); Treas. Reg. §§ 1.199A-3(b)(1), (2). To be qualified, the items must be effectively connected with the conduct of a trade or business in the United States and be included or allowed in determining taxable income. *Id*. Twenty percent (20%) of the amount of QBI for each qualified trade or business is calculated, and if there is QBI from multiple trades or businesses, 20% of the QBI of each is added together. IRC §§ 199A(b)(1)(A), (b)(2)(A). If the net amount is a loss, however, the total QBI is treated as zero, and the loss is carried forward to the next year where it is treated as a loss from a separate trade or business. IRC § 199A(c)(2); Treas. Reg. § 1.199A-1(c)(2)(i).

2. SSTBs Are Qualified Trades or Businesses

If an individual is allocated items of QBI, W-2 wages, or UBIA of qualified property from an SSTB, the amount of the individual's taxable income will determine whether or not the individual will be able to take those items into account for Section 199A purposes. For Stratum I individuals, all combined QBI counts, including any QBI from an SSTB. In other words, a Stratum I individual can simply ignore the fact that any items are being passed through from an SSTB because the SSTB is a qualified trade or business as to the individual. IRC § 199A(d)(3)(i); Treas. Reg. § 1.199A-1(c)(1).

3. Ignore All W-2 Wages and UBIA of Qualified Property

If an individual is allocated items of QBI, W-2 wages, or UBIA of qualified property, the amount of that individual's taxable income will determine whether or not the individual will be subject in whole or in part to the alternative limitation in computing the deductible amount, or QBI component.

[22] Although individual taxpayers are entitled to a personal exemption, Code Section 151(d)(5) provides that for tax years beginning after December 31, 2017 and before January 1, 2026, the personal exemption is zero.

Stratum I individuals are not subject to the alternative limitation. IRC § 199A(b)(3)(A); Treas. Reg. § 1.199A-1(c)(1). As a result, the individual's deductible amount is simply the sum of 20% of the individual's QBI with respect to each qualified trade or business, without regard to the amount of any W-2 wages or UBIA of qualified property, and with that calculation in hand, we can move on to the next steps. IRC § 199A(b)(2)(A); Treas. Reg. § 1.199A-1(c)(1).

4. Compute Qualified REIT Dividends and Qualified PTP Income

Determine if the individual has any qualified REIT dividends and qualified PTP income, even if the individual has no QBI. Qualified REIT dividends include all REIT dividends received in the taxable year that are not capital gain dividends or qualified dividend income. IRC § 199A(e)(3); Treas. Reg. § 1.199A-3(c)(2). In order to be a qualified REIT dividend, (1) the dividend must be from REIT stock held for more than 45 days (after taking into account certain holding period rules set forth in Section 246 of the Code) during the 91-day period beginning 45 days before the date the stock becomes ex-dividend, and (2) the shareholder cannot be obligated to make payments with respect to substantially similar or related property. Treas. Reg. § 1.199A-3(c)(2)(ii)(B). Qualified PTP income is the sum of the net amount of an individual's share of income, gain, deduction, and loss from a non-corporate PTP, plus any gain or loss attributable to transactions involving unrealized receivables or inventory of a partnership that result in ordinary income under Section 751(a) or (b) of the Code and that are attributable to the partnership's trades or businesses. IRC § 199A(e)(4); Treas. Reg. § 1.199A-3(c)(3)(i).

Any negative qualified REIT dividends need to be netted against positive qualified PTP income and vice versa. If it ends up that the individual's aggregate qualified REIT dividends and qualified PTP income is negative, this element of the combined amount will be zero, but the negative amount will carry forward to succeeding years for use in determining the aggregate qualified REIT dividends and qualified PTP income in following years. Treas. Reg. §§ 1.199A-1(c)(2)(ii), (d)(3). If the aggregate qualified REIT dividends and qualified PTP income amount is positive, calculate twenty percent (20%) of that amount, and to determine the individual's combined QBI amount, add that calculation to the sum of 20% of the individual's QBI with respect to each qualified trade or business.

5. Compute Taxable Income and Net Capital Gains

The Section 199A deduction is effectively capped at 20% of the individual's taxable income less net capital gains for the year. The final regulations clarify that net capital gains include qualified dividend income, which makes sense since they are already taxed at more favorable rates than ordinary income. Treas. Reg. § 1.199A-1(b)(3). As a result, the individual must compute taxable income (before the Section 199A deduction), and subtract from that amount any net capital gains. IRC §§ 199A(b)(2), (3)(A); Treas. Reg. § 1.199A-1(c). If this amount is zero or negative, stop – the individual has no Section 199A deduction. If the individual's taxable income less net capital gains is a positive amount, calculate 20% of that amount.

6. What is the Deduction?

For Stratum I individuals, the Section 199A deduction is the lesser of (i) twenty percent (20%) of QBI plus twenty percent (20%) of aggregate qualified REIT dividends and qualified PTP income, or (ii) 20% of the individual's taxable income less net capital gains. IRC § 199A(a). Therefore, in sum, determine the Stratum I individual's combined QBI amount by adding together the total of the individual's 20% of QBI from all qualified trades or businesses and the individual's 20% aggregate of qualified REIT dividends and qualified PTP income. If the amount is zero, stop – the individual has no Section 199A deduction. If the individual's combined QBI amount is positive, compare that amount to 20% of the individual's taxable income less net capital gains. The lesser of these two amounts is the individual's Section 199A deduction.

7. Example – Stratum I Individual

In 2018, individual A, a single taxpayer, is allocated QBI from a qualified trade or business of $100,000. After deductions, A's taxable income before the Section 199A deduction is $87,000, of which $1,000 is net capital gain. A had no qualified REIT dividends or PTP income. Because A's taxable income is below the threshold amount, it is irrelevant whether the trade or business is an SSTB. It also does not matter if any amount of W-2 wages or UBIA of qualified property of the trade or business is allocated to the individual. A's Section 199A deduction is the lesser of (i) the combined QBI amount of twenty percent (20%) of QBI plus twenty percent (20%) of aggregate qualified REIT dividends and qualified PTP income, or (ii) 20% of A's taxable income less net capital gains. In this case: (i) 20% x $100,000 + 20% x $0 = $20,000 and (ii) 20% x ($87,000 - $1,000) = $17,200. The lesser of the two is $17,200, which is A's Section 199A deduction for 2018.

D. Stratum III Individuals (Yes, III before II!) – Taxable Income Exceeds the Threshold Amount Plus the Phase-in Limit

1. Compute QBI for Each Qualified Trade or Business

Stratum III individuals, like every individual who is allocated items of QBI, begin determining the QBI component of the Section 199A deduction by computing all net amounts of qualified items of income, gain, deduction, and loss from each qualified trade or business. IRC §§ 199A(c)(1), (3)(A); Treas. Reg. §§ 1.199A-3(b)(1), (2). To be qualified, the items must be effectively connected with the conduct of a trade or business in the United States and be included or allowed in determining taxable income. *Id*. Because Stratum III individuals are over the threshold amount, they must perform additional computations and address certain limitations related to items from each qualified trade or business before any amount of QBI from multiple qualified trades or businesses can be added together.

2. SSTBs Are Not Qualified Trades or Businesses

Keep in mind that an SSTB may or may not be a qualified trade or business for Section 199A purposes, and for Stratum III individuals, SSTBs are not qualified trades or businesses. IRC § 199A(d). Therefore, Stratum III individuals are allowed no deduction for any amounts associated with an SSTB. Treas. Reg. §§ 1.199A-1(d)(2)(i), -5(a)(2). The final regulations confirm the suspicion that this rule applies to PTP income from a PTP that is an SSTB. Treas. Reg. §§ 1.199A-1(d)(3)(ii), -5(a)(2). Note that an individual does not have to participate in the SSTB for the SSTB rules to apply. Rather, the mere fact that the trade or business is an SSTB can taint the Section 199A items allocated to the individual from the SSTB, even if the individual is an indirect owner of the SSTB. *Id*. In other words, once the activity is an SSTB, the taint of the label remains.

3. Compute W-2 Wages and UBIA of Qualified Property for Each Qualified Trade or Business

Stratum III individuals are subject to the alternative limitation. That means that for each qualified trade or business, the individual must know both the W-2 wages allocated to that trade or business and the UBIA of qualified property for that trade or business. The rules for computing and allocating these amounts are outlined below.

4. Determine Combined QBI Amount

a. Compute QBI Component

For each qualified trade or business, the individual must determine (1) 20% of QBI, (2) 50% of W-2 wages, and (3) 25% of W-2 wages plus 2.5% of UBIA of qualified property. The individual then compares the greater of (2) and (3) to (1). The lesser of those two comparisons determines the individual's QBI component for each qualified trade or business. Once the QBI component for each qualified trade or business is computed, these amounts are added together. (Of course, an individual may elect pursuant to § 1.199A-4 to aggregate multiple trades or businesses in order to treat them as a single trade or business.) If the QBI component for any qualified (including aggregated) trade or business is negative, the negative amount is allocated pro rata to each qualified (including aggregated) trade or business with a positive QBI component. Treas. Reg. § 1.199A-1(d)(2)(iii). If an individual ends up with a negative total QBI, the individual's QBI component for that year is zero, the negative QBI amount is treated essentially as a loss coming from a separate trade or business and carries forward for Section 199A purposes as negative QBI to succeeding years for use in calculating the individual's potential Section 199A deduction in following years. IRC § 199A(c)(2); Treas. Reg. § 1.199A-1(d)(2)(iii)(B).

b. Compute Qualified REIT Dividends and PTP Income

Determine if the individual has any qualified REIT dividends and qualified PTP income, even if the individual has no QBI. Qualified REIT dividends include all REIT dividends received in the taxable year that are not capital gain dividends or qualified dividend income.

IRC § 199A(e)(3); Treas. Reg. § 1.199A-3(c)(2)(i). In order to be a qualified REIT dividend, (1) the dividend must be from REIT stock held for more than 45 days (after taking into account certain holding period rules set forth in Section 246 of the Code) during the 91-day period beginning 45 days before the date the stock becomes ex-dividend, and (2) the shareholder cannot be obligated to make payments with respect to substantially similar or related property. Treas. Reg. § 1.199A-3(c)(2)(ii)(B). Qualified PTP income is the sum of the net amount of an individual's share of income, gain, deduction, and loss from a non-corporate PTP, plus any gain or loss attributable to transactions involving unrealized receivables or inventory of a partnership that result in ordinary income under Section 751(a) or (b) of the Code and that are attributable to the partnership's trades or businesses. IRC § 199A(e)(4); Treas. Reg. § 1.199A-3(c)(3)(i). If, however, the PTP is an SSTB, the income from that PTP is not included. Treas. Reg. § 1.199A-5(a)(2).

Any negative qualified REIT dividends need to be netted against positive qualified PTP income and vice versa. If it ends up that the individual's aggregate qualified REIT dividends and qualified PTP income is negative, this element of the combined amount will be zero, but the negative amount will carry forward to succeeding years for use in determining the aggregate qualified REIT dividends and qualified PTP income in following years. Treas. Reg. § 1.199A-1(d)(3)(iii). If the aggregate qualified REIT dividends and qualified PTP income amount is positive, calculate twenty percent (20%) of that amount, and to determine the individual's combined QBI amount, add that calculation to the individual's QBI component with respect to each trade or business.

5. Compute Taxable Income and Net Capital Gains

Since the Section 199A deduction cannot exceed 20% of the individual's taxable income less net capital gains for the year, the individual must compute taxable income (before the Section 199A deduction), and subtract from that amount any net capital gains. IRC §§ 199A(b)(2), (3)(A); Treas. Reg. § 1.199A-1(d). Net capital gains are defined to include qualified dividend income. Treas. Reg. § 1.199A-1(b)(3). If the calculation is zero or negative, stop – the individual has no Section 199A deduction. If the individual's taxable income less net capital gains is a positive amount, calculate 20% of that amount.

6. What is the Deduction?

For Stratum III individuals, the Section 199A deduction is the lesser of (i) the combined QBI components plus twenty percent (20%) of aggregate qualified REIT dividends and qualified PTP income, or (ii) 20% of the individual's taxable income less net capital gains. IRC § 199A(a). Therefore, in sum, determine the Stratum III individual's combined QBI amount by adding together the total of the individual's QBI components from all qualified trades or businesses and the individual's 20% aggregate of qualified REIT dividends and qualified PTP income. If the amount is zero, stop – the individual has no Section 199A deduction. If the individual's combined QBI amount is positive, compare that amount to 20% of the individual's taxable income less net capital gains (none of which came from an SSTB). The lesser of these two amounts is the individual's Section 199A deduction.

7. Example – Stratum III Individual

In 2018, individual B, a single taxpayer, is allocated QBI from three trades or businesses, X, Y and Z. After deductions, B's taxable income before the Section 199A deduction is $1,000,000, of which $50,000 is net capital gain. B had qualified REIT dividends of $10,000 and qualified PTP income of $5,000. No election to aggregate the trades or businesses is made.

Business X is a qualified trade or business. QBI allocated to B from business X is $1,000,000. B's allocated share of X's W-2 wages is $500,000 and B's share of allocated share of X's UBIA of qualified property is $50,000. The QBI component is determined by computing (1) 20% of QBI, (2) 50% of W-2 wages, and (3) 25% of W-2 wages plus 2.5% of UBIA of qualified property, and then comparing the greater of (2) and (3) to (1). The lesser of those two comparisons determines the individual's QBI component for each qualified trade or business. As to business X, these figures are (1) 20% x $1,000,000 = $200,000; (2) 50% x $500,000 = $250,000; and (3) (25% x $500,000) + (2.5% x $50,000) = $126,250. The greater of (2) and (3) is (2), being $250,000. Comparing (2) to (1), since (1) $200,000 is the lesser amount, B's QBI component for business X is $200,000.

Business Y is an SSTB, with QBI allocated to B of $200,000, and with W-2 wages of $100,000 and UBIA of qualified property of $0 allocated to B. Because B's taxable income is above the threshold amount plus the phase-in amount, the amounts allocated to B from business Y are irrelevant because Y is an SSTB, and therefore, it is not a qualified trade or business as to B.

Business Z is a qualified trade or business. The QBI allocated to B from business Z is a loss of $100,000, with W-2 wages of $10,000 and UBIA of qualified property of $800,000 allocated to B. As to business Z, 20% of the $100,000 loss ($20,000) is less than the greater of 50% of $10,000 = $5,000 or (25% of $10,000 plus 2.5% of $ 800,000) = $22,500. As a result, B's QBI component for business Z is a loss of $20,000.

Netting the QBI components from business X and Z yields a total QBI of $180,000 for B. In addition, B adds to the combined QBI components 20% of aggregate qualified REIT dividends and qualified PTP income of $15,000, or $3,000. Thus, B's combined QBI amount is $180,000 + $3,000 = $183,000. B's Section 199A deduction is the lesser of (i) the combined QBI amount of $183,000, or (ii) 20% of B's taxable income less net capital gains or 20% x ($1,000,000 - $50,000) = $190,000. The lesser of the two is $183,000, which is B's Section 199A deduction for 2018.

E. Stratum II Individuals - Taxable Income Exceeds the Threshold Amount But is Within the Phase-in Limit

1. Compute QBI for Each Qualified Trade or Business

Stratum II individuals, like every individual who is allocated items of QBI, begin determining the QBI component of the Section 199A deduction by computing all net amounts of qualified items of income, gain, deduction, and loss from each qualified trade or business. IRC §§ 199A(c)(1), (3)(A); Treas. Reg. §§ 1.199A-3(b)(1), (2). To be qualified, the items must be effectively connected with the conduct of a trade or business in the United States and be included or allowed in determining taxable income. *Id*. Stratum II individuals are over the threshold amount, but within the phase-in limit, requiring them to perform several complex additional computations for each trade or business before any amount of QBI from multiple trades or businesses can be added together.

2. SSTBs Are Qualified Trades or Businesses but Subject to the Applicable Percentage

An SSTB may or may not be a qualified trade or business for Section 199A purposes. IRC § 199A(d). If an individual's taxable income is more than the threshold amount but less than the threshold amount plus the phase-in amount (i.e., a Stratum II individual), an SSTB is a qualified trade or business, but limitations apply to Section 199A items allocated to the individual from the SSTB. IRC § 199A(d)(3); Treas. Reg. § 1.199A-1(d)(2)(i). Specifically, in computing the QBI component from an SSTB, the individual must compute the "applicable percentage." The applicable percentage is 100%, less ((taxable income less the threshold amount) divided by the phase-out amount). IRC § 199A(d)(3)(B); Treas. Reg. § 1.199A-1(b)(2). The applicable percentage is applied to an individual's share of any QBI, W-2 wages, and UBIA of qualified property allocated to it from an SSTB which reduces the QBI component related to the SSTB. IRC § 199A(d)(3); Treas. Reg. § 1.199A-1(d)(2)(i). The applicable percentage is also applied to any PTP income received from a PTP that is an SSTB. Treas. Reg. §§ 1.199A-1(d)(3)(ii), -5(a)(2).

3. Compute W-2 Wages and UBIA of Qualified Property for Each Qualified Trade or Business

Stratum II individuals are subject (at least in part) to the alternative limitation. Therefore, for each qualified trade or business, the individual must know both the W-2 wages allocated from that trade or business and the UBIA of qualified property for that trade or business. With respect to each SSTB, only the applicable percentage of those amounts (as well as the applicable percentage of QBI) are considered. Treas. Reg. § 1.199A-2(d)(2)(i).

4. Apply Reduction Amount to All Qualified Trades or Businesses

In applying the alternative limitation, as to any qualified trade or business where the 20% of QBI portion of the QBI component exceeds the alternative limitation, Stratum II individuals must compute the reduction amount. The reduction amount is the product of (i) the excess amount times (ii) the ratio that the excess of taxable income over the threshold amount bears to the phase-out amount. IRC § 199A(b)(3)(B); Treas. Reg. § 1.199A-1(b)(9). The reduction amount is then applied to reduce the 20% of QBI portion of the QBI component of each qualified trade or business. IRC §§ 199A(b)(2), (3); Treas. Reg. § 1.199A-1(d)(2)(iv). As a reminder, the reduction amount is applied to amounts allocated from an SSTB after the applicable percentage has first been applied. Treas. Reg. § 1.199A-1(d)(2). The reduction amount is used in the computation of the QBI component for each qualified trade or business, as described immediately below.

5. Determine Combined QBI Amount

a. Compute QBI Component

For each qualified trade or business, the individual must determine (1) 20% of QBI, (2) 50% of W-2 wages, and (3) 25% of W-2 wages plus 2.5% of UBIA of qualified property. The individual then compares the greater of (2) and (3) to (1). If (1) is less than the greater of (2) or (3), then (1) is the Stratum II individual's QBI component for that trade or business. However, if (1) is more than the greater of (2) or (3), then the QBI component for that trade or business is equal to (1) reduced by the reduction amount. Once the QBI component for each qualified trade or business is computed, these amounts are added together to determine the combined QBI for the individual. (Of course, an individual may elect pursuant to § 1.199A-4 to aggregate multiple trades or businesses in order to treat them as a single trade or business.) If the QBI component for any qualified (included aggregated) trade or business is negative, the negative amount is allocated pro rata to each qualified (included aggregated) trade or business with a positive QBI component. Treas. Reg. § 1.199A-1(d)(2)(iii). If an individual ends up with a negative total QBI, the individual's QBI component for that year is zero, the negative QBI amount is treated essentially as a loss coming from a separate trade or business and carries forward for Section 199A purposes as negative QBI to succeeding years for use in calculating the individual's potential Section 199A deduction in following years. IRC § 199A(c)(2); Treas. Reg. § 1.199A-1(d)(2)(iii)(B).

b. Compute Qualified REIT Dividends and PTP Income

Determine if the individual has any qualified REIT dividends and qualified PTP income, even if the individual has no QBI. Qualified REIT dividends and qualified PTP income for Stratum II individuals are computed in the same manner as for Stratum I and III individuals, although for Stratum II individuals, only the applicable percentage of any income from a PTP that is an SSTB is included. Treas. Reg. §§ 1.199A-1(d)(3)(ii), -5(a)(2). If the aggregate qualified REIT dividends and qualified PTP income amount is positive, calculate twenty percent (20%) of that amount, and to determine the individual's combined QBI amount, add that calculation to the individual's QBI component with respect to each qualified trade or business.

6. Compute Taxable Income and Net Capital Gains

Since the Section 199A deduction cannot exceed 20% of the individual's taxable income less net capital gains for the year, the individual must compute taxable income (before the Section 199A deduction), and subtract from that amount any net capital gains. IRC §§ 199A(b)(2), (3)(A); Treas. Reg. § 1.199A-1(d). Net capital gains include qualified dividend income. Treas. Reg. § 1.199A-1(b)(3). If the calculation is zero or negative, stop – the individual has no Section 199A deduction. If the individual's taxable income less net capital gains is a positive amount, calculate 20% of that amount.

7. What is the Deduction?

For Stratum II individuals, the Section 199A deduction is the lesser of (i) the QBI components plus twenty percent (20%) of aggregate qualified REIT dividends and qualified PTP income, or (ii) 20% of the individual's taxable income less net capital gains. IRC § 199A(a). Therefore, in sum, determine the Stratum II individual's combined QBI amount by adding together the total of the individual's QBI components from all qualified trades or businesses and the individual's 20% aggregate of qualified REIT dividends and qualified PTP income. If the amount is zero, stop – the individual has no Section 199A deduction. If the individual's combined QBI amount is positive, compare that amount to 20% of the individual's taxable income less net capital gains. The lesser of these two amounts is the individual's Section 199A deduction.

8. Example – Stratum II Individual

In 2018, individual C, a single taxpayer, is allocated QBI from two qualified trades or businesses, X and Y. After deductions, C's taxable income before the Section 199A deduction is $170,000 of which none is net capital gain. C had qualified REIT dividends of $10,000 and PTP income of $5,000 (none of which is from an SSTB). No election to aggregate the trades or businesses is made.

Business X is a qualified trade or business. QBI allocated to C from business X is $500,000. C's allocated share of X's W-2 wages is $100,000, and C's allocated share of X's UBIA of qualified property is $1,400,000. The QBI component is determined by computing (1) 20% of QBI, (2) 50% of W-2 wages, and (3) 25% of W-2 wages plus 2.5% of UBIA of qualified property, and then comparing the greater of (2) and (3) to (1). If (1) is less than the greater of (2) or (3), then (1) is C's QBI component for X. However, if (1) is more than the greater of (2) or (3), then the QBI component for X is reduced by the reduction amount. As to business X, these figures are (1) 20% x $500,000 = $100,000; (2) 50% x $100,000 = $50,000; and (3) (25% x $100,000) + (2.5% x $1,400,000) = $60,000. The greater of (2) and (3) is (3), being $60,000. Comparing (3) to (1), since (1), or $100,000, is the greater amount, the QBI component of business X would otherwise be $100,000, but because (1) is the greater amount and C's taxable income is above the threshold amount and within the phase-in amount, C must compute her excess amount and her reduction amount. C must then reduce what would otherwise be her QBI component by the reduction amount. As to business X, the excess amount is (1), or $100,000, less the greater of (2) and (3), or $60,000. Therefore, the excess amount is $40,000. The reduction amount is the excess amount ($40,000) times C's taxable income less the threshold amount ($170,000 - $157,500) divided by the phase-in amount ($50,000), or $40,000 x $12,500/$50,000 = $10,000. Thus, C's QBI component for business X is $100,000 less the reduction amount of $10,000, or $90,000.[23]

Business Y is an SSTB, which because of C's taxable income, is a qualified trade or business. QBI allocated to C from business Y is of $200,000. C's allocated share of Y's W-2 wages is $100,000, and C's allocated share of Y's UBIA of qualified property is $0. As to business Y, because it is an SSTB, C must compute her applicable percentage, which will reduce each of the items allocated to her from Y. The applicable percentage is 100% less (taxable income in excess of the threshold divided by the phase-out amount), or 100% - (($170,000 - $157,500)/$50,000) = 75%. Multiplying the applicable percentage times the amount of each item allocated to C from Y gives C a QBI of $200,000 x 75% = $150,000, W-2 wages of $100,000 x 75% = $75,000, and UBIA of qualified property of $0 x 75% = $0.

The QBI component is determined by computing (1) 20% of QBI, (2) 50% of W-2 wages, and (3) 25% of W-2 wages plus 2.5% of UBIA of qualified property, and then comparing the greater of (2) and (3) to (1). If (1) is less than the greater of (2) or (3), then (1) is C's QBI component for Y. However, if (1) is more than the greater of (2) or (3), then the QBI component for Y is reduced by the reduction amount. As to business Y, these figures (taking into account the applicable percentage) are (1) 20% x $150,000 = $30,000; (2) 50% x $75,000 = $37,500; and (3) (25% x $75,000) + (2.5% x $0) = $18,750. The greater of (2) and (3) is (2), being $37,500. Comparing (2) to (1), since (1), or $30,000 is the lesser amount, C's QBI component for business Y is $30,000, and as to Y, C does not need to compute her excess amount or her reduction amount.

Combining the QBI components of business X and Y yields C's total QBI components of $90,000 + $30,000 = $120,000. In addition, C adds to the combined QBI components 20% of aggregate qualified REIT dividends and qualified PTP income of $15,000, or $3,000. Thus, C's combined QBI amount is $120,000 + $3,000 = $123,000. C's section 199A deduction is the lesser of (i) the combined QBI amount of $123,000, or (ii) 20% of C's taxable income less net capital gains or 20% x ($170,000 - $0) = $14,000. The lesser of the two is $14,000, which is C's Section 199A deduction for 2018.

[23] Note that C's taxable income is 25% above the threshold amount ($170,000/$157,500 = 125%). Thus, one might expect that C's alternative limitation should be 25% of the amount by which 20% of QBI exceeds the alternative limitation. Twenty percent (20%) of X's QBI exceeds the alternative limitation by $40,000 ($100,000 - $60,000). Therefore, the QBI component should be reduced by 25% of $40,000 or $10,000. This is in fact the result.

F. Determining W-2 Wages and Allocating Them to QBI

For Stratum II and III individuals, the wage component of the alternative limitation may apply in determining the Section 199A deduction. The Treasury regulations describe the determination of W-2 wages and how to properly allocate them to QBI as a three-step process to be followed by each individual or RPE that directly conducts the trade or business or aggregated trade or business:

1. Step one: Determine total W-2 wages paid in the taxable year

As described in the definition of W-2 wages, W-2 wages include amounts paid to an employee during a calendar year that ends in the relevant taxable year, including all wages, elective deferrals, and deferred compensation, including Roth contributions.[24] IRC §§ 199A(b)(4)(A), 402(g)(3), 402A, 457, 3401(a); Treas. Reg. § 1.199A-2(b)(2). Such amounts must be allocable to QBI, and must be properly included on a return filed with the Social Security Administration on or before the 60th day after the due date of the return, including any extensions. IRC §§ 199A(b)(4)(A), (B); Treas. Reg. § 1.199A-2(b)(2)(iii). Because reasonable compensation paid to an S corporation shareholder is wages, such reasonable compensation would be W-2 wages for Section 199A purposes. Furthermore, the individual or RPE that directly conducts a trade or business determines the W-2 wages for that trade or business, or aggregated trade or business. Treas. Reg. § 1.199A-2(a)(2).

Notice 2018-64 was issued concurrently with the proposed Treasury regulations to provide three methods by which W-2 wages can be calculated. IRS Notice 2018-64, 2018-35 IRB 347. Revenue Procedure 2019-11 was issued concurrently with the final Treasury regulations to formalize these methods. Rev. Proc. 2019-11, 2019-9 IRB 742. The three methods are known as (i) the unmodified box method, (ii) the modified Box 1 method, and (iii) the tracking wages method. In summary, each of the methods uses amounts as reported to employees on boxes on the W-2 to determine W-2 wages. Section 6 of Revenue Procedure 2019-11 clarifies that if a taxpayer has a short taxable year, the tracking wages method must be used and only the amounts described above that are actually paid, made, or deferred to employees in the short taxable year are included.

If the W-2 wages are not reported for Social Security purposes, they are presumed to be zero which means they don't count. Treas. Reg. § 1.199A-2(a)(2). Therefore, the proper preparation and timely filing of all Forms W-2 transmitted by a Form W-3 are critical. If W-2 wages are reported but then need to be corrected, how the corrected W-2 wages are treated depends on when the original return was filed and when the corrected return is filed. The general rule is that both the original returns and corrected returns must be filed by January 31 of the year following the calendar year the wages are paid. IRC § 6071(c). If both the original filing and the corrected filing occurs on or before the 60th day after the due date, including any extensions, then the corrected W-2 wages are used for Section 199A purposes. Treas. Reg. § 1.199A-2(b)(2)(iii)(B). If the original return was timely but the corrected return occurs after the 60th day after the due date, including any extensions, then any decrease in W-2 wages must be taken into account and any increase in W-2 wages is disregarded. *Id*. If both the original and corrected returns are late, then the W-2 wages are disregarded. Treas. Reg. § 1.199A-2(b)(2)(iii)(C).

Questions were raised as to how to handle wages paid to employees by third-party payors, since although the employees are doing work for another individual or RPE, the third-party payor's name will appear on the Form W-2 issued to the employees. If the rule was strict as to the payor, the individual or RPE would never have W-2 wages to use in calculating the alternative limitation. Relief was granted in § 1.199A-2(b)(2)(ii) to clarify that as long as the individual or RPE is the one who paid the wages to the common law employees or officers, that individual or RPE may take the wages into account.

2. Step two: Allocate W-2 wages between or among one or more trades or businesses

The W-2 wage limitation must be applied separately for each trade or business. In allocating W-2 wages, if an individual or RPE directly conducts more than one trade or business, the individual or RPE must allocate the W-2 wages to the respective trade or business that generated the wages. Treas. Reg. §§ 1.199A-2(b)(3), (5). In addition, if W-2 wages are allocable to more than one trade

[24] TCJA 2017 repealed Section 199 of the Code but as stated in the Preamble to both the proposed and final regulations, that section served as the starting point for the definition of W-2 wages for purposes of Section 199A, as well as serving as the starting point for several other provisions of Section 199A and the Treasury regulations thereunder.

or business, the W-2 wages are allocated to each trade or business in the same manner as the associated wage expenses. Treas. Reg. § 1.199A-2(b)(3).

If an individual acquires or disposes of all or a major portion of a trade or business or a unit of a trade or business such that the employees of the trade or business have different employers during the year, for purposes of Section 199A, the W-2 wages for each individual or entity are to be allocated based on the time of employment by each employer, regardless of whether the wages are otherwise reported by some other permissible method. Treas. Reg. § 1.199A-2(b)(2)(iv)(B).

3. Step three: Allocate W-2 wages to QBI

It is the responsibility of each individual or RPE to identify W-2 wages that are properly allocable to QBI for each trade or business or aggregated trade or business. Treas. Reg. § 1.199A-2(b)(4). Similar to step two, W-2 wages are allocable to QBI if the related wage expense is also used to compute QBI. *Id*. If a trade or business is conducted by an RPE, the RPE must report each partner's or shareholder's share of the W-2 wages and allocate the wages in the manner required by other provisions of the Code. *Id*. In addition, for a nongrantor trust or estate, if the W-2 wage limitation applies, the W-2 wages are to be allocated among the trust or estate and its beneficiaries in the same way as DNI is allocated. Treas. Reg. § 1.199A-6(d)(3)(ii). In determining DNI for Section 199A purposes, the separate share rule of Section 663(c) is taken into account, but the Section 199A deduction is not. *Id*.

G. Allocating UBIA of Qualified Property

The individual or RPE that directly conducts a trade or business or aggregated trade or business determines the UBIA of qualified property for that trade or business or aggregated trade or business. Treas. Reg. § 1.199A-2(a)(3). Similar to W-2 wages, if UBIA of qualified property is not determined and reported properly, it is presumed to be zero. Treas. Reg. § 1.199A-2(a)(3)(i). Allocation of UBIA of qualified property differs if the property is held by a partnership or S corporation. A partnership allocates UBIA of qualified property to each partner in the same way it allocates depreciation under § 1.704-1(b)(2)(iv)(g) on the last day of the taxable year. Treas. Reg. § 1.199A-2(a)(3)(ii). An S corporation allocates UBIA of qualified property to each shareholder based on the number of shares of stock held by the shareholder on the last day of the taxable year over all issued and outstanding shares. Treas. Reg. § 1.199A-2(a)(3)(iii). For a nongrantor trust or estate, UBIA of qualified property is allocated in the same manner as other Section 199A items – to the beneficiaries to the extent DNI is distributed (or deemed distributed) to the beneficiaries. Treas. Reg. § 1.199A-6(d)(3)(ii). In determining DNI for Section 199A purposes, the separate share rule of Section 663(c) is taken into account, but the Section 199A deduction is not. *Id*. Therefore, a beneficiary is allocated a share of the trust or estate's UBIA of qualified property based on the proportion of DNI either distributed or deemed distributed to the beneficiary. To the extent that less than all of a trust or estate's DNI is distributed, that portion of the trust or estate's UBIA of qualified property is retained by the trust or estate. *Id*. How the depreciation deduction for that property is allocated under Code Section 643(c) is irrelevant and does not affect how UBIA of qualified property is allocated for Section 199A purposes. If UBIA of qualified property is not determined and reported for each trade or business, however, it is presumed to be zero, although if the statute of limitations is still open on a return, the information can be reported on an amended or late-filed return. Treas. Reg. §§ 1.199A-2(a)(3), -6(b)(3)(ii), (iii).

H. Trusts and Estates

Code Section 199A applies to nongrantor trusts[25] and estates as well as to their beneficiaries.[26] The section can apply such that either the trust or estate may be treated as an individual and qualify for the Section 199A deduction, or the trust or estate may be treated as an RPE, passing the various elements of the deduction through to its beneficiaries who then, as individuals, may qualify for the Section 199A deduction.

Very little reference is made to trusts and estates in Code Section 199A. One special rule is found in Code Section 199A(f)(1)(B), which provides that for trusts and estates, the rules for apportionment of W-2 wages under repealed Code Section 199(d)(1)(B)(i) are used for the apportionment of W-2 wages and UBIA to qualified property for Section 199A purposes. Therefore, we must turn to the Treasury regulations for more guidance regarding the application of Section 199A to trusts and estates, with most of the guidance provided

[25] When referring to trusts in this paper, unless otherwise noted, the reference is to nongrantor trusts.

[26] For a discussion of general income tax rules applicable to trusts and estates, including the grantor trust rules, see Davis & Willms, *Ten Things Estate Planners Need to Know About Subchapter J*, 44th Ann. Notre Dame Tax & E. P. Inst. (2018).

in § 1.199A-6, and then to (surprise!) § 1.643(f)-1 regarding the application of Section 643(f) to trusts for Section 199A and all other purposes.

Understandably, a major focus of the comments submitted by ACTEC to Treasury and the IRS regarding the proposed regulations focus on trust and estate issues. Many of the issues noted in this section are discussed in further detail in those comments. Rather than regurgitating the comments, as noted above, they are attached as Exhibit A.

1. Grantor Trusts

Because of the nature of grantor trusts, it makes sense that Section 199A would not apply. Part E of Subchapter J of the Code provides a set of rules that override the general trust taxation rules and cause the income of certain trusts to be taxed to the grantor (or someone treated as the grantor) to the extent that he or she has retained prohibited enjoyment or control of trust income and/or principal. The key to the inquiry is whether the grantor enjoys trust benefits, has retained so much control, or has left so many "strings" attached to the trust as to be fairly treated as the true owner of the trust property for income tax purposes. The powers listed in the grantor trust rules are exclusive—no amount of control by the grantor will cause the grantor to be taxed if the power in question is not set forth in the Code. IRC § 671.

The grantor trust rules generally treat the grantor as the owner of any portion of the trust property over which a grantor trust power applies. As a result, all items of income, deduction, expenses, and credits associated with that portion of the trust are reported directly by the grantor on his or her income tax return. IRC § 671. In addition, if the assets included in that portion are sold by the grantor to a grantor trust (or vice versa), no gain is recognized on the sale. *See* Rev. Rul. 85-13, 1985-1 CB 184. Keep in mind that for all transfers in trust after March 1, 1986, for purposes of the grantor trust rules, when reading the term "grantor" throughout the rules, you need to read "or the grantor's spouse" afterwards, whether those words literally appear in the Code or not. IRC § 672(e). This is the spousal attribution or spousal unity rule. Another set of rules are important to keep in mind when reading the grantor trust rules: the portion rules. Each grantor trust rule states that it applies only to the portion of the trust over which the described power or interest is retained. For example, based upon the specific case at issue, the grantor trust rules may apply to only the income portion, only the principal portion, or both; they may apply to specific assets or fractions of a trust; or they may apply for some periods but not others. The portion described is then the portion (which may be all) of the trust that will be treated as being owned by the grantor for income tax purposes.

True to the premise that the grantor trust rules treat the grantor (or deemed grantor) as the owner of any portion of the trust property over which a grantor trust power applies, Code Section 199A does not apply to grantor trusts. Rather, the term "individual" in the Treasury regulations excludes grantor trusts, and the grantor or other person treated as the grantor calculates the Section 199A deduction as if he or she conducted the portion of the activities attributed to the trust. Treas. Reg. § 1.199A-1(a)(2), -6(d)(2).

What if a trust is partially a grantor trust and partially a nongrantor trust? This result can occur, for example, if a gift is made to a trust over which the beneficiary has a right of withdrawal but the right of withdrawal is not enough to cover the gift. IRC § 678(a)(1). For example, a gift of $100,000 is made to a trust that gives the beneficiary a right to withdraw $5,000 that year. Because the beneficiary's withdrawal right only applied to five percent (5%) of the trust, five percent (5%) of the trust will be a grantor trust as to the beneficiary and ninety-five percent (95%) of the trust will be a nongrantor trust treated as (depending on its terms) either a simple trust or a complex trust with the trust's taxable distributable net income taxed to potentially more than one beneficiary and/or the trust. IRC §§ 651, 652, 661, 662. Or, as another example, a gift of S corporation stock valued at $100,000 is made to a trust over which the beneficiary has a right to withdraw $5,000 that year. Although the beneficiary intends the trust to qualify as a subchapter S trust (QSST), no election is made, with the thought being that the beneficiary will be the deemed grantor because of the grantor trust rules. IRC § 1361(c)(2)(A)(i). Because the beneficiary's withdrawal right only applies to five percent (5%) of the trust and the beneficiary failed to make a QSST election, only five percent (5%) of the trust will be a grantor trust because the beneficiary will be deemed the grantor only over that portion, and the remaining ninety-five percent (95%) will be a nongrantor trust treated as (depending on its terms) either a simple trust or a complex trust. IRC §§ 678(a)(1), 1361(d). Presumably, if a trust is partially a grantor trust and partially a nongrantor trust, Code Section 199A will apply to the portion of the trust treated as a nongrantor trust, with the various components allocated accordingly.

2. Determine Stratum

a. Calculate Trust or Estate's Taxable Income and DNI

Broadly speaking, income earned by a nongrantor trust or an estate in any year is taxed to the trust or estate to the extent that the income is retained, but is taxed to the beneficiaries to the extent that it is distributed to the beneficiaries with the trust or estate receiving a distribution deduction in the latter case. IRC §§ 651, 652, 661, 662. Trustees and executors must work with state law definitions of "income" that are different from the tax law concept of "taxable income." IRC § 643(b). For example, capital gains are typically principal for state law purposes, even though they are taxable as income for federal income tax purposes. On the other hand, tax-exempt interest constitutes income under state law, even though it is not taxable income. The Code makes an effort to reconcile these differing definitions by using the concept of distributable net income ("DNI"). In summary, DNI in most cases is the taxable income of a trust or an estate (before its distribution deduction under Code Section 651 or 661), less its net capital gains,[27] plus its net exempt income. IRC § 643(a). Subject to several exceptions, the general rule is that any distribution from a trust or an estate will carry with it a portion of the trust or estate's DNI. Trust and estate distributions are generally treated as coming first from current income, with tax-free distributions of "corpus" arising only if distributions exceed DNI. IRC § 662. If distributions are made to multiple beneficiaries, DNI is generally allocated to them pro rata. IRC §§ 652, 662.

Once the trust or estate's taxable income is determined, we then know whether the trust or estate falls in Stratum I, II, or III. Because the threshold limits for single filers applies to trusts and estates, for 2018, the threshold amount is $157,500, and is $160,700 for 2019. Treas. Reg. § 1.199A-6(d)(3)(iv); Rev. Proc. 2018-57, 2018-49 IRC 827.

b. Taxable Income Determined With Regard to Distribution Deduction

As with other individuals, in calculating a trust or an estate's taxable income for Section 199A purposes, the Section 199A deduction is not taken into account. IRC § 199A(e)(1). A major change was made in the final Treasury regulations regarding how to calculate a trust's or estate's taxable income in order to determine the entity's threshold amount. The proposed regulations had provided that a trust or an estate's taxable income for Section 199A purposes was to be calculated before taking any distribution deduction, meaning the entity would have to consider all of its taxable income for threshold purposes, even if all of its taxable income was distributed to its beneficiaries. In the Preamble to the proposed regulations, Treasury and the IRS cited the reasoning for this position to be the fear of potential abuse because individuals could divide assets among multiple trusts so that each trust could claim a separate threshold amount.

Rather than preventing perceived potential abuse, ACTEC commented that this position appeared punitive to trusts, estates, and their beneficiaries; would cause trust or estate income to be counted twice for Section 199A purposes; and the proposed regulations should be revised to clarify that taxable income allocated to a trust or an estate should only be the taxable income retained by the trust or estate. Otherwise, as ACTEC commented, because Section 199A neither specifies that a trust or an estate's taxable income should be calculated in the manner set forth in the proposed regulations nor directs regulations be issued to so provide, Treasury and the IRS exceeded their authority.

Distributions from trusts and estates to beneficiaries are made for a myriad of reasons, most of which have nothing to do with tax avoidance. Congress identified and effectively dealt

[27] Capital gains are typically excluded from DNI, and as a result, they may be "trapped" in the trust or estate - if they are excluded from DNI, they simply cannot be carried out to beneficiaries when distributions are made, and so are taxed to the trust or estate. However, this rule is subject to three exceptions. Capital gains are included in DNI (and thus may be included in the amounts that carry out to beneficiaries) to the extent that they are, pursuant to the governing instrument or local law: (i) allocated to income; (ii) allocated to corpus but treated consistently by the trustee on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or (iii) allocated to corpus, but actually distributed to a beneficiary or utilized by the trustee in determining the amount that is distributed or required to be distributed to a beneficiary. *See* IRC § 643(a)(3); Treas. Reg. § 1.643(a)-3(b).

with the concern that distributions among multiple beneficiaries could be used to "improperly" shift taxable income among a trust or an estate and its beneficiaries when it adopted the multiple trust rules of Code Section 643(f), enacted for the very purpose of aggregating multiple trusts if the principal purpose of such trusts is the avoidance of federal income tax.

In the Preamble to the final regulations, Treasury and the IRS note that they agree that "distributions should reduce taxable income because the trust is not taxed on the income." Although this comment only mentions trusts, § 1.199A-6(d)(3)(iv) provides that for purposes of determining a trust's or an estate's taxable income and whether it exceeds the threshold amount, the distribution deduction under Code Sections 651 or 661 is to be taken into account. A welcome and correct reversal of position!

3. QBI, Etc. Follows DNI and the Separate Share Rule Applies

Because Section 199A and § 1.199A-6(d)(3)(i) requires each nongrantor trust and estate to calculate its respective QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income based on those items that are allocated to it, the trustee or executor will need to establish a system to track these items in its books and records. When a nongrantor trust and estate is allocated QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income, calculations of items related to Section 199A are first made at the trust or estate level, and then, if appropriate, are further allocated to the trust or estate's beneficiaries. If those items are further allocated to a beneficiary, the trust or estate becomes an RPE to the extent of its allocation. Treas. Reg. § 1.199A-6(d)(1). If a trust or an estate allocates a portion of these items to a beneficiary and retains a portion of these items, for Section 199A purposes, the trust or estate will be treated partially as an RPE and partially as an individual. *Id*.

The Treasury regulations adopt DNI as the method to allocate Section 199A items between a nongrantor trust or estate and its beneficiaries, and similar to the notion that DNI carries out to beneficiaries only to the extent of taxable income, Section 199A items are allocated to beneficiaries to the extent DNI is distributed (or deemed distributed) to the beneficiaries. Treas. Reg. § 1.199A-6(d)(3)(ii). For this purpose, DNI is computed without regard to any Section 199A deduction. *Id*. Therefore, a beneficiary is allocated a share of the trust or estate's QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income based on the proportion of DNI either distributed or deemed distributed to the beneficiary. To the extent that less than all of a trust or estate's DNI is distributed, that portion of the trust or estate's QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income is retained by the trust or estate. *Id*. In the case of UBIA of qualified property, how the depreciation or depletion deductions for that property are allocated under Code Section 643(c) is irrelevant and does not affect how UBIA of qualified property is allocated for Section 199A purposes. Once Section 199A items are allocated to a beneficiary, the beneficiary uses the allocated amounts to calculate the beneficiary's Section 199A deduction. Treas. Reg. §§ 1.199A-6(d)(1), (3)(i)-(ii). Likewise, the trust or estate uses its retained Section 199A items to compute its Section 199A deduction. If no DNI is distributed or deemed distributed to the beneficiaries or if the trust or estate has no DNI in any year, all Section 199A items will be allocated to the trust or estate, which will then calculate its Section 199A deduction. *Id*.

Although DNI is calculated for Section 199A purposes without regard to the Section 199A deduction, the separate share rule does apply when multiple beneficiaries exist. Treas. Reg. § 1.199A-6(d)(3)(ii). According to the separate share rule, when the governing instrument of a trust or estate (e.g., trust agreement or Will) or applicable local law creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries, then solely for purposes of allocating DNI, the "separate share rule" applies. IRC § 663(c). Under this rule, DNI is allocated among trust or estate beneficiaries based upon distributions of their respective "share" of the trust's or estate's DNI. *Id*. As a result, trustees and executors have to determine whether the trust agreement, Will, or state law creates separate economic interests in one beneficiary or class of beneficiaries. Likewise, if the separate share rule applies, items allocated for Section 199A purposes will be allocated among beneficiaries in the same way that DNI is allocated among the beneficiaries. Treas. Reg. § 1.199A-6(d)(3)(ii).

With the belief that it is necessary to clarify that the separate share rule applies only for allocation of Section 199A items and does not in and of itself create separate shares for purposes of determining threshold amounts, Treasury and the IRS issued proposed § 1.199A-6(d)(3)(iii) concurrently with the issuance of the final regulations under Section 199A. The proposed regulation provides that a trust that has substantially separate and independent shares for multiple beneficiaries will nevertheless be treated as a single trust for purposes of determining whether the trust is below or above the threshold amount. Prop. Treas. Reg. § 1.199A-6(d)(3)(iii). This rule mirrors the notion that the separate share rule is merely a tool for allocating DNI, and does not permit the treatment of separate shares as a separate trust. Treas. Reg. § 1.663-1(b).

4. Disrespected Trusts

As discussed further below, § 1.643(f)-1 was issued as an anti-avoidance rule to apply to all trusts, but an additional regulation was issued to apply to trusts only for Section 199A purposes. Somewhat cryptically, proposed § 1.199A-6(d)(3)(v) provided that "[t]rusts formed or funded with a significant purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A."[28] In the Preamble to the proposed regulations, Treasury and the IRS cited the reasoning for issuing this proposed regulation with regard to disrespected trusts as the fear of potential abuse by taxpayers who could divide assets among multiple trusts so that each trust could claim a separate threshold amount, and that such result "is inappropriate and inconsistent with the purposes of section 199A."

Several issues were raised with the proposed regulation. As with the anti-abuse rule of proposed § 1.643(f)-1, no guidance was given as to what rises to the level of a "significant purpose" for forming or funding trusts in order to receive a Section 199A deduction. ACTEC had noted in its comments that the purpose test in this proposed regulation was a "significant" purpose versus the purpose test in proposed § 1.643(f)-1 that it be "a principal" purpose. Prop. Treas. Reg. §§ 1.199A-6(d)(v), 1.643(f)-1. In addition, no guidance was given as to the effect of a trust being "disrespected." Again, these comments are attached and provide a through discussion of the many issues.

In issuing the final regulation, the Preamble states that the rule is designed to "thwart the creation of even one single trust with a principal purpose of avoiding, or using more than one, threshold amount." Accordingly, the final regulations revised the proposed regulation and § 1.199A-6(d)(3)(vii) now provides that "*[a] trust* formed or funded with a *principal* purpose of avoiding [sic], or of using more than one, threshold amount for purposes of calculating the deduction for section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A." [emphasis added] Pursuant to the final regulation, it is clear that this anti-avoidance, i.e. anti-abuse rule, applies even if only one trust is involved. In addition, the "principal" purpose test is substituted for a significant purpose test, and it seems clear that the consequences of the rule are limited to determining threshold amounts.

Unfortunately, the guidance with respect to this rule is still weak. For example, the Preamble further states that if a "trust creation violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under section 199A." No further guidance is given in the final regulation as to how aggregation occurs and the sole example provided focuses on calculation of the Section 199A deduction. For example, if trust distributions are made, does the distribution deduction apply if the trust is disrespected or will all of the trust's income (even distributed income) be aggregated with the grantor for determining the grantor's threshold? The similarity to the issue that arose when the proposed regulation providing that the distribution deduction did not apply for purposes of calculating a trust's taxable income is apparent. Without further guidance, it may be difficult for taxpayers and their advisors to measure the standards.

As a final note, § 1.199A-6(d)(vii) has its own effective date. Section 1.199A-6(e)(2)(i) provides that this anti-abuse rule applies for taxable years ending after December 22, 2017.

[28] As my partner notes, these disrespected trusts could be referred to as "Rodney Dangerfield trusts."

5. Multiple Trust Rules

In issuing the proposed Treasury regulations related to Code Section 199A, Treasury and the IRS took the opportunity to also issue proposed Treasury regulations related to Code Section 643(f), with the intent that those regulations will apply for all purposes, not just Section 199A. Prop. Treas. Reg. § 1.643(f)-1(a). Code Section 643(f), effective for tax years after March 1, 1984**,** provides that for purposes of Subchapter J of the Code, "under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust, if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) if a principal purpose of such trusts is avoidance of [income tax]." IRC § 643(f). In addition, for purposes of Section 643(f), spouses are treated as one person. *Id*.

Remember that in 1984 (and until 1986), trusts used the same income tax brackets as single individuals and did not have their own compressed income tax brackets. Setting up multiple trusts was a popular strategy to minimize income taxes. In response, Code Section 643(f) was enacted, but until now, no regulations related to the statute had been issued.

As set forth in the statute, in order for multiple trusts to be treated as one trust, Code Section 643(f) requires four elements: (1) there must be two or more trusts, (2) with substantially the same grantor(s), (3) with substantially the same primary beneficiary(ies), and (4) a principal purpose of the trusts is the avoidance of income tax. Taking into account the effective date, a fifth element could be that the trusts have to be entered into on or after March 2, 1984. The proposed Treasury regulations took the elements of the statute a step further, and suffice it to say, the proposed regulation was a disaster, inciting much criticism, including that Treasury and the IRS had overstepped their authority. For example, no guidance was given as to what is meant by the terms "primary beneficiary," "principal purpose," or "substantially the same" in terms of grantors or primary beneficiaries. Although examples are given in the legislative history for Code Section 643(f) and then were further adapted in proposed § 1.643-f(1), the examples are unclear and confusing. On these issues, ACTEC's comments are also extensive.

In issuing final § 1.643(f)-1, Treasury and the IRS dialed back their initial position, mostly gutting the language of the proposed regulation and deleting the examples that had been included. Section 1.643(f)-1(a) now provides that "two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax." With the final regulation, unfortunately, confusion remains. In the Preamble, Treasury and the IRS note that they have "taken under advisement" whether and how issues raised in comments can be addressed, but that in the meantime, Section 643(f) itself and the guidance provided in the legislative history for that statute are enough to rely on to determine if the rule has been violated.

Although the Treasury regulations provide that § 1.643(f)-1 will be effective for taxable years ending after August 16, 2018, it does not state whether the date a trust is formed or modified[29] has any influence on its application, i.e. whether any trusts are grandfathered. It appears that the regulation could apply to any trusts established or to which cash or additional property is contributed after March 1, 1984. For example, if a trust is a grantor trust but grantor trust status is terminated after the effective date of the proposed regulation, does this status change invoke § 1.643-f(1)? Although this questions was made in comments to the proposed regulations, no further guidance was given.

6. Electing Small Business Trusts (ESBTs)

Section 1.199A-6(d)(3)(vi) confirms that electing small business trusts (ESBTs) are entitled to a Section 199A deduction. An election to be treated as an ESBT is one of the elections that can be made pursuant to Code Section 1361 in order for an S corporation to maintain its status when any shareholder is what would otherwise be a disqualifying trust. With an ESBT, there can be multiple beneficiaries of the trust, so the restriction applied to QSSTs of only allowing one trust income beneficiary does not apply. IRC § 1361(e). The election for ESBT treatment is made by the trustee

[29] The term "modified" is used here on purpose. Although § 1.643(f)-1(a) provides that its application includes trusts to which additional cash or other property are contributed, the Preamble reiterates the position of Treasury and the IRS that it includes any arrangement involving multiple trusts that are modified.

of the trust by submitting a letter to the IRS center where the corporation files its income tax return and providing the information outlined in Treasury Regulation Section 1.1361-1(m)(2). IRC § 1361(e)(3). The election is to be made within two months and 15 days after the transfer of the stock to the trust or the expiration of the 2-year allowed holding period for shares transferred as a result of death, although late election relief is available. IRC § 1361(c)(2); Treas. Reg. § 1.1361-1(m)(2); *see also*, Rev. Proc. 2013-30, 2013-36 IRB 173.

For income tax purposes, when a trust that is not a grantor trust holds S corporation stock and the trustee makes an election to have the trust treated as an ESBT, all income from the S corporation is taxed to the trust at the highest income tax bracket, regardless of whether any income is distributed to a beneficiary and without regard to any threshold. IRC § 641(c). The portion of the trust that holds the S corporation stock is treated as if it were a separate trust. *Id*. Any non-S portion of the trust is taxed according to the normal rules for taxation of nongrantor trusts. Treas. Reg. § 1.641(c)-1(c). If all or any portion of an ESBT is a grantor trust, the income attributable to such portion is taxable to the grantor. Treas. Reg. § 1.641(c)-1(c).

The final regulations clarify that QBI and other Section 199A items are to be accounted for separately for each of the S portion, non-S portion, and any grantor portion from any S corporation owned by the ESBT. Treas. Reg. § 1.199A-6(d)(3)(vi). Although the proposed regulation did not specify if this separate treatment also applied for determining the Section 199A threshold amounts, the final regulations clarify that for purposes of determining whether the ESBT's taxable income exceeds the threshold amount, the S and non-S portions of the trust are to be treated as a single trust. *Id*.

7. Charitable Trusts

No specific provisions were made in Section 199A or the proposed regulations regarding charitable remainder trusts (CRTs) and whether a Section 199A deduction would be available to recipients of any taxable portion of such trusts that could result in a deduction. As noted in the Preamble to the proposed regulations, Treasury and the IRS requested comments with regard to this issue as well for taxable beneficiaries of other split-interest trusts. ACTEC submitted comments with regard to this request, noting that the times that it would apply should be rare because of the nature of charitable trusts and the typical avoidance of any unrelated business taxable income (UBTI) due to the resulting high (100%) excise tax. *See* Treas. Reg. § 1.664-1(c)(1). The times that it would apply would most likely be because the trust held non-UBTI interests that generate income such as rental real estate income and REIT dividends. Noting that such trusts are subject to certain tier rules set forth in Code Section 664, and not the tier rules for non-charitable trusts set forth in Code Sections 652 and 662, the comments remind us that the Section 664 tiers are based on a difference in tax rates and have nothing to do with a deduction like Section 199A.

Treasury and the IRS issued proposed regulations in this regard concurrently with the issuance of the final regulations under Section 199A, and declined to adopt the specific suggestion made by ACTEC as to how Section 199A items received by a CRT would be allocated by it, instead taking a more taxpayer friendly approach. Proposed § 1.199A-6(d)(3)(v) provides that although Section 199A does not apply to a CRT, any annuity or unitrust amount distributed by a CRT can carry out Section 199A items to the distributee and are classified and allocated according to the general rules under § 1.664-1(d), with the recipient then using those amounts to determine its own Section 199A deduction. Referencing the Section 664 regulation means that QBI, qualified REIT dividends, and qualified PTP income will be allocated within the ordinary income "tier," distributed after other ordinary income subject to a higher rate of tax (not taking into account Section 199A) has been distributed, and then allocated proportionately to the recipient with other income subject to the same tax rate as the QBI, qualified REIT dividends, and qualified PTP income. If there is more than one recipient, the items are to be allocated pro rata. Prop. Treas. Reg. § 1.199A-6(d)(3)(v). If the CRT has any W-2 wages or UBIA of qualified property, those items are allocated to the recipients based on their shares of total QBI, whether or not the QBI is distributed. *Id*. A helpful example is provided in proposed § 1.199A-6(d)(3)(v).

I. Other Special Section 199A Rules

1. Aggregation of Trades or Businesses

Recognizing that it is not uncommon for trades or businesses to operate through more than one entity, § 1.199A-4 adopts rules to allow individuals or RPEs, under certain conditions, to elect to aggregate multiple trades or businesses so that they are treated as a single trade or business for purposes of determining the QBI component and its related limitations. In other words, the individual, and pursuant to a change in the final regulations an RPE, has the opportunity to aggregate the individual's or RPE's share of QBI, W-2 wages, and UBIA of qualified property for trades or businesses the individual operates directly or that are operated through RPEs, or that an RPE operates directly or through a lower-tier RPE. Treas. Reg. § 1.199A-4(b)(2). Aggregation may be especially useful when the alternative limitation comes into play. If, for example, one trade or business has little or no W-2 wages or UBIA of qualified property but another has a substantial amount of either, aggregating the two may increase the alternative limitation, thereby increasing the QBI component. Otherwise, an individual must determine the QBI component and apply the limitations to each separate trade or business. Because aggregation only applies for purposes of the wage and UBIA of qualified property limitations, it is of no help for and no use to individuals who have taxable income below the threshold amount (Stratum I individuals).

Importantly, the final regulations added the ability for RPEs to aggregate. Treas. Reg. § 1.199A-4(b)(2)(ii). If an RPE aggregates, the individual owners cannot "undo" the aggregation and the RPE and owners must report consistently, although the individual can elect to aggregate additional trades or businesses with those aggregated by an RPE. Treas. Reg. §§ 1.199A-4(b)(2)(i), (c). Likewise, an upper-tier RPE may not "undo" aggregation by a lower-tier RPE, but an upper-tier can elect to aggregate additional trades or businesses with those aggregated by a lower-tier RPE. Treas. Reg. §§ 1.199A-4(b)(2)(ii), (c). If, however, an RPE does not aggregate, individual owners make their own independent decision to aggregate or not. Treas. Reg. § 1.199A-4(b)(2)(i). And, just because an individual or RPE does not aggregate in one year does not mean that the individual or RPE cannot decide to aggregate in a later year. Treas. Reg. § 1.199A-4(c)(1), (3). Once an individual or RPE makes the aggregation election, however, it is a permanent election for future years (at least through 2025) for that individual or RPE and for the trades or businesses that are aggregated. IRC § 199A(i); Treas. Reg. § 1.199A-4(c)(1), (3). Accordingly, individuals and RPEs should not make the election lightly. Just because aggregation in one year will provide a good result does not necessarily mean that it will provide a good result in future years.

Aggregation is a separate concept from the requirement that when taking the Section 199A deduction, if an individual has QBI from multiple trades or businesses and either the individual or an RPE does not elect to aggregate the trades or businesses or the trades or businesses do not qualify for aggregation, the individual must calculate the QBI from each trade or business and net the amounts to determine combined QBI. IRC § 199A(b)(1)(A). Also, if the individual or RPE elects not to aggregate or the trades or businesses do not qualify for aggregation, the individual must determine whether the alternative limitation, which involves the calculations based on W-2 wages and UBIA of qualified property, limits the QBI component for each trade or business.

What if the individual or RPE later takes part in or acquires a new trade or business, or if an aggregated trade or business no longer meets the conditions for aggregation? As long as a new trade or business meets the qualifications to be aggregated, it can be added to the already aggregated trades or businesses, but if a trade or business no longer qualifies for aggregation because the facts and circumstances related to that trade or business significantly change, it must be removed from the aggregated group. Treas. Reg. § 1.199A-4(c)(1), (3).

The regulations specify that if an individual elects to aggregate, the QBI, W-2 wages, and UBIA of qualified property for each of those trades or businesses are aggregated first, and then the W-2 and UBIA of qualified property limitations in § 1.199A-1(d)(2)(iv) are applied. Treas. Reg. §§ 1.199A-2(a)(2), (a)(3), (b)(3), (b)(4), -3(a), -4(b)(2)(i).

In order to aggregate multiple trades or businesses, those trades or businesses cannot be SSTBs but they must have several things in common. Treas. Reg. § 1.199A-4(b). In broad strokes, there are requirements related to common ownership and common operations, and although the requirements may make one think of the grouping rules under Code Section 469, the rules are different and must be applied independently for each purpose, i.e. the Section 199A deduction versus the passive activity loss rules. Specifically, the requirements that an individual or RPE must show are set forth in § 1.199A-4(b)(1) and include:

(1) Common ownership:

(a) The same person(s), directly or by attribution under Sections 267(b) or 707(b), must own fifty percent (50%) or more of each of the trades or businesses. For S corporations, ownership is determined by the issued and outstanding shares of the corporation, and for partnerships, ownership is determined by the capital and profits of the partnership. Treas. Reg. § 1.199A-4(b)(1). Keep in mind that the common ownership test is strictly to determine whether the trades or businesses qualify for aggregation; for example, there is no rule that an individual who is making the election to aggregate own any minimum percentage.

A major change came about in the final regulations regarding attribution. In the proposed regulation, family attribution was quite limited and attribution from a trust or an estate to its beneficiaries was not addressed, and as a result, comments were provided asking for better rules regarding attribution. By referencing Code Sections 267(b) and 707(b) in the final regulations for determining attribution, not only does attribution by a spouse, children, grandchildren, and parents apply, but attribution between siblings applies as well. If one reviews those Code Sections, one will also see that attribution involving trusts, estates, and their beneficiaries, as well as many other relationships are now included.

(b) The common ownership exists for a majority of the tax year, and pursuant to the final regulations, that ownership must exist on the last day of the taxable year. Treas. Reg. § 1.199A-4(b)(1)(ii).

(2) Same tax year: All items attributable to each of the trades or businesses are reported on returns with the same taxable year, and short taxable years don't count. Treas. Reg. § 1.199A-4(b)(1)(iii).

(3) Common operations: Based on all facts and circumstances, the trades or businesses to be aggregated must have two of the following three factors listed in § 1.199A-4(b)(1)(v):

(a) They must provide products, property, or services that are the same or are commonly offered together, such as a car dealership and its service department or a shipping company and its warehouse operations.

(b) They must share facilities or significant centralized business elements, such as a restaurant and catering operation.

(c) They must operate in coordination with, or rely on, one or more of the trades or businesses to be aggregated, such as a steelyard, a company that ships finished steel, and a construction company that installs the finished steel.

If an individual or RPE chooses to aggregate multiple trades or businesses, the individual or RPE is subject to annual reporting requirements. For individuals, a statement is to be attached to the individual's tax return identifying the trades or businesses to be aggregated by providing for each, (1) a description, name and EIN, (2) information about any that were formed, acquired, ceased to do business, or were disposed of, (3) information identifying any trades or businesses that were aggregated by an RPE of which the individual is an owner, and (4) "such other information as the Commissioner may require in forms, instructions, or other published guidance." Treas. Reg. § 1.199A-4(c)(2)(i). If an RPE chooses to aggregate multiple trades or businesses, the RPE must provide similar information but does so on an attachment to each owner's Schedule K-1. Treas. Reg. § 1.199A-4(c)(4)(i). In either event, failure to disclose does not result in deemed disaggregation of the trades or businesses, but means that the IRS may disaggregate them. *Id*. If the IRS disaggregates trades or businesses, the individual or RPE may not aggregate those trades or businesses for the following three taxable years. Treas. Reg. §§ 1.199A-4(c)(2)(ii), (4)(ii). If an individual or RPE does not aggregate for a tax year, other than for year 2018, the individual or RPE cannot later amend a return and aggregate. Treas. Reg. §§ 1.199A-4(c)(1), (3).

An important item was missing from the regulations: how is an individual to know who all of the owners of the trade or business are, their respective ownership percentage, and whether any interests can be attributed to each other pursuant to the family attribution rules? Treasury and the IRS acknowledge that individuals will need information to determine whether the common ownership test is met and requested comments regarding whether a reporting or information sharing requirement should be required. ACTEC suggested that RPEs should include information regarding the owners and their respective ownership percentage interest on each Schedule K-1 it provides to its owners. Pursuant to the final regulations and the Preamble, Treasury and the IRS concluded that expanding the ability to aggregate to RPEs was sufficient to address the reporting and information sharing concerns.

2. No (or Limited) Segregating Trades or Businesses

After the enactment of Section 199A, much talk ensued of possible ways to circumvent the SSTB rules by segregating or splitting off portions of a trade or business so that after the restructuring, the portion of the trade or business that would be treated as an SSTB would be isolated, thereby opening up the non-SSTB portion to a potential Section 199A deduction. For example, talk ensued about having a law firm segregate the partners from the associates from the administrative divisions with the idea that separate entities could be structured to hold these functions to divert a portion of revenue so that it would be characterized as non-SSTB revenue. To serve as anti-abuse rules to prevent such "maneuvering," the proposed regulations provided attribution rules coupled with an incidental rule to limit these strategies. The final regulations eliminated the incidental rule and revised the attribution rules to a more bright line common ownership test. Specifically, if a trade or business provides property or services to an SSTB and there is at least fifty percent (50%) common ownership among the trades or businesses, then the portion of the trade or business that is providing its property or services to the commonly owned trade or business will be treated as a separate SSTB as to the related parties. Treas. Reg. § 1.199A-5(c)(2). For purposes of the common ownership test, as was done for aggregation, the related party rules of Code Sections 267(b) and 707(b) are used. Treas. Reg. § 1.199A-5(c)(2)(ii). Presumably, the relaxation of the rules regarding segregation may provide opportunities for segregation, albeit limited, but those option may be more complicated than what would be gained. This anti-abuse rule applies to taxable years ending after December 22, 2017. Treas. Reg. § 1.199A-5(e)(2)(i).

3. Other Anti-Abuse Rules

Congress instructed Treasury and the IRS to address a myriad of rules rather than addressing these rules itself in Section 199A. These rules include anti-abuse rules, some of which are discussed above, regarding (a) the holding period for qualified property to curb the ability to purchase property "last minute," (b) the holding period for REIT stock for the purposes of what constitutes a qualified REIT dividend, (c) attribution and other rules to prevent widespread segregation of business activities in an attempt to isolate the SSTB portion, (d) characterization of employees and independent contractors, and (e) rules related to multiple trusts and disrespected trusts. In addition to these rules, Section 199A(h) directs Treasury and the IRS to prescribe specific anti-abuse rules. These anti-abuse rules include rules to prevent related parties from using transfers to manipulate the depreciable period of qualified property, and rules to determine the UBIA of qualified property acquired in like-kind exchanges or involuntary conversions. In issuing regulations in both regards, Treasury and the IRS looked to other established rules and made the point initially in the Preamble to the proposed regulations that in doing so, their use "will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them."

a. Manipulation of Depreciable Period of Qualified Property Between Related Taxpayers

The first anti-abuse directive in Code Section 199A(h) directs Treasury and the IRS to prescribe rules to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, by applying rules similar to those under Code Section 179(d)(2). IRC § 199A(h)(1). Code Section 179(d)(2) defines "purchase" for the purpose of determining property that is eligible for Section 179 expensing and excepts out purchases of property from certain related taxpayers.

In the Preamble to the proposed regulations, Treasury and the IRS related this directive to requests for guidance regarding the treatment of qualified property acquired in non-recognition transfers. Proposed § 1.199A-2(c)(2)(iv) provided that if an individual or RPE acquires qualified property in a non-recognition transfer described in Code Section 168(i)(7)(B), such as property transferred to a corporation or partnership in exchange for stock or a partnership interest under Code Section 351 or 721, a two-step process determined the date the property was first placed in service with the worst case scenario as the result. Under the proposed regulations, the transferee was required to keep the original life of any qualified property for purposes of determining the depreciable period without getting to "restart" it based on when the transferee actually placed the property in service.

At the same time, under the UBIA of qualified property rules regarding carryover basis, the transferee received only the transferor's depreciated basis. Prop. Treas. Reg. §§ 1.199A-2(c)(2)(iv), (3).

The final regulations tempered this harsh result and permit the transferee to use the transferor's UBIA of qualified property and placed-in-service date, except in circumstances when the transferee's UBIA in the property exceeds the transferor's UBIA in the property or when money changes hands in the transaction. Treas. Reg. §§ 1.199A-2(c)(2)(iv), (3)(iv). If the transferor pays any money in the transaction, the transferee's UBIA of qualified property is increased by that amount, and if the transferee pays any money in the transaction, the transferee's UBIA of qualified property is decreased by that amount. Treas. Reg. § 1.199A-2(c)(3)(iv). Note that if a principal purpose of the transaction is to increase UBIA of the qualified property, these rules do not apply and instead, the UBIA of the qualified property will be its basis as determined under other relevant provisions of the Code. Treas. Reg. § 1.199A-2(c)(3)(vi). In determining the depreciable period, for any portion of the transferee's UBIA of qualified property that exceeds the transferor's UBIA of qualified property, the transferee uses the date of transfer as the placed-in-service date for this separate portion. Treas. Reg. § 1.199A-2(c)(2)(iv).

b. UBIA of Qualified Property from Like-Kind Exchanges and Involuntary Conversions

The second anti-abuse directive in Code Section 199A(h) directs Treasury and the IRS to prescribe rules for determining the UBIA of qualified property acquired in like-kind exchanges (as in a Code Section 1031 exchange) or involuntary conversions (as in a Code Section 1033 conversion). IRC § 199A(h)(2). In response to Section 199A(h)(2)'s directive for the Secretary to prescribe anti-abuse rules related to determining UBIA of qualified property for like-kind exchanges and involuntary conversions, proposed § 1.199A-2(c)(2)(iii) imposed a "worst of all options" rule for these events, which effectively left the property received in the exchange with the exchanged property's placed-in-service date, while treating only its depreciated basis as UBIA of the replacement property.

Fortunately, the final regulations provide in general that for replacement property received in a like-kind exchange or involuntary conversion, an individual or RPE will be entitled to use as its UBIA the transferee's UBIA (and not adjusted basis) in the relinquished or converted property. However, to give effect to any "boot" given or received in the transaction, the final regulations require that UBIA of qualified property be decreased by any "excess boot" received. "Excess boot" is defined as boot representing the excess of the fair market value of the relinquished or converted property on the date of the exchange over its fair market value on the date it was acquired by the taxpayer. Treas. Reg. §§ 1.199A-2(c)(3)(ii), (iii). Other qualified property received by the taxpayer in the transaction has a UBIA equal to its fair market value. *Id*. Note that as with non-recognition transfers, if a principal purpose of the transaction is to increase UBIA of the qualified property, these rules do not apply and instead, the UBIA of the qualified property will be its basis as determined under other relevant provisions of the Code. Treas. Reg. § 1.199A-2(c)(3)(vi). For determining the depreciable period, similar to non-recognition transfers, as to the portion of the individual's or RPE's UBIA in the replacement property that equals the individual's or RPE's UBIA in the relinquished or converted property, the individual or RPE uses the first placed-in-service date of the relinquished or converted property as the placed-in-service date for the replacement property. Treas. Reg. § 1.199A-2(c)(2)(iii). For any additional property received or excess UBIA in the replacement property, the excess portion is treated as separate qualified property first placed in service when the other property was first placed in service by the individual or RPE. *Id*.

c. Last Minute Purchases of Qualified Property

As mentioned above in the definition of qualified property, in an attempt to avoid taxpayers gaming the system by acquiring property at the end of the taxable year to maximize a Section 199A deduction for individuals by lessening the effect of the alternative limitation, and then quickly disposing of the property, the Treasury regulations impose a holding period for qualified property. Specifically, § 1.199A-2(c)(1)(iv) provides that if property is acquired within 60 days of the end of the taxable year and disposed of within 120 days of acquisition without having been used in the trade or business for at least 45 days before disposition, the property will not be qualified property unless the taxpayer can show that the principal purpose of acquiring and disposing of the property in less time was for a reason "other than increasing the section 199A deduction." The holding period was established as an anti-abuse rule and applies to taxable years ending after December 22, 2017. Treas. Reg. § 1.199A-2(d)(2)(iv).

d. Employees vs. Independent Contractors

A qualified trade or business does not include the trade or business of performing services as an employee. IRC § 199A(d)(1)(B); Treas. Reg. § 1.199-5(d)(1). Therefore, no items of income, gain, loss, or deduction from those services are QBI. *Id*. Consequently, anyone who is an employee and receives wages is not personally eligible for the deduction, regardless of whether the employee is classified by the employer as an independent contractor or otherwise for employment tax purposes. Treas. Reg. § 1.199A-5(d)(2).

In an effort to curb potential abuse by someone who has been properly classified as an employee from trying to be re-classified as other than an employee, even though the person is performing substantially the same services, § 1.199A-5(d)(3) establishes the rebuttable presumption that the person is in the trade or business of performing services as an employee. To rebut the presumption, the individual must show that the individual is performing services in a capacity other than an employee. *Id*. Relaxing the restrictions and requirements related to the presumption set forth in the proposed regulations, the final regulations provide that the presumption expires three years after the person ceases to be classified as an employee, and the final regulations provide that an individual may rebut the presumption by providing records, such as an employment agreement, that corroborates the non-employee status. Treas. Reg. § 1.199A-5(d)(3). This anti-abuse rule applies to taxable years ending after December 22, 2017. Treas. Reg. § 1.199A-5(e)(2)(i).

In contrast to seeking reclassification as other than an employee, because a higher amount of W-2 wages will lessen the effect of the alternative limitation, some trades or businesses may seek to generate a higher amount of W-2 wages. As a result, they may want to reclassify independent contractors as employees in order to increase their W-2 wages. As issued, the proposed regulations do not prohibit such a reclassification, although the reclassification may be prevented by other federal laws. Reclassifying an independent contractor as an employee has far-reaching ramifications beyond Section 199A, including providing employee benefits, so caution is warranted when considering making such a change.

4. Effective Dates

For the most part, the regulations related to Section 199A apply to taxable years ending after the date the final regulations became final, i.e. after February 8, 2019. Treas. Reg. §§ 1.199A-1(f)(1), -2(d)(1), -3(e)(1), -4(e)(1), -5(e)(1), -6(e)(1). Certain provisions of the regulations apply to taxable years ending after December 22, 2017, the date of the enactment of TCJA 2017, and that effective date is noted herein with the discussion related to those regulations. Note that the Preamble provides that taxpayers have a choice for 2018 and may rely on either the proposed regulations or the final regulations, but will need to pick one. In addition, in the discussion of the multiple trust rules, the somewhat confusing effective date of August 16, 2018, the date of the issuance of the proposed regulations, is noted.

J. Miscellaneous

1. 2018 Forms, Schedules, and Instructions

On various dates between August and October of 2018 (all after the issuance of the proposed Treasury regulations), the IRS issued draft forms and instructions for 2018 income tax filings, including for the Form 1040, U.S. Individual Income Tax Return; Form 1041, U.S. Income Tax Return for Estates and Trusts; Form 1065, U.S. Return of Partnership Income; Form 1120S, U.S. Income Tax Return for S Corporation; and related Schedules K-1 for Forms 1041, 1065, and 1120S to report a respective beneficiary's, partner's, or shareholder's share of income, deductions, credits, etc. Although, understandably, the entity returns make no mention of Section 199A, Schedules K-1 and the instructions for both that schedule and the related return provide information about the

Section 199A deduction. The instructions for each return have been updated, and only the instructions for Form 1120S have not been updated since the final regulations were released with the last update being on January 17, 2019. The instructions for the Schedule K-1 for each relevant return show that reporting for Section 199A purposes is done in the "other information" box, which is Box 20 on a Form 1065, Schedule K-1; Box 17 on Form 1120S, Schedule K-1, and Box 14 on Form 1041, Schedule K-1.

For the Form 1040, a "simplified" worksheet is included as part of the instructions. Although the worksheet only applies for individuals whose taxable income is below the threshold amount (Stratum I individuals), a copy is attached as Exhibit B. Note that although line 11 of the simplified worksheet indicates that for calculating the Section 199A deduction, income is entered on the line, the instructions for that line clarify that it is taxable income. In order to obtain further information regarding such things as what constitutes a trade or business or what to do if taxable income falls within the phase-in range, the instructions refer us to Publication 535, which was published in final form on January 25, 2019.

2. Penalties

Section 6662 of the Code provides the general rule for imposing a penalty for the substantial understatement of income tax. The general rule is that an additional tax, or penalty, of 20% of the underpayment is added if the understatement exceeds the greater of 10% of the tax required to be shown on the return or $5,000. IRC § 6662(a), (b)(2), (d)(1)(A). For Section 199A purposes, Section 6662 was amended to provide that for anyone who claims the Section 199A deduction, the general rule is revised by substituting 5% for 10%, regardless of whether the Section 199A deduction influences the understatement. IRC § 6662(d)(1)(C); Treas. Reg. § 1.199A-1(e)(6).

3. Non-calendar Year End RPEs

In recognizing that an RPE could have a fiscal year end instead of a calendar year end, Treasury and the IRS provided some special rules. If an individual is determining QBI, W-2 wages, UBIA of qualified property, or aggregate qualified REIT dividends and qualified PTP income received from an RPE whose taxable year began before December 31, 2017 but ends after January 1, 2018, the individual is to treat those items as having been received in the individual's taxable year when the RPE's taxable year ends. Treas. Reg. §§ 1.199A-1(f)(2), -2(d)(2)(ii), -3(e)(2)(ii), -4(e)(2), -5(e)(2)(ii), -6(e)(2)(ii). For year 2018, the result is interesting. Even if one RPE incurred the items in the taxable year prior to the individual's taxable year, say the RPE's taxable year ends on March 31, 2018, the items incurred in the latter nine months of 2017 will still be reported to the individual to use for a potential Section 199A deduction for 2018.

VI. CONCLUSION

Section 199A and its related proposed but now final Treasury regulations add a new income tax wrinkle, albeit temporary for now, when planning involves businesses and their owners. Section 1.643(f)-1 also adds a new wrinkle, and uncertainty, in trust planning. Regardless, estate planners must be aware of and have working knowledge regarding the income tax issues that are important to their clients!