Bloomberg Tax

Special Report

Section 199A:

Understanding the 20% "Pass-Through Deduction"

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Introduction

Section §199A was added to the Code by the 2017 tax act. It permits a taxpayer other than a corporation (i.e., individuals, trusts, and estates) to deduct a certain amount of qualified business income (QBI) from pass-through entities (sole proprietorships, partnerships, and S corporations). The deduction is equal to the lesser of the taxpayer's combined qualified business income amount or 20% of the excess, if any, of the taxpayer's taxable income over net capital gain. There are essentially two categories that make up the "combined qualified business income amount." The first category is equal to the sum of the deductible amounts for each of the taxpayer's qualified trades or businesses (which is equal to 20% of the QBI from each of the taxpayer's qualified trades or businesses (subject to certain limitations)). The second category is equal to 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income. The deduction is an individual deduction, not a deduction for the pass-through entity itself. The deduction is available for tax years beginning after December 31, 2017, but before January 1, 2026.
[§199A; 701 T.M., I.B.2.; TPS ¶4040.01.F.]

Our new IRC 199A Deduction Calculator enables you to determine the 20% combined deduction under IRC §199A for all of the taxpayer's trades or businesses and allows you to easily change your entries to compute the deduction under various fact patterns. Request your free trial https://www.bna.com/taxandaccounting/ today to discover proven expertise that will help you plan and comply with confidence.

What's Inside

Excerpts From Portfolio 701-1st: Choice of Entity: Operational Issues

Deduction for Qualified Business Income of Pass-Through Entities and Sole Proprietorships (§199A)

For tax years beginning after December 31, 2017, taxpayers (other than C corporations) with pass-through income from partnerships, S corporations, and sole proprietorships may be eligible to deduct 20% of "qualified business income" (QBI), as well as 20% of qualified REIT dividends and qualified publicly traded partnership income. 41.1 In the case of a partnership or S corporation, the deduction applies at the partner or shareholder level. 41.2 Trusts and estates are also eligible for the deduction. 41.3 Section 199A(f)(4) grants the IRS the authority to carry out regulations for the application of the §199A deduction to tiered entities.

41.1 §199A, as added by the 2017 tax act, Pub. L. No. 115-97, §11011(a). The deduction is available for tax years beginning after December 31, 2017 and terminates for tax years beginning after December 31, 2025. See the 2017 tax act, §11011(e) (effective date), non-code provision, and, §11011(a) (termination clause), codified at §199A(i).

41.2 §199A(f)(1)(A)(i). Generally, individual partners and S corporation shareholders will need to calculate a §199A deduction for their 2018 calendar years. For those partners and S corporation shareholders holding interests in fiscal year partnerships or S corporations, it would appear appropriate to include their K-1 data for the pass-through entity's year ending in 2018 even though some of the income and deduction items relate to 2017. The same approach should be used when the deduction expires in 2025 by not picking up K-1 items for the corporation's tax year beginning in 2025. See Nellen, A., The Sec. 199A Qualified business income deduction and fiscal years, The Tax Advisor (Mar. 15, 2018). Given that §199A is a deduction and not a change in tax rates, §15 would not apply.

41.3 §199A(f)(1)(B). Special rules apply. See I.B.2.b., below.

The §199A deduction reduces taxable income and is not allowed in computing adjusted gross income. 41.4 Taxpayers are eligible for the deduction whether or not they itemize. 41.5

41.4 §62(a), as amended by the 2017 tax act, §11011(b)(1) .

41.5 See §63(b)(3) and §63(d)(3), as amended by the 2017 tax act, §11011(b)(2)-(3). Taxpayers who itemize are not subject to any additional limitations on the deduction.

The §199A deduction is equal to the lesser of:

(1) the taxpayer's combined qualified business income amount, or

(2) an amount equal to 20% of the excess (if any) of:

(a) the taxable income of the taxpayer, over

(b) the net capital gain of the taxpayer. 41.6

41.6 §199A(a), as amended by the 2018 Consolidated Appropriations Act (2018 CAA), Pub. L. No. 115-141, Div. T, §101(b). Amendments made to §199A by the 2018 CAA are retroactive as though included in the 2017 tax act. See 2018 CAA, Div. T, §101(d).

For this purpose, the net capital gain of the taxpayer is determined under §1(h), and consists of the taxpayer's net long-term capital gain for the taxable year over the taxpayer's short-term capital loss for the taxable year, plus the taxpayers qualified dividend income. 41.7

41.7 §1(h)(11)(A). See Kehl, The Most Important Deduction in the 2017 Tax Act: §199A, 34 Tax Mgmt. Real Estate J. 48 (Mar. 7, 2018). See also 562 T.M., Capital Assets – Related Issues.

For purposes of determining the taxpayer's §199A deduction, the taxpayer's taxable income is computed without regard to the §199A deduction. 41.8

41.8 §199A(e)(1).

The deduction is not available for income attributable to a specified service trade or business. 41.9 However, there is an exception to this exclusion if a taxpayer's taxable income does not exceed a taxable income threshold amount. The specified trade or business exclusion is discussed in more detail in I.B.2.a.(1)(c) , below.

41.9 §199A(d)(1).

To prevent abuse, taxpayers claiming the §199A deduction are subject to the substantial understatement of income tax penalty if the understatement exceeds the greater of (1) 5% of the tax required to be shown on the return for the taxable year, or (2) $5,000. 41.10 Further, the IRS is granted authority to carry out regulations requiring or restricting the allocation of items and wages and to provide for reporting requirements. 41.11

41.10 §6662(d)(1)(C), as added by the 2017 tax act, §11011(c). For a discussion of accuracy-related penalties, see 634 T.M., Civil Tax Penalties.

41.11 §199A(f)(4)(A) .

Observation: The 20% pass-through deduction lowers the effective income tax rate on qualified trade or business income passed through to partners, LLC members, S corporation shareholders, and sole proprietors. The 2017 tax act also lowered the marginal income tax rate on C corporations to 21% with a maximum 20% rate on individual dividends. The amount of the 20% pass-through deduction varies from one taxpayer to another because of the W-2 wage limitation (discussed in I.B.2.a.(1)(b), below). As attractive as the C corporation 21% rate is, pass-through entities need to carefully consider whether the 20% pass-through deduction is more favorable to them. This will require extensive modeling based on each client's facts. There is nothing in the 20% pass-through deduction that should trigger massive conversions to regular corporate status. Although in the right situations, conversions might make sense based on unique facts.

(a) Combined Qualified Business Income Amount –

The taxpayer's combined qualified business income amount for the tax year is:

(1) the sum of the deductible QBI determined for each qualified trade or business carried on by the taxpayer, plus

(2) 20% of the aggregate amount of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income. 41.12

41.12 §199A(b)(1).

A special rule applies to patrons of specified agricultural or horticultural cooperatives which reduces the combined qualified business income amount attributable to such patron's qualified trade or business by the lesser of:

(1) 9% of the QBI of the qualified trade or business which is properly allocable to qualified payments received from the cooperative, or

(2) 50% of the W-2 wages of the trade or business which are properly allocable to such qualified payments. 41.13

41.13 §199A(b)(7), added by the 2018 CAA, Div. T, §101(b)(3). Amendments made to §199A by the 2018 CAA are retroactive to the date of enactment of the 2017 tax act. 2018 CAA, Div. T, §101(d).

This reduction in the combined qualified business income amount offsets the benefit provided by the special rules for agricultural and horticultural cooperatives and the deduction for their patrons discussed in more detail in I.B.2.c., below.

Editor's Note: The 2018 CAA repealed the deduction for qualified cooperative dividends and modified the rules applicable to specified agricultural and horticultural cooperatives. This change remedies the "grain glitch" from §199A as originally enacted in the 2017 tax act. The "grain glitch" was a deduction for 20% of qualified cooperative dividends based on gross (not net) income, not subject to a W-2 wage limitation, and only limited by the total taxable income (reduced by net capital gain) of the taxpayer.

(1) Deductible Qualified Business Income for Qualified Trade or Business –

The deductible QBI for each qualified trade or business generally is equal to the lesser of:

(1) 20% of the taxpayer's QBI with respect to the trade or business, or

(2) the W-2 wage limitation. 41.14

41.14 §199A(b)(2).

(a) Qualified Business Income –

QBI is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer. 41.15 A qualified trade or business is defined as any trade or business other than a specified service trade or business (see I.B.2.a.(1)(c), below) or the trade or business of being an employee. 41.16

> 41.15 §199A(c)(1). QBI does not include any qualified REIT dividends or qualified publicly traded partnership income. For alternative minimum tax (AMT) purposes, QBI is determined without regard to any adjustments under §56 through §59. §199A(f)(2). For a discussion of the individual AMT, see 587 T.M., Noncorporate Alternative Minimum Tax.
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> 41.16 §199A(d)(1). While explicitly omitting specified service trades or businesses and the trade or business of being an employee from the qualified trade or business definition, §199A does not further define "trade or business" for purposes of the deduction.

Items of income, gain, deduction, and loss are qualified items only to the extent (1) they are included or allowed in the determination of the taxpayer's taxable income for the tax year, and (2) they are effectively connected with the conduct of a trade or business within the United States or Puerto Rico. 41.17 In the case of a partnership or S corporation, each partner or S corporation shareholder takes into account such person's allocable share of each qualified item of income, gain, deduction, and loss. 41.18

> 41.17 §199A(c)(3)(A). Income from Puerto Rico is only included if all such income is taxable under §1. §199A(f)(1)(C)(i).
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> 41.18 §199A(f)(1)(A)(ii).

Observation: To be qualified business income, all qualified items of income, gain, deductions or loss must be included or allowed in computing taxable income for the year. 41.19 Because of this requirement it would seem that qualified business income would be computed after applying the basis limitation rules for partnerships (§704(d)) and for S corporations (§1366(d)), the §465 at-risk rules and the §469 passive activity loss rules. 41.20 Section 461(l)(6) dealing with excess business losses specifically requires that §469 applies before §461(l). All of these limitations need to be taken into account before calculating taxable income and the §199A deduction.

> 41.19 §199A(c)(3)(A)(ii).
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> 41.20 Kehl, James .M., The Most Important Deduction in the 2017 Tax Act: §199A, 34 Tax Mgmt. Real Estate J. 48 (Mar. 7, 2018).

QBI does not include specified items of income, gain, deduction, and loss. 41.21 Specified items under §199A(c)(3)(B) include: short-term or long-term capital gain and loss; dividends, income equivalent to a dividend, or payment in lieu of dividends (other than patronage dividends under §1385(a)(1)); interest income not properly allocable to a trade or business); gain or loss described

in §954(c)(1)(C) (commodities transactions) or §954(c)(1)(D) (foreign currency gains); income, gain, deduction or loss taken into account under §954(c)(1)(F) (notional principle contracts) (other than items attributable to notional principle contracts entered into in transactions qualifying under §1221(a)(7)); amounts received from annuities not received in connection with the trade or business; and any item of deduction or loss properly allocable to the listed items.

41.21 §199A(c)(3)(B).

Note: As originally enacted, QBI did not include specified "investment" items. The 2018 CAA struck the term investment from §199A(c)(3)(B) clarifying that a taxpayer may not take into account any of the specified items even if they are not related to investment. 41.22

41.22 2018 CAA, Div. T, §101(b)(2)(B). Amendments made to §199A by the 2018 CCA are retroactive as though included in the 2017 tax act. 2018 CAA, Div. T, §101(d).

QBI also does not include (1) reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business, (2) any guaranteed payment by a partnership (described in §707(c)) to a partner for services rendered with respect to the trade or business, or (3) to the extent provided in regulations, any amount paid by a partnership (described in §707(a)) to a partner acting other than in his or her capacity as a partner for services. 41.23

41.23 §199A(c)(4).

(b) W-2 Wage Limitation –

The W-2 wage limitation is equal to the greater of:

(1) 50% of the W-2 wages with respect to the trade or business, or

(2) the sum of:

(a) 25% of the W-2 wages with respect to the trade or business, plus

(b) 2.5% of the unadjusted basis (immediately after acquisition) of all qualified property. 41.24

41.24 §199A(b)(2)(B).

For purposes of §199A(b), Congress has granted the IRS the authority to issue regulations in the case of a taxpayer with a short taxable year, or where the taxpayer acquires, or disposes of, a major portion of a trade or business. 41.25

41.25 See §199A(b)(5).

(i) W-2 Wages –

W-2 wages are defined as the total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of

its employees during the calendar year ending during the tax year of the taxpayer. 41.26 W-2 wages do not include (1) any amount that is not properly allocable to QBI as a qualified item of deduction, and (2) any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for filing such return. 41.27 Thus, amounts paid to independent contractors are not included in the definition of W-2 wages. In the case of a partnership or S corporation, each partner or S corporation shareholder is treated as having W-2 wages for the tax year equal to such person's allocable share of W-2 wages of the partnership or S corporation for the taxable year. 41.28 A partner's or shareholder's share of W-2 wages is determined in the same manner as such person's allocable share of wage expenses. 41.29

41.26 §199A(b)(4)(A). See §6051(a)(3) and §6051(a)(8).

41.27 §199A(b)(4)(B)-(C)

41.28 §199A(f)(1)(A)(iii).

41.29 §199A(f)(1) (flush language).

(ii) Qualified Property –

Qualified property is defined as tangible property of a character subject to depreciation (1) that is held by, and available for use in, the qualified trade or business at the end of the tax year, (2) that is used in the production of QBI, and (3) for which the depreciable period has not ended before the end of the tax year. 41.30 The depreciable period with respect to qualified property is defined as the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (1) the date 10 years after that date, or (2) the last day of the last full year in the applicable recovery period that would apply to the property under §168 (without regard to §168(g)). 41.31 In the case of a partnership or S corporation, each partner or S corporation shareholder is treated as having unadjusted basis (immediately after acquisition) of qualified property for the tax year equal to such person's allocable share of unadjusted basis (immediately after acquisition) of qualified property of the partnership or S corporation for the taxable year. 41.32 A partner's or shareholder's share of the unadjusted basis (immediately after acquisition) is determined in the same manner as such person's allocable share of depreciation. 41.33

41.30 §199A(b)(6)(A).

41.31 §199A(b)(6)(B).

41.32 §199A(f)(1)(A)(iii).

41.33 §199A(f)(1) (flush language). In the case of an S corporation, the shareholder's allocable share is the shareholder's pro rata share of the item.

To prevent abuse between related parties, rules similar to the rules under §179(d)(2) apply to prevent the manipulation of the depreciable period of qualified property. 41.34 Further, the IRS is granted authority to provide rules for determining the unadjusted basis (immediately after acquisition) of qualified property acquired in like-kind exchanges or conversion transactions. 41.35

41.34 §199A(h)(1).

41.35 §199A(h)(2).

(iii) Taxable Income Exception to Limitation –

If the taxpayer's taxable income does not exceed an applicable threshold amount, the W-2 wage limitation does not apply to limit the taxpayer's deduction. 41.36 The threshold amount is $315,000 for joint filers and $157,500 for all other taxpayers (indexed for inflation). 41.37 The W-2 wage limitation phases in for a taxpayer with taxable income in excess of the applicable threshold amount and is fully phased in for a taxpayer with taxable income in excess of the applicable threshold amount plus $100,000 for joint filers and $50,000 for other taxpayers. 41.38 The phase in of the limitation requires the taxpayer to reduce the deduction by the amount which bears the same ratio to the excess amount as the amount which exceeds the taxable income threshold bears to to $100,000 or $50,000, whichever is applicable. 41.39 The excess amount is the excess of 20% of QBI over the W-2 wage limitation, calculated as though the W-2 wage limitation applied. 41.40 The limitation is fully phased in for joint filers with taxable income in excess of $415,000 and all other taxpayers with taxable income in excess of $207,500.

41.36 §199A(b)(3)(A).
41.37 §199A(e)(2).
41.38 §199A(b)(3)(B).
41.39 §199A(b)(3)(B)(ii).
41.40 §199A(b)(3)(B)(iii).

In other words, the amount of the W-2 wage limitation that is phased in is equal to: (1) 20% of QBI minus the W-2 wage limitation, multiplied by (2) the ratio of (i) taxable income in excess of the applicable threshold amount, to (ii) the applicable threshold amount.

Example 1: T operates a business that generates $25,000 of QBI during the year and T pays $8,000 of W-2 wages during the year. T files a joint return with taxable income of $300,000. T's §199A deduction is $5,000 ($25,000 x 20%). Because T's taxable income does not exceed than the $315,000 threshold amount, the W-2 wage limitation does not apply to limit T's deduction.

Example 2: Assume the same facts as Example 1, except that T's taxable income for the year is $420,000. The W-2 wage limitation fully applies to limit T's 199A deduction because T's taxable income exceeds $415,000 ($315,000 threshold amount plus $100,000). The W-2 wage limitation is $4,000 ($8,000 W-2 wages x 50%). Thus, T's §199A deduction is limited to $4,000.

Example 3: Assume the same facts as Example 1, except that T's taxable income for the year is $355,000. The W-2 wage limitation is phased in because T's taxable income is between $315,000 and $415,000. The amount of the W-2 wage limitation that is phased in is equal to $400 (($5,000 - $4,000) x (($355,000 - $315,000)/$100,000))). Thus, T's §199A deduction is limited to $4,600 ($5,000 - $400).

Example 4: Assume the same facts as Example 1, except that T's taxable income for the year is $395,000. The W-2 wage limitation is phased in because T's taxable income is between

$315,000 and $415,000. The amount of the W-2 wage limitation that is phased in is equal to $800 (($5,000 - $4,000) x (($395,000 - $315,000)/$100,000))). Thus, T's §199A deduction is limited to $4,200 ($5,000 - $800).

(c) Specified Service Trade or Business Exclusion

(i) Specified Service Trade or Business –

Generally, a specified service trade or business is excluded from the definition of qualified trade or business. 41.41 A specified service trade or business is defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Therefore, no deduction is generally allowed with respect to the income of a specified service trade or business. 41.42

41.41 §199A(d)(1).

41.42 §199A(d)(2) . §199(d)(2)(A).

Section 199A borrows the exclusion from "qualified trade or business" found in §1202(e)(3)(A) except that it does not include engineering or architectural services in its definition of specified service trade or business. 41.43 The Conference Report notes that a similar list appears in §448(d)(2)(A) and Reg. §1.448-1T(e)(4)(i). 41.44 Specifically, the Conference Report explains that under the §448 regulations, the provision of services not directly related to the medical field, even if such services relate to the health of the recipient are not performance of services in the field of health. 41.45 Similarly, the performance of services in the field of the performing arts includes the performing artists themselves, but not promoters or broadcasters. 41.46

41.43 §199(d)(2)(A).

41.44 H.R. Conf. Rep. No. 466, 115th Cong., 1st Sess. 216 (2017).

41.45 H.R. Conf. Rep. No. 466, 115th Cong., 1st Sess. 216, fn 44 (2017). See Reg. §1.448-1T(e)(4)(ii).

41.46 H.R. Conf. Rep. No. 466, 115th Cong., 1st Sess. 216, fn 45 (2017). See Reg. §1.448-1T(e)(4)(iii). Note that Reg. §1.448-1T(e)(4)(iii) excludes the services by athletes from the performance of services in the performing arts, however, athletics are separately included in the §199A definition of specified service trades or businesses by way of reference to §1202(e)(3).

Editor's Note: Caution should be taken when looking to Reg. §1.448-1T(e) for guidance as the list service businesses is not as extensive as found in §1202(e)(3)(A). Moreover, §1202(e)(3) defines a qualified trade or business as "any trade or business other than any trade or business involving the

performance of service . . ." whereas §448(d)(2)(A) defines a qualified personal service corporation "as any corporation substantially all of the activities of which involve the performance of services . . ."

Observation: A trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners is a very broad category of specified service businesses. The IRS needs to provide guidance quickly as certain businesses do not clearly fit in or out of this category of specified service trades or businesses.

While not controlling, there is limited guidance available on this issue in the form of PLRs addressing the question under §1202(e)(3). In PLR 201717010 the IRS ruled that a company providing laboratory reports to health care professionals was not involved in the performance of services in the field of health, nor in the performance of services where the principle asset of the trade or business was the reputation or skill of one or more of its employees. In so finding, the IRS noted, "the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers." In PLR 201436001 the IRS stated "the thrust of §1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services." Because the company's business involved deployment of manufacturing and intellectual property assets, and not "offering service[s] in the form of individual expertise," the company was not involved in the performance of services where the principle asset of the trade or business was the reputation or skill of one or more of its employees.

(ii) Taxable Income Exception to Exclusion –

If a taxpayer's taxable income does not exceed an applicable threshold amount, the exclusion does not apply and the taxpayer is allowed a deduction with respect to the QBI of a specified service trade or business. 41.47 For purposes of the specified service trade or business exclusion, the threshold amount is $315,000 for joint filers and $157,500 for all other taxpayers (indexed for inflation). 41.48 The specified service trade or business exclusion phases in for taxpayers with taxable income in excess of the applicable threshold amount and is fully phased in for taxpayers with taxable income in excess of the applicable threshold amount plus $100,000 for joint filers and $50,000 for other taxpayers. 41.49 As the exclusion phases in, the taxpayer may only take into account the "applicable percentage" of QBI and the W-2 wage limitation. 41.50 The applicable percentage is 100% reduced by the percentage equal to the ratio which taxable income in excess of the threshold bears to $100,000 or $50,000, whichever is applicable. 41.51 The exclusion is fully phased in for joint filers with taxable income in excess of $415,000 and other taxpayers with taxable income in excess of $207,500.

> 41.47 §199A(d)(3)(A). Taxpayers with taxable income from a specified service trade or business below the threshold amount do not need to calculate the W-2 wage limitation because the W-2 wage limitation is also subject to the same threshold amount.
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> 41.48 §199A(e)(2). The Conference Report noted that it expects these threshold amounts to deter high-income taxpayers from attempting to convert wages or other compensation for personal services into income eligible for the 20% deduction. H.R. Conf. Rep. No. 466, 115th Cong., 1st Sess. 222 (2017).
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> 41.49 §199A(d)(3)(A).
> 41.50 §199A(d)(3)(A).

41.51 §199A(d)(3)(B).

Example 5: T operates a specified service trade or business that generates $25,000 of QBI during the year and T pays $8,000 of W-2 wages during the year. T files a joint return with taxable income of $300,000. T's § 199A deduction is $5,000 ($25,000 x 20%). Because T's taxable income does not exceed than the $315,000 threshold amount, the specified service trade or business exclusion does not apply to limit T's deduction.

Example 6: Assume the same facts as Example 5, except that T's taxable income for the year is $420,000. Because the specified service trade or business exclusion fully applies, T does not have a §199A deduction.

Example 7: Assume the same facts as Example 5, except that T's taxable income for the year is $355,000. T's applicable percentage is 60% (1-(($355,000-$315,000)/$100,000)). Thus T must initially calculate QBI and W-2 wages based on the applicable percentage. T's applicable percentage of QBI is $15,000 ($25,000 X 60%) and W-2 wages is $4,800 ($8,000 X 60%). 20% of QBI is $3,000 and the W-2 wage limitation is $2,400. The W-2 wage limitation is phased in because T's taxable income is between $315,000 and $415,000. The amount of the W-2 wage limitation that is phased in is equal to $240 (($3,000 - $2,400) x (($355,000 - $315,000)/$100,000))). Thus, T's §199A deduction is limited to $2,760 ($3,000 - $240).

Example 8: Assume the same facts as Example 5, except that T's taxable income for the year is $395,000. T's applicable percentage is 20% (1-(($395,000-$315,000)/$100,000)). Thus T must initially calculate QBI and W-2 wages based on the applicable percentage. T's applicable percentage of QBI is $5,000 ($25,000 X 20%) and W-2 wages is $1,600 ($8,000 X 20%). 20% of QBI is $1,000 and the W-2 wage limitation is $800. The W-2 wage limitation is phased in because T's taxable income is between $315,000 and $415,000. The amount of the W-2 wage limitation that is phased in is equal to $160 (($1,000 - $800) x (($395,000 - $315,000)/$100,000))). Thus, T's §199A deduction is limited to $840 ($1,000 - $160).

(d) Carryover of Losses —

If the net amount of QBI from all qualified trades or businesses during the tax year is a loss, it is carried forward as a loss from a qualified trade or business in the next tax year. 41.52 Any deduction of the taxpayer allowed in a subsequent year is reduced (but not below zero) by 20% of any such carryover qualified business loss. 41.53

41.52 §199A(c)(2).

41.53 H.R. Conf. Rep. No. 466, 115th Cong., 1st Sess. 214 (2017). Note that the example in the Conference Report uses a 23% deduction as originally proposed in the Senate amendment.

Example 9: Taxpayer has a net loss with respect to a qualifying trade or business in Year 1 of $1,000. In Year 2, taxpayer has qualifying business income of $1,500. Ordinarily, taxpayer would be entitled to a deduction under §199A of $300 (1,500 X 20%) in Year 2. However, taxpayer must reduce the deduction by 20% of the carryover loss amount or $200 (1,000 X 20%). Thus, in Year 2, taxpayer is only entitled to a deduction of $100. 41.54

41.54 Example 5 is from Bilsky & Hodges, Tax Reform Impact on Partnerships and Partners, 59 Tax Mgmt. Memo. 3 (Jan. 8, 2018).

(2) Qualified REIT Dividends —

Qualified REIT dividends are generally defined as any dividend received from a REIT other than a dividend that is a capital gain dividend (as defined in §857(b)(3)) or a qualified dividend (as defined in §1(h)(11)). 41.55 For a discussion of the taxation of REITs, see 742 T.M., Real Estate Investment Trusts.

41.55 §199A(e)(3).

(3) Qualified Publicly Traded Partnership Income —

Qualified publicly traded partnership income is generally, with respect to any qualified trade or business of the taxpayer, 41.56 defined as the sum of (1) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss from a publicly traded partnership not treated as a corporation, and (2) gain recognized by the taxpayer on disposition of its interest in the publicly traded partnership that is treated as ordinary income. 41.57 Qualified items have the same meaning for this purpose as for QBI, discussed in I.B.2.a.(1)(a) , above. For further discussion, see 723 T.M., Publicly Traded Partnerships.

41.56 See I.B.2.a.(1)(c), above.

41.57 §199A(e)(4) .

(b) Special Rules for Trusts and Estates —

Trusts and estates are eligible for the deduction. For purposes of the W-2 wage limitation, rules similar to the rules under former § 199 (as in effect on December 1, 2017) apply for apportioning any W-2 wages and unadjusted basis of qualified property between fiduciaries and beneficiaries. 41.58

41.58 §199A(f)(1)(B). See Reg. §1.199-5(e)(2).

Observation: It is not clear how the §199A deduction will apply to electing small business trusts. The Conference Report, H.R. Conf. Rep. No. 466, 115th Cong., 1st Sess. 224 (2017), broadly states that trust and estates are eligible for the deduction. But §641(c) may present some technical issues. There are limited adjustments that can be made to the S corporation portion of an ESBT. However, it is clear Congress intended the 20% deduction would be available to "trusts" which includes ESBTs. Guidance from the IRS would be useful.

Internal Revenue Code, § 199A. Qualified business income

Editor's Note: Section 199A, added by Pub. L. 115-97, Sec. 11011(a) , and amended by Pub. L. 115-141, Div. T, Sec. 101, is effective for taxable years beginning after December 31, 2017.

I.R.C. § 199A(a) Allowance Of Deduction – In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the lesser of–

I.R.C. § 199A(a)(1) – the combined qualified business income amount of the taxpayer, or

I.R.C. § 199A(a)(2) – an amount equal to 20 percent of the excess (if any) of–

I.R.C. § 199A(a)(2)(A) – the taxable income of the taxpayer for the taxable year, over

I.R.C. § 199A(a)(2)(B) – the net capital gain (as defined in section 1(h)) of the taxpayer for such taxable year.

I.R.C. § 199A(b) Combined Qualified Business Income Amount – For purposes of this section–

I.R.C. § 199A(b)(1) In General – The term "combined qualified business income amount" means, with respect to any taxable year, an amount equal to–

I.R.C. § 199A(b)(1)(A) – the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus

I.R.C. § 199A(b)(1)(B) – 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

I.R.C. § 199A(b)(2) Determination Of Deductible Amount For Each Trade Or Business – The amount determined under this paragraph with respect to any qualified trade or business is the lesser of–

I.R.C. § 199A(b)(2)(A) – 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

I.R.C. § 199A(b)(2)(B) – the greater of–

I.R.C. § 199A(b)(2)(B)(i) – 50 percent of the W-2 wages with respect to the qualified trade or business, or

I.R.C. § 199A(b)(2)(B)(ii) – the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

I.R.C. § 199A(b)(3) Modifications To Limit Based On Taxable Income

I.R.C. § 199A(b)(3)(A) Exception From Limit – In the case of any taxpayer whose taxable income for the taxable year does not exceed the threshold amount, paragraph (2) shall be applied without regard to subparagraph (B).

I.R.C. § 199A(b)(3)(B) Phase-in Of Limit For Certain Taxpayers

I.R.C. § 199A(b)(3)(B)(i) In General – If–

I.R.C. § 199A(b)(3)(B)(i)(I) – the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and

I.R.C. § 199A(b)(3)(B)(i)(II) – the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,

then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

I.R.C. § 199A(b)(3)(B)(ii) Amount Of Reduction – The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as–

I.R.C. § 199A(b)(3)(B)(ii)(I) – the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to

I.R.C. § 199A(b)(3)(B)(ii)(II) – $50,000 ($100,000 in the case of a joint return).

I.R.C. § 199A(b)(3)(B)(iii) Excess Amount – For purposes of clause (ii), the excess amount is the excess of–

I.R.C. § 199A(b)(3)(B)(iii)(I) – the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

I.R.C. § 199A(b)(3)(B)(iii)(II) – the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

I.R.C. § 199A(b)(4) Wages, Etc.

I.R.C. § 199A(b)(4)(A) In General – The term "W–2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

I.R.C. § 199A(b)(4)(B) Limitation To Wages Attributable To Qualified Business Income – Such term shall not include any amount which is not properly allocable to qualified business income for purposes of subsection (c)(1).

I.R.C. § 199A(b)(4)(C) Return Requirement – Such term shall not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.

I.R.C. § 199A(b)(5) Acquisitions, Dispositions, And Short Taxable Years – The Secretary shall provide for the application of this subsection in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year

I.R.C. § 199A(b)(6) Qualified Property – For purposes of this section:

I.R.C. § 199A(b)(6)(A) In General – The term "qualified property" means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167 –

I.R.C. § 199A(b)(6)(A)(i) – which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

I.R.C. § 199A(b)(6)(A)(ii) – which is used at any point during the taxable year in the production of qualified business income, and

I.R.C. § 199A(b)(6)(A)(iii) – the depreciable period for which has not ended before the close of the taxable year.

I.R.C. § 199A(b)(6)(B) Depreciable Period – The term "depreciable period" means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of–

I.R.C. § 199A(b)(6)(B)(i) – the date that is 10 years after such date, or

I.R.C. § 199A(b)(6)(B)(ii) – the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to subsection (g) thereof).

I.R.C. § 199A(b)(7) Special Rule With Respect To Income Received From Cooperatives – In the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the amount determined under paragraph (2) with respect to such trade or business shall be reduced by the lesser of–

I.R.C. § 199A(b)(7)(A) – 9 percent of so much of the qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such cooperative, or

I.R.C. § 199A(b)(7)(B) – 50 percent of so much of the W-2 wages with respect to such trade or business as are so allocable.

I.R.C. § 199A(c) Qualified Business Income – For purposes of this section–

I.R.C. § 199A(c)(1) In General – The term "qualified business income" means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends or qualified publicly traded partnership income.

I.R.C. § 199A(c)(2) Carryover Of Losses – If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year.

I.R.C. § 199A(c)(3) Qualified Items Of Income, Gain, Deduction, And Loss – For purposes of this subsection–

I.R.C. § 199A(c)(3)(A) In General – The term "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction, and loss to the extent such items are–

I.R.C. § 199A(c)(3)(A)(i) – effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c) , determined by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and

I.R.C. § 199A(c)(3)(A)(ii) – included or allowed in determining taxable income for the taxable year.

I.R.C. § 199A(c)(3)(B) Exceptions – The following items shall not be taken into account as a qualified item of income, gain, deduction, or loss:

I.R.C. § 199A(c)(3)(B)(i) – Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.

I.R.C. § 199A(c)(3)(B)(ii) – Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G) . Any amount described in section 1385(a)(1) shall not be treated as described in this clause.

I.R.C. § 199A(c)(3)(B)(iii) – Any interest income other than interest income which is properly allocable to a trade or business.

I.R.C. § 199A(c)(3)(B)(iv) – Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1) (applied by substituting "qualified trade or business" for "controlled foreign corporation").

I.R.C. § 199A(c)(3)(B)(v) – Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).

I.R.C. § 199A(c)(3)(B)(vi) – Any amount received from an annuity which is not received in connection with the trade or business.

I.R.C. § 199A(c)(3)(B)(vii) – Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

I.R.C. § 199A(c)(4) Treatment Of Reasonable Compensation And Guaranteed Payments – Qualified business income shall not include–

I.R.C. § 199A(c)(4)(A) – reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

I.R.C. § 199A(c)(4)(B) – any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

I.R.C. § 199A(c)(4)(C) – to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

I.R.C. § 199A(d) Qualified Trade Or Business – For purposes of this section–

I.R.C. § 199A(d)(1) In General – The term "qualified trade or business" means any trade or business other than–

I.R.C. § 199A(d)(1)(A) – a specified service trade or business, or

I.R.C. § 199A(d)(1)(B) – the trade or business of performing services as an employee.

I.R.C. § 199A(d)(2) Specified Service Trade Or Business – The term "specified service trade or business" means any trade or business–

I.R.C. § 199A(d)(2)(A) – which is described in section 1202(e)(3)(A) (applied without regard to the words "engineering, architecture,") or which would be so described if the term "employees or owners" were substituted for "employees" therein, or

I.R.C. § 199A(d)(2)(B) – which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

I.R.C. § 199A(d)(3) Exception For Specified Service Businesses Based on Taxpayer's Income

I.R.C. § 199A(d)(3)(A) In General – If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), then–

I.R.C. § 199A(d)(3)(A)(i) – any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but

I.R.C. § 199A(d)(3)(A)(ii) – only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

I.R.C. § 199A(d)(3)(B) Applicable Percentage – For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of–

I.R.C. § 199A(d)(3)(B)(i) – the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

I.R.C. § 199A(d)(3)(B)(ii) – $50,000 ($100,000 in the case of a joint return).

I.R.C. § 199A(e) Other Definitions – For purposes of this section–

I.R.C. § 199A(e)(1) Taxable Income – Except as otherwise provided in subsection (g)(2)(B), taxable income shall be computed without regard to any deduction allowable under this section.

I.R.C. § 199A(e)(2) Threshold Amount

I.R.C. § 199A(e)(2)(A) In General – The term "threshold amount" means $157,500 (200 percent of such amount in the case of a joint return).

I.R.C. § 199A(e)(2)(B) Inflation Adjustment – In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to–

I.R.C. § 199A(e)(2)(B)(i) – such dollar amount, multiplied by

I.R.C. § 199A(e)(2)(B)(ii) – the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.

The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7) .

I.R.C. § 199A(e)(3) Qualified REIT Dividend – The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which–

I.R.C. § 199A(e)(3)(A) – is not a capital gain dividend, as defined in section 857(b)(3), and

I.R.C. § 199A(e)(3)(B) – is not qualified dividend income, as defined in section 1(h)(11).

I.R.C. § 199A(e)(4) Qualified Publicly Traded Partnership Income – The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of–

I.R.C. § 199A(e)(4)(A) – the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) which is not treated as a corporation under section 7704(c) , plus

I.R.C. § 199A(e)(4)(B) – any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a) .

I.R.C. § 199A(f) Special Rules

I.R.C. § 199A(f)(1) Application To Partnerships And S Corporations

I.R.C. § 199A(f)(1)(A) In General – In the case of a partnership or S corporation–

I.R.C. § 199A(f)(1)(A)(i) – this section shall be applied at the partner or shareholder level,

I.R.C. § 199A(f)(1)(A)(ii) – each partner or shareholder shall take into account such person's allocable share of each qualified item of income, gain, deduction, and loss, and

I.R.C. § 199A(f)(1)(A)(iii) – each partner or shareholder shall be treated for purposes of subsection (b) as having W–2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W–2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).

For purposes of clause (iii), a partner's or shareholder's allocable share of W–2 wages shall be determined in the same manner as the partner's or shareholder's allocable share of wage expenses. For purposes of such clause, partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition of qualified property shall be determined in the same manner as the partner's or shareholder's allocable share of depreciation. For purposes of this subparagraph, in the case of an S corporation an allocable share shall be the shareholder's pro rata share of an item

I.R.C. § 199A(f)(1)(B) Application To Trusts And Estates – Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W–2 wages shall apply to the apportionment of W–2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

I.R.C. § 199A(f)(1)(C) Treatment Of Trades Or Business in Puerto Rico

I.R.C. § 199A(f)(1)(C)(i) In General – In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term 'United States' shall include the Commonwealth of Puerto Rico.

I.R.C. § 199A(f)(1)(C)(ii) Special Rule For Applying Limit – In the case of any taxpayer described in clause (i), the determination of W–2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.

I.R.C. § 199A(f)(2) Coordination With Minimum Tax – For purposes of determining alternative minimum taxable income under section 55 , qualified business income shall be determined without regard to any adjustments under sections 56 through 59.

I.R.C. § 199A(f)(3) Deduction Limited To Income Taxes – The deduction under subsection (a) shall only be allowed for purposes of this chapter.

I.R.C. § 199A(f)(4) Regulations – The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section, including regulations–

I.R.C. § 199A(f)(4)(A) – for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and

I.R.C. § 199A(f)(4)(B) – for the application of this section in the case of tiered entities.

I.R.C. § 199A(g) Deduction For Income Attributable To Domestic Production Activities Of Specified Agricultural Or Horticultural Cooperatives

I.R.C. § 199A(g)(1) Allowance Of Deduction

I.R.C. § 199A(g)(1)(A) In General – In the case of a taxpayer which is a specified agricultural or horticultural cooperative, there shall be allowed as a deduction an amount equal to 9 percent of the lesser of–

I.R.C. § 199A(g)(1)(A)(i) – the qualified production activities income of the taxpayer for the taxable year, or

I.R.C. § 199A(g)(1)(A)(ii) – the taxable income of the taxpayer for the taxable year.

I.R.C. § 199A(g)(1)(B) Limitation

I.R.C. § 199A(g)(1)(B)(i) In General – The deduction allowable under subparagraph (A) for any taxable year shall not exceed 50 percent of the W-2 wages of the taxpayer for the taxable year.

I.R.C. § 199A(g)(1)(B)(ii) W-2 Wages – For purposes of this subparagraph, the W-2 wages of the taxpayer shall be determined in the same manner as under subsection (b)(4) (without regard to subparagraph (B) thereof and after application of subsection (b)(5)), except that such wages shall not include any amount which is not properly allocable to domestic production gross receipts for purposes of paragraph (3)(A).

I.R.C. § 199A(g)(1)(C) Taxable Income Of Cooperatives Determined Without Regard To Certain Deductions – For purposes of this subsection, the taxable income of a specified agricultural or horticultural cooperative shall be computed without regard to any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

I.R.C. § 199A(g)(2) Deduction Allowed To Patrons

I.R.C. § 199A(g)(2)(A) In General – In the case of any eligible taxpayer who receives a qualified payment from a specified agricultural or horticultural cooperative, there shall be allowed as a deduction for the taxable year in which such payment is received an amount equal to the portion of the deduction allowed under paragraph (1) to such cooperative which is–

I.R.C. § 199A(g)(2)(A)(i) – allowed with respect to the portion of the qualified production activities income to which such payment is attributable, and

I.R.C. § 199A(g)(2)(A)(ii) – identified by such cooperative in a written notice mailed to such taxpayer during the payment period described in section 1382(d).

I.R.C. § 199A(g)(2)(B) Limitation Based On Taxable Income – The deduction allowed to any taxpayer under this paragraph shall not exceed the taxable income of the taxpayer determined without regard to the deduction allowed under this paragraph and after taking into account any deduction allowed to the taxpayer under subsection (a) for the taxable year.

I.R.C. § 199A(g)(2)(C) Cooperative Denied Deduction For Portion Of Qualified Payments – The taxable income of a specified agricultural or horticultural cooperative shall not be reduced under section 1382 by reason of that portion of any qualified payment as does not exceed the deduction allowable under subparagraph (A) with respect to such payment.

I.R.C. § 199A(g)(2)(D) Eligible Taxpayer – For purposes of this paragraph, the term "eligible taxpayer" means–

I.R.C. § 199A(g)(2)(D)(i) – a taxpayer other than a corporation, or

I.R.C. § 199A(g)(2)(D)(ii) – a specified agricultural or horticultural cooperative.

I.R.C. § 199A(g)(2)(E) Qualified Payment – For purposes of this section, the term "qualified payment" means, with respect to any eligible taxpayer, any amount which–

I.R.C. § 199A(g)(2)(E)(i) – is described in paragraph (1) or (3) of section 1385(a),

I.R.C. § 199A(g)(2)(E)(ii) – is received by such taxpayer from a specified agricultural or horticultural cooperative, and

I.R.C. § 199A(g)(2)(E)(iii) – is attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative under paragraph (1).

I.R.C. § 199A(g)(3) Qualified Production Activities Income – For purposes of this subsection–

I.R.C. § 199A(g)(3)(A) In General – The term "qualified production activities income" for any taxable year means an amount equal to the excess (if any) of–

I.R.C. § 199A(g)(3)(A)(i) – the taxpayer's domestic production gross receipts for such taxable year, over

I.R.C. § 199A(g)(3)(A)(ii) – the sum of–

I.R.C. § 199A(g)(3)(A)(ii)(I) – the cost of goods sold that are allocable to such receipts, and

I.R.C. § 199A(g)(3)(A)(ii)(II) – other expenses, losses, or deductions (other than the deduction allowed under this subsection), which are properly allocable to such receipts.

I.R.C. § 199A(g)(3)(B) Allocation Method – The Secretary shall prescribe rules for the proper allocation of items described in subparagraph (A) for purposes of determining qualified production activities income. Such rules shall provide for the proper allocation of items whether or not such items are directly allocable to domestic production gross receipts.

I.R.C. § 199A(g)(3)(C)

I.R.C. § 199A(g)(3)(C)(i) In General – For purposes of determining costs under subclause (I) of subparagraph (A)(ii), any item or service brought into the United States shall be treated as acquired by purchase, and its cost shall be treated as not less than its value immediately after it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts.

I.R.C. § 199A(g)(3)(C)(ii) Exports For Further Manufacture – In the case of any property described in clause (i) that had been exported by the taxpayer for further manufacture, the increase in cost or adjusted basis under clause (i) shall not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture.

I.R.C. § 199A(g)(3)(D) Domestic Production Gross Receipts

I.R.C. § 199A(g)(3)(D)(i) In General – The term "domestic production gross receipts" means the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of any agricultural or horticultural product which was manufactured, produced, grown, or extracted by the taxpayer (determined after the application of paragraph (4)(B)) in whole or significant part within the United States. Such term shall not include gross receipts of the taxpayer which are derived from the lease, rental, license, sale, exchange, or other disposition of land.

I.R.C. § 199A(g)(3)(D)(ii) Related Persons

I.R.C. § 199A(g)(3)(D)(ii)(I) In General – The term "domestic production gross receipts" shall not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.

I.R.C. § 199A(g)(3)(D)(ii)(II) Related Person – For purposes of subclause (I), a person shall be treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).

I.R.C. § 199A(g)(4) Specified Agricultural Or Horticultural Cooperative – For purposes of this section–

I.R.C. § 199A(g)(4)(A) In General – The term "specified agricultural or horticultural cooperative" means an organization to which part I of subchapter T applies which is engaged–

I.R.C. § 199A(g)(4)(A)(i) – in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or

I.R.C. § 199A(g)(4)(A)(ii) – in the marketing of agricultural or horticultural products.

I.R.C. § 199A(g)(4)(B) Application To Marketing Cooperatives – A specified agricultural or horticultural cooperative described in subparagraph (A)(ii) shall be treated as having manufactured, produced, grown, or extracted in whole or significant part any agricultural or horticultural product marketed by the specified agricultural or horticultural cooperative which its patrons have so manufactured, produced, grown, or extracted.

I.R.C. § 199A(g)(5) Definitions And Special Rules

I.R.C. § 199A(g)(5)(A) Special Rule For Affiliated Groups

I.R.C. § 199A(g)(5)(A)(i) In General – All members of an expanded affiliated group shall be treated as a single corporation for purposes of this subsection.

I.R.C. § 199A(g)(5)(A)(ii) Partnerships Owned By Expanded Affiliated Groups – For purposes of paragraph (3)(D), if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group shall be treated as a single taxpayer during such period.

I.R.C. § 199A(g)(5)(A)(iii) Expanded Affiliated Group – For purposes of this subsection, the term "expanded affiliated group" means an affiliated group as defined in section 1504(a), determined–

I.R.C. § 199A(g)(5)(A)(iii)(I) – by substituting "more than 50 percent" for "at least 80 percent" each place it appears, and

I.R.C. § 199A(g)(5)(A)(iii)(II) – without regard to paragraphs (2) and (4) of section 1504(b).

I.R.C. § 199A(g)(5)(A)(iv) Allocation Of Deduction – Except as provided in regulations, the deduction under paragraph (1) shall be allocated among the members of the expanded affiliated group in proportion to each member's respective amount (if any) of qualified production activities income.

I.R.C. § 199A(g)(5)(B) Special Rule For Cooperative Partners – In the case of a specified agricultural or horticultural cooperative which is a partner in a partnership, rules similar to the rules of subsection (f)(1) shall apply for purposes of this subsection.

I.R.C. § 199A(g)(5)(C) Trade Or Business Requirement – This subsection shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business.

I.R.C. § 199A(g)(5)(D) Unrelated Business Taxable Income – For purposes of determining the tax imposed by section 511, this section shall be applied by substituting "unrelated business taxable income" for "taxable income" each place it appears in this section (other than this subparagraph).

I.R.C. § 199A(g)(5)(E) Special Rule For Cooperative With Oil Related Qualified Production Activities Income

I.R.C. § 199A(g)(5)(E)(i) In General – If a specified agricultural or horticultural cooperative has oil 16 related qualified production activities income for any taxable year, the amount otherwise allowable as a deduction under paragraph (1) shall be reduced by 3 percent of the least of–

I.R.C. § 199A(g)(5)(E)(i)(I) – the oil related qualified production activities income of the cooperative for the taxable year,

I.R.C. § 199A(g)(5)(E)(i)(II) – the qualified production activities income of the cooperative for the taxable year, or

I.R.C. § 199A(g)(5)(E)(i)(III) – taxable income.

I.R.C. § 199A(g)(5)(E)(ii) Oil Related Qualified Production Activities Income – For purposes of this subparagraph, the term "oil related qualified production activities income" means for any taxable year the qualified production activities income which is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (within the meaning of section 927(a)(2)(C), as in effect before its repeal) during such taxable year.

I.R.C. § 199A(g)(6) Regulations – The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this subsection, including regulations which prevent more than 1 taxpayer from being allowed a deduction under this subsection with respect to any activity described in paragraph (3)(D)(i). Such regulations shall be based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal).

I.R.C. § 199A(h) Anti-Abuse Rules – The Secretary shall–

I.R.C. § 199A(h)(1) – apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and

I.R.C. § 199A(h)(2) – prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

I.R.C. § 199A(i) Termination – This section shall not apply to taxable years beginning after December 31, 2025.

(Added by Pub. L. 115-97 , title I, Sec. 11011(a), 131 Stat. 2054 , Dec. 22, 2017; amended by *Pub. L. 115-141*, Div. T, Sec. 101, Mar. 23, 2018, 132 Stat. 348.)

BACKGROUND NOTES

AMENDMENTS

2018 – Subsec. (a). *Pub. L. 115-141*, Div. T, Sec. 101(b)(1), amended subsec. (a). Before amendment, it read as follows:

"(a) In General.–In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of–

"the lesser of–

"(A) the combined qualified business income amount of the taxpayer, or

"(B) an amount equal to 20 percent of the excess (if any) of–

"(i) the taxable income of the taxpayer for the taxable year, over

"(ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus

"(2) the lesser of–

"(A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or

"(B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

"The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year."

Subsec. (b)(7). *Pub. L. 115-141*, Div. T, Sec. 101(b)(3), added par. (7).

Subsec. (c)(1). *Pub. L. 115-141*, Div. T, Sec. 101(b)(2)(A), amended par. (1) by striking ", qualified cooperative dividends,".

Subsec. (c)(3)(B). *Pub. L. 115-141*, Div. T, Sec. 101(b)(2)(B)(i)(I), amended the matter preceding clause (i) by striking "investment".

Subsec. (c)(3)(B)(ii). *Pub. L. 115-141*, Div. T, Sec. 101(b)(2)(B)(i)(II), by adding the sentence at the end.

Subsec. (e)(1). *Pub. L. 115-141*, Div. T, Sec. 101(a)(2)(A), amended par. (1) by substituting "any deduction" for "the deduction".

Subsec. (e)(1). *Pub. L. 115-141*, Div. T, Sec. 101(a)(2)(C), amended par. (1) by substituting "Except as otherwise provided in subsection (g)(2)(B), taxable income" for "Taxable income".

Subsec. (e)(4)-(5). *Pub. L. 115-141*, Div. T, Sec. 101(b)(2)(B)(ii), struck par. (4) and redesignated par. (5) as par. (4). Before being struck, par. (4) read as follows:

"(4) Qualified Cooperative Dividend.—The term 'qualified cooperative dividend' means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which—

"(A) is includible in gross income, and

"(B) is received from—

"(i) an organization or corporation described in section 501(c)(12) or 1381(a), or

"(ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T."

Subsec. (g). *Pub. L. 115-141*, Div. T, Sec. 101(a)(1), amended subsec. (g). Before amendment, it read as follows:

"(g) Deduction Allowed To Specified Agricultural Or Horticultural Cooperatives

"(1) In General.—In the case of any taxable year of a specified agricultural or horticultural cooperative beginning after December 31, 2017, there shall be allowed a deduction in an amount equal to the lesser of—

"(A) 20 percent of the excess (if any) of—

"(i) the gross income of a specified agricultural or horticultural cooperative, over

"(ii) the qualified cooperative dividends (as defined in subsection (e)(4)) paid during the taxable year for the taxable year, or

"(B) the greater of—

"(i) 50 percent of the W–2 wages of the cooperative with respect to its trade or business, or

"(ii) the sum of 25 percent of the W-2 wages of the cooperative with respect to its trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property of the cooperative

"(2) Limitation.—The amount determined under paragraph (1) shall not exceed the taxable income of the specified agricultural or horticultural for the taxable year.

"(3) Specified Agricultural Or Horticultural Cooperative.—For purposes of this subsection, the term "specified agricultural or horticultural cooperative" means an organization to which part I of subchapter T applies which is engaged in—

"(A) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product,

"(B) the marketing of agricultural or horticultural products which its patrons have so manufactured, produced, grown, or extracted, or

"(C) the provision of supplies, equipment, or services to farmers or to organizations described in subparagraph (A) or (B)."

EFFECTIVE DATE OF 2018 AMENDMENTS

Amendments by *Pub. L. 115-141*, Div. T, Sec. 101(a) and (b), effective as if included in section 11011 of Pub. L. 115-97 [effective for taxable years beginning after December 31, 2017].

EFFECTIVE DATE

Effective for taxable years beginning after December 31, 2017.

Sample of Recent News Stories

How Firms Could Sidestep Tax Law's Pass-Through Deduction Limits

By Lydia O'Neal

Professional service businesses are weighing the possibility of spinning off administrative or other back-office units of their pass-through businesses to qualify for a 20 percent deduction under the new tax law.

Such moves could help law firms and others sidestep the new tax code Section 199A deduction's exclusions, practitioners told Bloomberg Tax, though most are waiting for the Internal Revenue Service to issue guidance before moving to restructure.

"Law, accounting—any of the businesses that don't qualify in and of themselves for the 199A deduction, for whatever reason, whether they're specified services, or whether it's just a skills and reputation issue—you could do it with any of them," said Michael Greenwald, a partner at Friedman LLP. "It would be owned by the same people who own the professional practice, but they'd be making their profit there from non-professional activities."

Meanwhile, a coalition of S corporation groups is pushing the IRS and the Treasury Department to allow the businesses they represent to do practically the opposite—aggregating into a single unit the pass-through businesses they've held as separate entities, often for non-tax reasons, since long before the tax overhaul.

Spinning Off and Writing Off

Under the tax act , individuals who own pass-through businesses can take a 20 percent deduction as long as they don't earn more than $157,500 for single filers, or $315,000 for married taxpayers filing jointly, after which the deduction begins to phase out.

Beyond incomes of $207,500 for single filers and $415,000 for joint filers, certain "specified service trade or business" types listed in Section 1202(e)(3)(A), along with those involving "performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities," are excluded, according to the statute. Among those Section 1202(e)(3)(A) trade or business types are those in health, law, performing arts, consulting, athletics, accounting, or "any trade or business where the principal asset" is an employee's or owner's "reputation or skill," but the law left out engineering and architecture trades or businesses.

But if, for example, a law firm spun off its administrative, information technology, or other non-principal operations from the law office and formed a "brother-sister" business structure, the law firm could pay the back-office entity to perform those necessary but non-principal duties, allowing the entity to take advantage of the deduction, said Stephen Looney, chair of the Corporate and Tax Department at Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth P.A. in Orlando, Fla. And it could pay the spun-off entity a lot, he and other practitioners said, maximizing the 20 percent write-off.

The restructuring move should pass muster as long as it is supported by a "business purpose," Looney said, and not solely for tax reasons. For professions laden with legal risk, he said, such as law and health care, separation of IT and equipment entities from the professional operations could prevent legal liabilities erupting in one entity from contaminating the business as a whole.

Better Together?

That's the main reason many business owners have held their pass-through businesses in multiple entities for years, according to S corporation group representatives who spoke with Bloomberg Tax. But those organizations fear many of their members won't get access to the deduction because of another limit based on wages.

Above the $157,500 and $315,000 income thresholds, the deduction is calculated as the lesser of 20 percent of qualified business income or a separate percentage of either W-2 wages or a combination of wages and capital.

If a pass-through business owner has two entities—one that manages payroll and the other that handles operations—the owner will calculate zero qualified business income (or potentially a loss) for the payroll entity, though it may pay wages, and zero wages for the operations entity, though it may generate qualified business income. For each separately, the lesser of the two calculations would be zero, but by making those calculations as if those entities were one business, the owner may be able to get some of the deduction.

In a March 19 letter , 43 groups, including the American Institute of CPAs and the U.S. Chamber of Commerce, as well as associations for roofing workers, cleaning companies, and wine and beer wholesalers, asked Treasury and IRS officials to permit pass-through businesses composed of grouped entities to aggregate when calculating the Section 199A deduction. More specifically, they requested treatment as an economic unit composed of multiple activities in accordance with passive loss rules under Section 469.

"Allowing aggregation or grouping will not open the new deduction to gaming opportunities because the wage and investment limitations provide a strict cap on the size of the deduction, regardless of how it is measured," the letter said, "while the new rules could ensure that income from excluded service activities is not taken into account for purposes of the calculation."

Your Move, IRS

The IRS, which declined to comment, included "computational, definitional, and anti-avoidance guidance under new §199A" in its updated 2017-2018 Priority Guidance Plan , a list of projects it hopes to finish by June 30.

Practitioners are encouraging clients to wait for an IRS decision before spinning off their back-office operations into separate entities, according to those who spoke with Bloomberg Tax.

"It is among the highest priorities for the government to do some regulatory guidance, but we don't know how far they're going to go with it," said Kevin Anderson, a partner in the National Tax Office of BDO USA LLP. "We don't know whether an idea like this will work, and we also think that there should not be any hurry to rush into a structure like this."

The issue is complicated by the effort of representatives of multi-entity, aggregated S corporations to keep the IRS from forcing their members to do something similar as a means of getting the deduction.

"We already know there are businesses that want to disaggregate to take advantage of the statute, and there are businesses that want to aggregate to take advantage of the statute," said David Kamin, a New York University School of Law professor who focuses on tax and budget policy. He added that the provision is "very hard to govern," and that regulating it is "going to be messy."

Kamin, who served as special assistant to the president on federal tax and budget issues in the later years of the Obama administration, described a potential decision by the IRS to let pass-throughs have it both ways as a worst-case scenario that "would clearly maximize revenue loss." (The Joint Committee on Taxation, in a Dec. 18 report (JCX-67-17), estimated the Section 199A deduction would cost $414.5 billion over 10 years.) He also stressed that the limitation only applies above the income thresholds.

But Brian Reardon, president of the Washington-based S Corporation Association, one of the groups that signed the letter, warned that, absent a decision by the government to let pass-throughs aggregate, companies could be ushered into costly reorganization. Other representatives from groups that signed the letter who spoke with Bloomberg Tax decried a lack of tax fairness between pass-throughs and C corporations, which the law afforded a 21 percent rate.

"I think they can deal with both" aggregating and disaggregating, Reardon, who served as special assistant for economic policy under former President George W. Bush, said of the IRS. "The goal there is not to game the system. These are real businesses—they're not very large."

Worth the Cost?

The letter, to Treasury Assistant Secretary for Tax Policy David Kautter and IRS Principal Deputy Chief Counsel William Paul, warned that "moving business activity from one form to another, particularly a form that is going to be taxed at just 21 percent, will not save the Treasury revenues, but it will impose significant transaction costs on these businesses."

Similar costs would likely hit excluded professional service firms' bottom lines if they decide to split with their administrative or other non-principal services, practitioners told Bloomberg Tax.

"There's obviously a natural tendency to try to overpay for those things, so you'd want to have a kind of a transfer pricing study to make sure that your pricing between the two entities was appropriate," said Greenwald. "The issue is, is the cost of setting up that other business worth it based on how much you're going to actually save in the long run? That's going to turn on how much profit you can shift to that entity."

Still, Looney said the decline in the top rate for pass-throughs with the help of the deduction, to 29.6 percent from 37 percent, is "a pretty big spread," so "there'd have to be a lot of added costs for it not to be worth it."

Possible Considerations

Anderson pointed out that Treasury Regulations Section 1.448-1T(e)(4) stipulates, for a similar group of professional services, that "administrative and support services" are considered "incident to the actual performance of services in a qualifying field." This, he said, could raise questions of whether a spun-off administrative entity should really be considered separate, and could be an argument the IRS "might want to pursue if they see all these side-by-side entities popping up."

In Moline Properties, Inc. v. Commissioner, on the other hand, the U.S. Supreme Court ruled in 1943 that, for federal tax purposes, a company created for a business purpose will be treated as a separate entity.

While a 2011 case—Morton v. United States —broke the precedent set by Moline, two officials in the IRS Office of Associate Chief Counsel in October 2017 issued a memorandum addressed

to another agency official in the Large Business & International deputy commissioner's office suggesting that the break in precedent ought to be ignored. The 2011 decision, they said, "is an aberration that the Service should not follow, because Moline Properties is broadly applicable to S corporations."

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Partners Could Face More Penalties Under New Tax Law

By Laura Davison

The new tax law makes it easier for the IRS to levy penalties on pass-through business owners who understate the amount of tax they owe, a change that is meant to deter taxpayers from taking aggressive positions, a government official said.

The tax law reduces the threshold at which the government can charge penalties to partnerships, limited liability companies, and S corporation owners who claim the deduction under tax code Section 199A.

"There is a lot of concern about the potential for abuse here," said Paul McLaughlin, legislation counsel for the Joint Committee on Taxation, Congress' official scorekeeper, at a conference on the tax law sponsored by the District of Columbia Bar Taxation Community. "There are two ways to stop speeding. One is to put a whole lot more cops out there. The other is to raise the fines."

The tax code generally levies a penalty if taxes are underpaid by 10 percent or more under tax code Section 6662. However, if a taxpayer claims this deduction, the penalty, which can be 20 percent of the unpaid tax, kicks in if the tax is understated by 5 percent.

This rule applies regardless of the size of the deduction claimed, Robert J. Crnkovich, a principal at Ernst & Young LLP, said. This provision, which hasn't received much attention, is important for pass-through owners to understand when they are calculating their tax risk, he said.

The concept for the Section 199A deductions stems from the domestic production deduction under Section 199.

That tax break for U.S. manufacturing has bipartisan support, and the Senate Republicans saw mimicking that approach as an opportunity to get Democrats to back the tax bill, Christopher H. Hannah, senior tax policy adviser at the Senate Finance Committee, said.

The bill ultimately passed in December with only Republican support. However, the provision is set to expire in 2026, when it could need the backing of both parties to be extended.

The conference was hosted by Jones Day and co-sponsored by Bloomberg Tax and Tax Analysts.

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Tax Law Prompts S Corps to Examine Their Structures: A Primer

By Laura Davison

Businesses are considering whether their corporate structures make the most sense in light of the new tax law, which changes the effective tax rate for many companies—depending on industry, kind of structure, and location.

That question can be especially difficult for closely held, usually family businesses that are often structured as S corporations. These entities, along with other pass-throughs such as limited liability companies and partnerships, flow their income through to their investors, who pay the tax.

S corporations are beginning to model out how the new tax law will affect their businesses, tax professionals told Bloomberg Tax. The new law likely won't result in a mass conversion from pass-through to C corporation status, but the changes are significant enough for every business to take a look at what makes the most sense for them, the practitioners said.

Here are some things to question as the new tax act (Pub. L. No. 115-97) takes effect.

How Much Income Qualifies for 20 Percent Deduction?

The new tax law provides a 20 percent deduction for pass-through entities, including S corporations. But the tax break, in tax code Section 199A, phases out for service companies like medical practices and consulting firms beyond certain taxable income levels—$157,500 for individuals, $315,000 for joint filers. The deduction is also limited by how much the company pays in wages to employees.

Knowing how much income will be subject to the deduction is critical to determining whether it's advantageous to be an S corporation, Kevin Anderson, a partner in the National Tax Office of BDO USA LLP in Washington, told Bloomberg Tax.

"If we just assumed that all S corporation shareholders would be subject to the maximum rates of tax and assume all their income is eligible for 20 percent deduction, it's fair to say it's advantageous to be operating as an S corporation," Anderson said.

But many companies will find that the deduction is more limited, either because not all their income is considered to be qualifying business income or because they don't pay enough in wages. Companies need to model out how the deduction will apply in their specific cases to know what their effective tax rate will be, he said.

Is an S Corp the Best Business Structure?

Once an S corporation knows what its effective tax rate likely will be, it can compare it with the new regime for C corporations.

The new tax law lowers the corporate tax rate to 21 percent from 35 percent, a large reduction that is causing S corporations to reconsider whether they should convert to being taxed as C corporations.

"People are still in the figuring-it-out phase," said Laura E. Krebs Al-Shathir, counsel at Capes, Sokol, Goodman & Sarachan, PC in St. Louis, Mo. "I haven't helped anyone walk through the conversion process and I'm not even sure I'd advise a new business to form as a C corporation. I'm not seeing people convert. I'm seeing people think about it."

Companies need to think about how much of their earnings they plan to distribute to their shareholders. While corporations will pay a 21 percent income tax rate—and pass-through owners will pay about 29.6 percent, depending on their tax bracket and the type of income—corporate distributions will still be taxed.

"The biggest determinant on if you should go to C is how much of the profits you expect to distribute as dividends," said Mel Schwarz, director of tax legislative affairs in Grant Thornton LLP's National Tax Office in Washington. "If you're going to distribute all the profits as dividends as a C corporation, your tax rate is going to be higher than if you are a pass-through."

The distribution policies can vary widely among family businesses, said Bryan Keith, managing director in Grant Thornton's National Tax Office. S corporations will need to consider whether there are family members who are used to getting distributions each year or if there are trusts that have distribution requirements, he said.

Owners considering moving to a corporate structure should be aware of the accumulated earnings tax, a 20 percent tax on companies holding on to too much cash, and the personal holding company tax, another 20 percent penalty on undistributed passive income earned in a closely held C corporation.

Companies should also consider whether they expect losses in the future, Krebs Al-Shathir said. If you stay a pass-through those losses can flow through to the owners and offset other types of income, she said.

When Can a Company Choose Not to Be an S Corporation?

A company must choose to revoke a subchapter S election by March 15 to have it apply for the whole year if it is a calendar-year taxpayer. (If it has a different tax year, the company needs to make the election by the 15th day of the third month of the year.)

But if a company decides midyear it's no longer advantageous to be an S corporation, it can make the election at that point and have it be effective from that point onward, Anderson said.

If a company elects to terminate its S corporation status, it can't reapply for S corporation status for five years.

"My initial recommendation is that S corporations ought to sit tight and be patient," Anderson said.

Are There Plans to Sell or Acquire Another Company?

If there are any plans to sell the company in the near future, it makes sense to stay an S corporation because it's much easier to sell a company with a single layer of tax, Schwarz said.

Even if there aren't immediate plans to sell the company, unexpected situations can arise, he said.

"A lot of these are family companies," he said. "Private planes can fall out of the sky and the family is not in a position to continue the biz. Or people come and they offer more money than you've ever dreamed of for the business."

Asset sales, as opposed to stock sales, are particularly attractive for S corporations looking to sell or to buy another company. Buying the assets allows the owners to depreciate the property, which is even more beneficial under the GOP tax plan, which expands expensing provisions.

Acquiring the assets of a pass-through entity allows the buyer to avoid the second layer of tax they would trigger if they were buying a corporation's assets. Deals involving corporations require the buyers to pay tax on the entity-level gain and for the shareholders to pay tax on the distributed earnings.

What About International Operations?

While many of the territorial international tax provisions in the new tax law don't apply to pass-throughs, Schwarz said there is one big advantage: S corporations can defer the tax on unrepatriated earnings as long as they keep their status. If you convert to a C corporation, it will trigger that tax, he said.

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§199A Gets an Update Three Months After Its Enactment

By James M. Kehl, CPA*

Introduction

One of the most important provisions of the 2017 tax act[1] is §199A.[2] This provision is "an accountant's code section"[3] because it is a detailed calculation consisting of several elements that requires an understanding of many terms and definitions. Discussions with other tax professionals have indicated that the best method for explaining §199A and the multitude of tax issues underlying this new provision is through examples. Accordingly, this article will present a calculation of the §199A deduction for a fictitious married couple and dissect the various computations and tax issues entailed by the §199A deduction in Worksheet 1, Worksheet 2, and Worksheet 3, which will be discussed below. Some strategies and suggestions made by various tax professionals will also be discussed in this article. This article will also discuss §199A(g)(1), as amended by the Consolidated Appropriations Act 2018.[4]

Taxpayer Entitled to the §199A Deduction

For most taxpayers, the §199A deduction will be the Combined Qualified Business Income Amount; for a specified agricultural or horticultural cooperative, the §199A deduction will be an amount that is based on the cooperative's Qualified Production Activities Income (QPAI); for some eligible taxpayers who own a qualified trade or business and who are also patrons of specified agricultural or horticultural cooperatives, the §199A deduction will be the Combined Qualified Business Income Amount plus a deduction allocated to those eligible taxpayers by the specified agricultural or horticultural cooperatives owned by those patrons.[5] The Combined Qualified Business Income Amount component as allowed by §199A(a) is limited to 20% of the excess (if any) of a taxpayer's taxable income before the §199A deduction over the taxpayer's net capital gain (as defined in §1(h) for that taxable year.[6]

A deduction is also allowed by §199A(g)(1) to specified agricultural or horticultural cooperatives that have QPAI and taxable income. Those specified agricultural or horticultural cooperatives are permitted by §199A(g)(2) to allocate all or some of their §199A(g)(1) deduction to their patrons who are eligible taxpayers that receive qualified payments from those cooperatives. Except for §199A(g)–§199A(i), the remainder of §199A defines and explains various aspects of the Combined Qualified Business Income Amount component of the §199A deduction. The §199A(a) deduction is allowed to a taxpayer "other than a corporation."[7]

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[1] Pub. L. No. 115-97 (the 2017 tax act).

[2] All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified. Section 199A was added by the 2017 tax act, §11011(a).

[3] That term was first used by the author to describe §199, the deduction for income attributable to domestic production activities, in James M. Kehl, *The Practical Guide to the Code Section 199 Deduction* (2d ed. 2007), p. 9. Section 199 was repealed by the 2017 tax act effective for tax years beginning after December 31, 2017.

[4] Pub. L. No. 115-141, Div. T, §101(a).

[5] §199A(a), §199A(g)(1), and §199A(g)(2).

[6] §199A(a).

[7] *Id.*

A taxpayer ''other than a corporation'' includes individual taxpayers[8] as well as trusts and estates.[9] Partnerships and S corporations do not take a QBI deduction; instead, this deduction is taken at the partner or shareholder level.[10] At that level, each partner or shareholder takes into account that owner's allocable share of the qualified items of income, gain, deduction, and loss of the partnership or S corporation.[11]

The example in this article is about a fictional married couple filing a joint return for 2018. That married couple has, among other things, income from two limited liability companies (LLC No. 1 and LLC No. 2) that are treated as partnerships for federal income tax purposes. LLC No. 3 is an engraving business operated as a sole proprietorship by one of the persons filing a joint return. LLC No. 3 has no employees and owns some engraving equipment. The tax return information for this married couple is presented on Worksheet 1 titled ''Summary of Taxpayer Information.''

In order to calculate the §199A deduction, taxpayers will need certain information about their businesses in 2018 that they did not need in prior years. This information includes the taxpayers' allocable shares of each entity's W-2 wages and the taxpayers' allocable shares of each entity's unadjusted basis immediately after acquisition of qualified property.

The calculation of the §199A deduction is perhaps the final calculation that will be made on the taxpayer's tax return. This is because some of the limits of the components of the §199A deduction are based on taxable income. Except as provided in §199A(g)(2)(B), when the term ''taxable income'' is used in §199A, it refers to taxable income that is calculated without regard to any deduction allowable under §199A.[12] Any §199A deduction is neither a deduction in computing the adjusted gross income of individual taxpayers[13] nor is it an itemized deduction for those taxpayers.[14] However, the §199A deduction is a deduction from taxable income for individual taxpayers who take the standard deduction[15] and for individual taxpayers who itemize their deductions.[16] In the example for this article, the §199A deduction is shown as the last deduction in the computation of the taxable income of the fictitious taxpayers.

Qualified Business Income Amount

The §199A deduction for eligible taxpayers who are neither specified agricultural or horticultural cooperatives nor patrons of those cooperatives consists of the Combined Qualified Business Income Amount[17] to the extent that amount does not exceed 20% of the excess of a taxpayer's taxable income for the year before any §199A deduction over the taxpayer's net capital gain (as defined by §1(h)) for the taxable year.[18] The Combined Qualified Business Income Amount is defined by §199A(b)(1) as the sum of the deductible amounts for each qualified trade or business of the taxpayer plus 20% of the total amount of a taxpayer's qualified REIT dividends and qualified publicly traded partnership income for the taxable year.

[8] Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st. Sess. (2017) (hereinafter Joint Statement), 28.
[9] Joint Statement, 40.
[10] §199A(f)(1)(A)(i).
[11] §199A(f)(1)(A)(ii).
[12] §199A(e)(1).
[13] §62(a).
[14] §63(d)(3), as amended by the 2017 tax act, §11011(b)(3).
[15] §63(b)(3).
[16] Joint Statement, 39.
[17] §199A(a)(1).
[18] §199A(a)(2).

Application to Example: The §199A Deductible Amount for each qualified trade or business of the taxpayer is illustrated on Worksheet 2, titled ''Determination of Deductible Amount for Each Qualified Trade or Business.'' The deductible amount for each of the taxpayer's qualified trades or businesses is calculated in accordance with the provisions of §199A(b)(2). The Combined Qualified Business Income Amount is computed by totaling the deductible amounts for each of the taxpayer's qualified trades or businesses and adding 20% of the aggregate amount of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income to that total.[19] The amount of the deduction for the Combined Qualified Business Income Amount is limited by §199A(a)(2) to an amount that the author has chosen to describe as the ''20% Excess Taxable Income Limit'' on Worksheet 3, titled ''Deduction for Qualified Business Income.'' Certain categories of taxable income are part of this §199A(a)(1)(B) limitation.

The first phrase used in §199A(a)(1)(B) to describe this limitation is ''an amount equal to 20 percent of the excess (if any) of the taxable income of the taxpayer for the taxable year.''[20] The words ''taxable income'' as used in that phrase refer to a taxpayer's taxable income computed without regard to any §199A deduction.[21] The next words of §199A(a)(2)(B) are ''over the net capital gain (as defined in §1(h).'' The term ''net capital gain'' is defined by §1222(11) as the ''excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.'' However, the parenthetical phrase of §199A(a)(2)(B) states that net capital gain is ''as defined in §1(h).'' The definition of ''net capital gain'' for purposes §1(h) is delineated by §1(h)(11)(A), which states that ''the term 'net capital gain' means net capital gain (determined without regard to this paragraph) increased by qualified dividend income.'' Thus for purposes of §199A(a)(2)(B), net capital gain consists of the excess of a taxpayer's net long-term capital gain for the taxable year over that taxpayer's short-term capital loss for that taxable year (the definition of net capital gain contained in §1222(11) plus the taxpayer's qualified dividend income for the year (the additional amount included in net capital gain by §1(h)(11)(A)).

Generally, qualified dividend income consists of dividends received by a taxpayer during a taxable year from domestic corporations and qualified foreign corporations[22] but does not include any dividend distributions from corporations which, for the taxable year in which the distribution is made or for the preceding taxable year, are exempt from tax under §501 (certain tax-exempt organizations and qualified pension, profit-sharing, and stock bonus plans) or that are certain farmers' cooperatives exempt from tax under §521.[23] Qualified dividends also do not include any dividends that are deductible under §591[24] nor any dividends described in §404(k).[25] Certain dividends on shares of stock not owned for certain required periods of time cannot be qualified dividends.[26] Finally, qualified dividends are not dividends on any shares of stock to the extent a taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.[27] For this reason, the calculation of a taxpayer's 20% Excess Taxable Income limit must include a reduction of a taxpayer's taxable income before any §199A deduction by: 1) the amount of a taxpayer's regular qualified dividends and 2) the amount of a taxpayer's net long-term capital gain in excess of the taxpayer's net short-term capital loss.

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[19] §199A(b)(1).
[20] §199A(a)(2)(B).
[21] 21 §199A(e)(1).
[22] §1(h)(11)(B)(i)(I)–§1(h)(11)(B)(i)(II).
[23] §1(h)(11)(B)(ii)(I).
[24] §1(h)(11)(B)(ii)(II).
[25] §1(h)(11)(B)(ii)(III).
[26] §1(h)(11)(B)(iii)(I).
[27] §1(h)(11)(B)(iii)(II).

Application to Example: The taxpayer's 20% Excess Taxable Income Amount of $80,400 exceeds the taxpayer's Combined Qualified Business Income Amount of $59,600. Therefore, the taxpayer's §199A deduction is $59,600.

Combined Qualified Business Income Amount

The Combined Qualified Business Income Amount concept is the centerpiece of §199A and is the sum of two amounts. The first amount is the sum of the deductible amounts for each qualified trade or business that is carried on by the taxpayer.[28] The second amount is 20% of the taxpayer's aggregate amount of qualified REIT dividends plus qualified publicly traded partnership income for the taxable year.[29] The word "each" indicates that the deductible amount for a qualified trade or business must be separately determined on an individual basis for every trade or business of the taxpayer. These separately determined amounts for all of the taxpayer's qualified trades or businesses are then totaled. A taxpayer must first decide whether an activity is a "trade or business." If an activity constitutes a trade or business, it must then be determined whether that trade or business is a "qualified" trade or business carried on by the taxpayer.

Trade Or Business

The Conference Agreement and the Senate Amendment of the Committee Reports to the 2017 tax act do not discuss the meaning of a "trade or business."[30] The House Bill, which was not adopted by the Conference Agreement, states that "a business activity means an activity that involves the conduct of any trade or business."[31] For purposes of this definition, the House Bill states that "an activity has the same meaning as under the present-law passive loss rules (§469)."[32] Even though Reg. §1.469-4 is titled "Definition of Activity," it does not define the word "activity." Instead, Reg. §1.469-4(b)(1) contains a definition of trade or business activities. That definition states that trade or business activities are neither rental activities nor activities incidental to holding property for investment. Trade or business activities are activities that: "i) involve the conduct of a trade or business (within the meaning of §162); ii) are conducted in anticipation of the commencement of a trade or business; or iii) involve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)."[33]

Whether an activity involves "the conduct of a trade or business within the meaning of §162" was an issue that arose in connection with the publication of the §1411 Final Regulations. These regulations state that "the term trade or business refers to a trade or business within the meaning of section 162."[34] There is no definition of the term "trade or business" in §162. However, the IRS stated that the reference to §162 in the definition of a trade or business "incorporates case law and administrative guidance applicable to §162."[35] In an old case, the Supreme Court stated that whether a taxpayer's activities constitute "carrying on a business requires an examination of the facts in each case."[36]

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[28] §199A(b)(1)(A).
[29] §199A(b)(1)(B).
[30] Many of the cases, concepts, and other guidance presented in this section are also discussed in ¶15.04[B] and ¶19.11[C][1] of CCH's Partnership Tax Treatise entitled "Federal Taxation of Partnerships & Partners," by Patricia Hughes-Mills, Thomas Humphreys, James Kehl, and Stuart Rosow.
[31] Conf. Rep. to Acc. H.R. 1, H.R. Rep. No. 115-466, 115 Cong., 1st Sess. 26 (2017).
[32] *Id.*
[33] Reg. §1.469-4(b)(1).
[34] Reg. §1.1411-1(d)(12).
[35] T.D. 9644, 78 Fed. Reg. 72,393 (Dec. 2, 2013). *See* Summary of Comments and Explanation of Provisions, Section 5, B, ii, a. of Comments and Explanation of Provisions, Section 5, B, ii, a.
[36] *Higgins v. Commissioner*, 312 U. S. 212 (1941).

The Supreme Court discussed the characteristics of a trade or business for purposes of §162 in Commissioner v. R. P. Groetzinger.[37] In that case, the Supreme Court stated that a taxpayer had to be engaged in an "activity with continuity and regularity" with a primary purpose of earning income or profit in order to be conducting a trade or business. "Sporadic" activities that are either hobbies or engaged in for amusement are not trades or businesses.[38] In *Stanton v. Commissioner*,[39] the Fifth Circuit opined that "regularity" would involve devoting substantial time to the activity that is alleged to be a trade or business. In *Nieman v. Commissioner*,[40] the Tax Court stated that "a taxpayer is 'continually' and 'regularly' involved in a business activity only if he can show extensive business activity over a substantial period."[41] In *Douglas v. Commissioner*,[42] the Tax Court ruled that a taxpayer who bought 11 properties, renovated seven of those properties, and sold two of them in past years was not engaged in the business of developing real property "on a regular and continuous basis" because he failed to sell any of those properties during the years being litigated. Two cases decided by the Eighth Circuit opined that a profit motive evidenced by a genuine intention to make a profit is perhaps the most important factor in determining the existence of a trade or business.[43] In summary, these cases seem to indicate that a §162 trade or business activity is an activity engaged in on a regular, continuous, and substantial basis with the primary objective of earning a profit.

A trade or business differs from an activity engaged in by the taxpayer for the production of income that is described in §212. A §212 activity is not a trade or business. Whether an activity is a trade or business or an activity engaged in for the production of income is an issue that is likely to be present in the case of rental properties.

In *Edward R. Curphey v. Commissioner*,[44] a dermatologist who worked 40 hours a week at a hospital also owned and managed six rental properties. The Tax Court had to decide whether the ownership and management of these rental properties constituted a trade or business. The Tax Court acknowledged its history of ruling in several cases that the rental of only a single piece of real estate constituted a trade or business. However, the Tax Court refused to conclude that the ownership and management of rental properties either did constitute or did not constitute a trade or business, as a matter of law, in every case. In this case, the Tax Court held that the taxpayer's efforts in finding new tenants, supplying furnishings, and making the units ready for new tenants "were sufficiently systematic and continuous to place him in the business of real estate rental." [45]

In the Preamble to the §1411 Final Regulations, commentators cited old cases where the courts had decided that the rental of a single property could rise to the level of a trade or business.[46] The IRS acknowledged that there may have been situations where the rental of a single property required sufficient regular and continuous involvement so that the rental activity was a §162 trade or business. However, the IRS did not believe that, as a matter of law, the rental of a single property was a trade or business in every case.[47] The IRS cited an example in Reg. §1.212-1(h) as an example of a rental property that was not a trade or business.[48]

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[37] 480 U.S. 23 (1987).
[38] *Id.*
[39] 399 F.2d 326, *aff'g* T.C. Memo 1967-137.
[40] T.C. Memo 2016-11.
[41] *Id.*
[42] T.C. Memo 1998-165, aff'd, 181 F.3d 87 (4th Cir. 1999), in an unpublished *per curiam opinion*.
[43] *American Academy of Family Physicians v. United States*, 91 F.3d 1155 (8th Cir. 1996), and *DKD Enterprises, Inc. v. Commissioner*, 685 F.3d 730 (8th Cir. 2012), *aff'g in part, rev'g and rem'g in part*, T.C. Memo 2011-29.
[44] 73 T.C. 766 (1980).
[45] *Id.*
[46] T.D. 9644. These cases were *Fackler v. Commissioner*, 45 B.T.A. 708 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943); *Hazard v. Commissioner*, 7 T.C. 372 (1946); and *Lagreide v. Commissioner*, 23 T.C. 508 (1954).
[47] T.D. 9644.
[48] *Id.*

In the Committee Reports to the Revenue Act of 1980, Congress stated that "an activity is not considered to be a trade or business activity solely because the property used in the activity may be eligible for special capital gain or ordinary loss treatment under §1231. Further, in the case of rental activities, there must be significant furnishing of services incident to the rentals to constitute an active business (within the meaning of §162) rather than an investment. Thus, a rental activity is not considered to be an active trade or business solely because deductions attributable to it are allowable in computing adjusted gross income (§62(5)). In general, the operation of an apartment complex, an office building, or a shopping center would constitute an active trade or business." [49] From this it can be deduced that it is unlikely the lessor in a triple net lease arrangement would be considered to be involved in a trade or business because that lessor is not furnishing significant services to the lessee.

Whether a rental of a single property is considered a trade or business for purposes of the §199A(a) deduction will probably be a source of contention between taxpayers and the IRS. In T.D. 9644, the IRS stated that "within the scope of a §162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a §162 trade or business, bright-line definitions are impractical and would be imprecise."[50] The IRS thus did not provide a definition of a §162 trade or business for purposes of §1411. However, in Reg. §1.1411-5(b)(3) Ex. 1, the IRS concluded that the rental of a commercial building by an unmarried individual to another entity did not involve the conduct of a trade or business because that unmarried individual was "not involved in the activity of the commercial building on a regular and continuous basis." [51]

Further Guidance Needed: Until further guidance is received, it would seem that a trade or business for purposes of the §199A deduction would be an "activity conducted on a regular, continuous and substantial basis" [52] that has the objective of making a profit. A rental activity will have to be carefully evaluated as to whether it constitutes a trade or business. Some tax advisors may feel that a rental of one property may constitute a trade or business based on the court decisions in some old cases. It may be prudent for those advisors to consider the IRS's comments concerning that issue with respect to §1411.

A Single Trade or Business Versus Several Trades or Businesses

It is customary for many real estate owners to conduct business through several entities. A homebuilder may build several developments located in different areas. The homebuilder may use a separate passthrough entity for each project. Does this homebuilder have one trade or business or several trades or businesses? Under the passive loss regulations of Reg. §1.469-4(c)(1), if the homebuilding activities constitute an appropriate economic unit, then they could be a single activity. That test is a facts and circumstances test whereby certain factors (common control, common ownership, interdependence, etc.) are weighed.[53] The passive activity regulations are not necessarily the primary authority for defining a trade or business, but they may provide guidance for making this determination. A similar decision would have to be made in the case of a real estate professional that builds, owns, and operates several apartment houses and commercial buildings. This professional

[49] Committee Reports on Pub. L. No. 98-605 (Miscellaneous Revenue Act of 1980).
[50] T.D. 9644.
[51] Reg. §1.1411-5(b)(3) Ex. 1.
[52] §1061(c)(2).
[53] Reg. §1.469-4(c)(2).

may have a construction company that erects the buildings and a management company that manages those properties after the construction is completed. Each apartment house and commercial building is owned in a separate partnership that has different partners. In this case, the construction company, the real estate management company, each apartment house partnership, and each commercial building partnership would seem to be separate activities that would have to satisfy the regular, continuous, and substantial activity trade or business standards on their own.

Qualified Trade or Business

After it is determined that an activity or group of activities constitutes a trade or business, it must then be determined if the activity or group of activities is a "qualified trade or business." For purposes of §199A, a "qualified trade or business" is any trade or business that is neither a "specified service trade or business" nor a trade or business of performing services as an employee.[54]

Performance of services as an employee is a trade or business carried on by a taxpayer [55] that is a separate trade or business from the business of an employer. Whether there is an employer-employee relationship in a specific situation is a question of fact that is usually determined by common law rules.[56] The relationship between a trade or business and a worker is usually dependent upon the degree of control that a business has over a person performing services for that business.[57] An employee receives a W-2 from the employer whereas an independent contractor receives a Form 1099.

Some commentators have suggested that employees of certain specified service trades or businesses can avoid classification as employees by forming a partnership with other employees. This partnership would be an independent contractor with respect to the trade or business and a partner's distributive share of the income from this partnership's trade or business could be QBI if the partner's taxable income does not exceed certain threshold amounts.[58] Anyone considering this strategy should be cognizant of the anti-abuse rule of Reg. §1.701-2(a)(1) and §1.701-2(a)(1)(2). Those provisions state that a partnership must be bona fide; furthermore, the partnership transactions must be undertaken for a substantial business purpose[59] and "must be respected under substance over form principles." [60] If the formation of this partnership is deemed to have a principal purpose of reducing the partners' federal tax liabilities in a manner that is contrary to the intent of Subchapter K of the Code, the IRS "can recast" or disregard the partnership form "to achieve tax results that are consistent with the intent of Subchapter K." [61] If these "employees" are admitted as partners to an established partnership and the purpose of their admission is to incentivize those individuals to remain with the partnership as owners, then this anti-abuse rule may not apply.

Specified Service Trade or Business

A "specified service trade or business" is any trade or business that involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business if the principal asset

[54] §199A(d)(1).
[55] §62(a)(1).
[56] *Weber v. Commissioner*, 103 T.C. 378 (1994).
[57] FSA 200127004. This was discussed in Kehl, *Practical Guide to the Sec. 199 Deduction*, pp. 44–45.
[58] Avi-Yonah et al., "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation," (Dec. 7, 2017), and "The Games They Will Play: An Update on the Conference Committee Tax Bill" (Dec. 18, 2017).
[59] Reg. §1.701-2(a)(1).
[60] Reg. §1.701-2(a)(2).
[61] Reg. §1.701-2(b).

of that trade or business is the reputation or skill of one or more of its employees or owners.[62] A "specified service trade or business" also includes any trade or business involving the performance of investing and investment management services as well as trading or dealing in securities (as defined in §475(c)(2)), partnership interests, or commodities (as defined in §475(e)(2)).[63]

Further Guidance Needed: Until future guidance is received, tax practitioners may have to rely on the limited guidance in the Conference Committee Reports to §199A and perhaps some prior cases, rulings, and regulations involving §448 in deciding whether a service business is a specified service trade or business.

The footnotes to the Joint Explanatory Statement of the Committee of Conference on H.R. 1 with respect to §199A point out certain provisions in the Temporary Regulations under §448 that more closely define the services referred to in §199A(d)(2)(A) and §1202(e)(3)(A).[64] One of these footnotes states "that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals" but "does not include the provision of services not directly related to a medical field." The operation of a health club or spa is not a service in the field of health.[65] The IRS has privately ruled that performing unique and patented lab tests and providing the results to healthcare providers was not a trade or business in the field of health.[66] However, the rendering of medical services by veterinarians was ruled to be a service in the field of health.[67] Similarly, a corporation that provided radiation therapy to its patients was deemed to be performing services in the field of health.[68] The performance of ultrasound services was deemed by the Tax Court to be services in the field of health.[69]

Another footnote in the Joint Statement concerning §199A points out that the §448 Temporary Regulations state that the performance of services in the field of performing arts includes only the services of actors, actresses, singers, entertainers, and similar artists in their capacities and does not include the services of managers or promoters of those artists nor does it include the services of broadcasters or radio station employees who disseminate those artists' performances to the public.[70]

Footnote 46 in the Joint Statement concerning §199A makes the point that the performance of services in the field of consulting includes only the services of "advice and counsel" and does not include economically similar services.[71] A taxpayer in the business of providing economic analyses and forecasts and giving advice to clients based on those forecasts and analyses is considered to be engaged in the field of consulting.[72] A business of determining a client's electronic data processing needs is considered a consulting business.[73]

The Tax Court has ruled that a bookkeeping and tax return preparation business was engaged in the performance of accounting services for purposes of §448(d)(2) despite the fact that it employed no certified public accountants.[74] In Reg. §1.448-1T(e)(5)(vii) Ex. 1, a C corporation

[62] §199A(d)(2)(A).
[63] §199A(d)(2)(B).
[64] Joint Statement, 30–31.
[65] Joint Statement, 30–31, n.44, referring to Reg. §1.448-1T(e)(4)(ii).
[66] PLR 201717010.
[67] Rev. Rul. 91-30.
[68] *W.W. Eure, M.D., Inc. v. Commissioner*, T.C. Memo 2007-124.
[69] *Zia-Ahmadi v. Commissioner*, T.C. Summ. Op. 2017-39.
[70] Joint Statement, 31, n.45, referring to §1.448-1T(e)(4)(iii).
[71] Joint Statement, 31, n.46, referring to §1.448-1T(e)(4)(iv).
[72] Reg. §1.448-1T(e)(4)(B) Ex. 1.
[73] Reg. §1.448-1T(e)(4)(B) Ex. 2.
[74] *Rainbow Tax Services, Inc. v. Commissioner*, 128 T.C. 42 (2007).

that prepared tax returns and financial statements was not only considered to be performing services in the field of accounting, but administrative and support services that were incidental to those activities were considered part of that trade or business. On the other hand, services of that corporation in renting and maintaining a leased portion of an office building that it owned, as well as administrative and support services performed with respect to those leasing activities, were services in a field that was not accounting.[75]

Perhaps the hardest test in determining whether a business is a specified service trade or business will be deciding if the principal asset of that trade or business is the reputation or skill of one or more of its employees or owners. PLR 201717010 said that a company with expertise in certain laboratory testing that had employees who, other than the laboratory director, were not considered healthcare professionals was not engaged in a trade or business where the principal asset is the reputation or skill of one or more of its employees.[76] The Tax Court held in a 2012 case[77] that even though the success of an insurance business that sold prepaid legal service policies was due to the efforts of its two owners, the principal asset of that trade or business was its training and organizational structure and not the reputation or skill of its owners because most of the policies were sold by independent contractors, including the two owners in their capacities as commission salesmen.[78] In PLR 201436001, the IRS ruled that a company engaged in research, development, manufacture, and commercialization of experimental drugs that used manufacturing and intellectual property assets to create value for customers did not perform services in the health industry within the meaning of §1202(e)(3) nor was it "in the business of offering service in the form of individual expertise." [79]

Depending on how the IRS decides to apply this "principal asset" standard, this could be the hardest standard for even a non-specified service trade or business to meet. For instance, could a business with a reputation for providing unique landscaping or lawn services based on the skills of its highly trained employees or owners be considered a specified service trade or business using this standard? [80] If so, then many non-specified service trades or businesses could be trapped by the specified service business net.

Further Guidance Needed: One of the major questions raised is how the IRS will determine whether a service business is a specified service trade or business. The definition of a specified service trade or business in §199A(d)(2)(A) refers to §1202(e)(3)(A). That section states that a non-qualified business for purposes of §1202 is "any trade or business involving the performance of services" in the prohibited fields. If the IRS chooses to interpret those words literally, then a trade or business that performs any prohibited services could be a specified service trade or business.[81] On the other hand, if the IRS adopts the substantial activity standard of Temp. Reg. §1.448-1T(e)(4)(i), then the performance of services in a prohibited field would be substantial "only if 95 percent or more of the time spent by employees of the" trade or business were spent providing services in that prohibited field. Time spent by employees in providing incidental services to a prohibited business (typing, administrative tasks, etc.) would be counted as part of time spent in the prohibited field. Future guidance in this area is necessary.

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[75] Reg. §1.448-1T(e)(5)(vii) Ex. 1(ii).
[76] PLR 201717010.
[77] *Owen v. Commissioner*, T.C. Memo 2012-21.
[78] Ruth M. Wimer, *Tax Reform: Form W-2 Significance for Pass-through 20% Section 199A Deduction*, 10 Daily Tax Rep. J-1 (Jan. 16, 2018).
[79] PLR 201436001.
[80] This thought was expressed in Avi-Yonah et al., "The Games They Will Play: An Update on the Conference Committee Tax Bill," n. 58, above.
[81] *Id.*

There have also been discussions about businesses splitting off a portion of their activities in order to separate a non-specified service trade or business from a specified service trade or business. For example, a medical partnership that owns its own building and that leases that building to other unrelated tenants may consider putting that building into another partnership so that the net rental income from that building is considered QBI. Will this work? The answer may depend upon whether leasing that building is considered a separate trade or business. If significant services are provided to unrelated tenants, then the leasing activity may meet the regular, continuous, and substantial activity tests necessary to be a trade or business. Based on the examples contained in Reg.§1.448-1T, merely splitting out administrative and support services that are incidental to a prohibited field will probably not establish a separate trade or business.

Whether certain trades or businesses are specified service trades or businesses will be one of the issues tax practitioners will have to grapple with over the next several years.

Exception for Specified Service Businesses Based on Taxable Income

If a taxpayer's taxable income before the §199A(a) deduction is less than a threshold amount, then the exclusion of a specified service trade or business from the definition of a qualified trade or business does not apply.[82] The threshold amount is $157,500 in the case of a single individual or $315,000 (200% of $157,500) in the case of a joint return.[83] These threshold amounts will be increased for taxable years beginning after 2018 for an inflation adjustment.[84]

This taxable income threshold may effectively transform certain service businesses that would be qualified trades or businesses into specified service trades or businesses that would result in total or partial disallowance of any §199A deduction. Tax advisors may devise strategies to prevent this conversion of QBI into non-QBI by generating additional deductions that reduce the taxpayer's taxable income (paying wages to relatives, establishing defined benefit pension plans, acquiring necessary equipment that qualifies for the §179 election to expense depreciable property, and/or the additional allowance for depreciation described in §168(k), etc.). These are traditional tax planning strategies that should accomplish their purpose if properly executed.

There is also a rule whereby a specified service trade or business can be a partially qualified trade or business based on a taxpayer's taxable income before the §199A(a) deduction. Under that rule, a taxpayer's share of a specified service trade or business's qualified items of income, gain, deduction, or loss and the taxpayer's share of that business's W-2 wages and unadjusted basis immediately after acquisition of qualified property are taken into account in computing that business's deductible §199A(a) amount only to the extent of the "applicable percentage" of those amounts.[85] The applicable percentage for a taxpayer's taxable year is 100% reduced (but not below zero) by a percentage equal to the ratio of the amount of the taxpayer's taxable income before the §199A(a) deduction in excess of the threshold amount bears to $50,000 ($100,000 in the case of a joint return).[86]

Example
Henry is a married doctor who has the following items applicable to his medical practice: $100,000 of qualified business income, $200,000 of W-2 wages, and

[82] §199A(d)(3)(A)(i).
[83] §199A(e)(2)(A).
[84] §199A(e)(2)(B).
[85] §199A(d)(3)(A).
[86] §199A(d)(3)(B).

$60,000 of unadjusted basis immediately after acquisition of qualified property. The joint tax return of Henry and his wife indicate a taxable income before the §199A deduction of $365,000. The amount of this taxable income before the §199A deduction of $365,000 exceeds the threshold amount of $315,000 by $50,000. This excess amount bears a ratio of .5 to 1 to $100,000, the phase-out amount for a joint return. The percentage equal to this ratio is 50%. Thus only 50% (100% minus 50%) of Henry's qualified business income, W-2 wages, and unadjusted basis immediately after acquisition of qualified property are taken into account in computing Henry's QBI deduction with respect to his medical practice.[87]

Qualified Business Income

After it is determined that a taxpayer has one or more qualified trades or businesses or partially qualified trades or businesses, the QBI for each qualified trade or business of the taxpayer must be determined. In general, a taxpayer's QBI for a trade or business is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.[88] All qualified items of income, gain, deduction, and loss must either be included in or allowed as deductions in computing a taxpayer's taxable income for the year.[89] This provision reaffirms the rule that QBI for a trade or business is computed after application of: (1) the basis limitation rules for partnerships and S corporations; (2) the §465 at-risk rules; and (3) the passive activity loss rules of §469. Furthermore, items of income, gain, deduction, and loss are characterized as qualified items only to the extent those items are effectively connected with the conduct of a trade or business within the United States as determined under the rules of §864(c).[90] If a taxpayer has QBI from sources within Puerto Rico that is taxable under §1, that income shall be considered as effectively connected with the conduct of a trade or business within the United States if it would be treated as such under the rules of §864(c).[91] For purposes of determining alternative minimum taxable income, no adjustments to regular taxable income specified in §56–§59 are made to QBI.[92]

QBI does not include any reasonable compensation paid to the taxpayer by a qualified trade or business for services rendered to that business.[93] The IRS is authorized by §1366(e) to increase the compensation of shareholders of a family-owned S corporation to amounts that are considered reasonable compensation for services rendered if those shareholders did not receive compensation for the value of their services. The IRS may also reclassify any loans from an S corporation to shareholders as wages if those loans represent reasonable compensation to the employeeshareholder.[94] If S corporation distributions or loans to shareholders are considered reasonable compensation to shareholders, then QBI of the S corporation's trade or business would be reduced.

QBI also does not include any guaranteed payments to a partner described in §707(c) that are paid to a partner for services rendered to a qualified trade or business.[95] Some advisors might suggest that partners who receive guaranteed payments from a partnership that generates QBI may increase their distributive share of QBI from that partnership by foregoing their guaranteed payments in exchange for a priority allocation of partnership profits in the form of a preferred

[87] This example is based on the one found in the Joint Statement, 36, Ex. 1.
[88] §199A(c)(1).
[89] §199A(c)(3)(A)(ii).
[90] §199A(c)(3)(A)(i).
[91] §199A(f)(1)(C)(i).
[92] §199A(f)(2).
[93] §199A(c)(4)(A).
[94] *Joly v. Commissioner*, T.C. Memo 1998-361, *aff'd*, 211 F.3d 1269 (6th Cir. 2000).
[95] §199A(c)(4)(B).

return. Because this priority allocation of partnership profits is a distributive share of partnership profits, it should be QBI. This seems like a reasonable strategy. However, anyone adopting this strategy should consider that, in the case of a family partnership, any portion of a partner's distributive share of partnership income that is determined to be reasonable compensation for services under §704(e) could be considered a §707(c) guaranteed payment that would reduce QBI. A partner that currently receives a guaranteed payment who is considering this strategy may wish to consider that he or she may be giving up a payment that is certain in exchange for an uncertain amount of profits that will only increase a 20% deduction — i.e., he or she may be exchanging a dollar for 20 cents.

A partner may also receive partnership distributions that are considered payments to that partner for services rendered to a partnership under §707(a). These amounts are not, to the extent to be provided in future regulations, QBI.[96] This provision could result in a partner's QBI being reduced if the partner is determined to have engaged in a disguised sale with a partnership that was not reported as a sale for income tax purposes.

QBI does not include any qualified REIT dividends or qualified publicly traded partnership income.[97] A qualified REIT dividend is a dividend received from a real estate investment trust that is neither a capital gain dividend (as defined in §857(b)(3)) nor qualified dividend income (as defined in §1(h)(11)).[98] Because capital gain dividends and qualified dividend income are subject to preferential rates of 0%, 15%, or 20%,[99] including capital gain distributions or qualified REIT dividends in QBI would result in giving a taxpayer a double tax benefit.

For purposes of §199A, qualified publicly traded partnership income of a taxpayer includes the sum of: (1) the net amount of the taxpayer's allocable share of each item of QBI of a publicly traded partnership that is not a corporation, plus (2) any gain recognized by the taxpayer from a sale or disposition of the taxpayer's interest in the publicly traded partnership that is treated as ordinary income under §751(a).100 The QBI of a publicly traded partnership is determined after applying the rules of §199A(c)(4) for partnership guaranteed payments and payments to partners for services rendered to the partnership.[101]

As noted in the first paragraph under the caption in this article titled ''Combined Qualified Business Income Amount,'' the second amount in the Combined Qualified Business Amount is 20% of a taxpayer's aggregate amount of qualified REIT dividends and qualified publicly traded partnership income. Tax professionals have suggested that individuals owning interests in specified service trades or businesses that own and lease buildings to those businesses may increase their §199A deduction by forming a REIT. Those professionals would then become beneficial owners of that REIT after transferring their buildings to the REIT in exchange for shares or certificates of beneficial interest in the REIT. The businesses would then lease the buildings from that REIT for a large amount of rent.[102] This strategy may have limited application because a REIT may be very expensive to form and is subject to requirements that it not be closely held[103] and that it have beneficial ownership of at least 100 persons.[104]

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[96] §199A(c)(4)(C).
[97] §199A(c)(1).
[98] §199A(e)(3).
[99] §1.
[100] §199A(e)(4).
[101] §199A(e)(4)(A).
[102] Avi-Yonah et al., ''The Games They Will Play: An Update on the Conference Committee Tax Bill,'' n.58, above.
[103] §856(a)(6).
[104] §856(a)(5).

QBI and Investment Income

Because QBI consists of items of business income, gains, losses, and deductions, the following items are excluded from QBI.

- Short-term capital gains and losses and long-term capital gains and losses.[105] It should be noted that any income under §1245, §1250, §1252, §1253, §1254, and other sections that is treated as ordinary income and that is attributable to a qualified trade or business should be included in QBI as a qualified item of gain. On the other hand, any loss treated as an ordinary loss under §1231 is probably an item of loss that reduces QBI if that loss is attributable to a qualified trade or business. A §1231 gain that is ultimately taxed as a long-term capital gain would seem to be excluded from QBI. Based on §199A(e)(5)(B), gain from the sale or exchange of a partnership interest that is treated as ordinary income under §751(a) should also be QBI because it would seem to be attributable to ordinary income assets of a qualified trade or business.

- Any dividends, including any payments in lieu of dividends that are made pursuant to an agreement to which §1058 applies. Patronage dividends described in §1385(a)(1) are not dividends described in this exclusion.[106]

- Interest income that is not properly allocable to a trade or business.[107] An example of interest income properly allocable to a trade or business would be interest on accounts receivable from the sale of property in the ordinary course of a trade or business that customarily extends credit to customers and charges interest on past-due accounts receivable.

- Excess of gains over losses from transactions in commodities. This exclusion from QBI does not apply to gains or losses arising out of commodity hedging transactions that are active business gains or losses from the sale of commodities, but only if substantially all of the commodities of the qualified trade or business are: (1) supplies described in §1221(a)(8) that are regularly used or consumed in the ordinary course of the qualified trade or business; (2) inventory or property held primarily for sale described in §1221(a)(1); or (3) real property or depreciable property used in the qualified trade or business that is described in §1221(a)(2).[108]

- Excess of foreign currency gains over foreign currency losses (as defined in §988(b) that are attributable to §988 transactions unless those transactions are directly related to the business needs of the qualified trade or business.[109]

- Any item of income, gain, deduction, or loss from notional principal contracts taken into account under §954(c)(1)(F) (determined without regard to clause (ii) thereof) and other than items attributable to notional principal contracts entered into as clearly identified hedging transactions that are treated as ordinary income assets rather than capital assets under §1221(a)(7).[110]

- Any amounts received from annuities that are not used in connection with the qualified trade or business.[111]

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[105] §199A(c)(3)(B)(i).
[106] §199A(c)(3)(B)(ii).
[107] §199A(c)(3)(B)(iii).
[108] §199A(c)(3)(B)(iv).
[109] *Id.*
[110] §199A(c)(3)(B)(v).
[111] §199A(c)(3)(B)(vi).

- Any item of deduction or loss that is properly allocable to any of the amounts described in any of the preceding seven items.[112]

The QBI concept is different from the Excess Business Loss concept of §461(l). A taxpayer's Excess Business Loss is calculated by offsetting the aggregate deductions of all of a taxpayer's trades or businesses against the aggregate gross income or gain attributable to those trades or businesses.[113] QBI excludes capital gains that are attributable to a qualified trade or business. For purposes of §461(l), capital gain attributable to a trade or business is "gain" that reduces a taxpayer's Excess Business Loss.

Other Rules for QBI

A taxpayer may have more than one qualified trade or business and one of those qualified trades or businesses may have a loss for the taxable year. If so, that loss is to be multiplied by 20% and offset against the §199A(b)(2) deductible amount of the profitable qualified trades or businesses. This treatment is indicated by one of the examples in the in the Joint Statement concerning §199A.[114] It is also indicated by the definition of QBI, which states that QBI is the net amount of the qualified items of income, gain, deduction, or loss for any qualified trade or business of the taxpayer.[115] Following the rules of §199A(b)(2)(A), the qualified trade or business's loss is to be multiplied by 20%. Because this loss will be a negative number, it will be less than the greater of the W-2 Wages Limit or the W-2 Wages/Property Limit, which will either be zero or a positive number. Because the deductible QBI amount for any trade or business is the lesser of (1) 20% of QBI for that qualified trade or business or (2) the greater of (a) 50% of the qualified trade or business's W-2 wages or (b) 25% of that business's W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of qualified property, the negative 20% of QBI will necessarily be the lower than zero or any positive amount.

Application to Example: In the example in Worksheet 2, LLC No. 3 is a qualified trade or business of the taxpayers that has a loss of ($39,000) for the taxable year. Multiplying that amount by 20% yields a 20% of QBI amount of ($7,800), which is less than the amounts computed under the W-2 Wages Limit and the W-2 Wages/Property Limit. At the bottom of the example, this negative 20% of QBI from LLC No. 3 is offset against the sum of the 20% deductible amounts for the other profitable qualified trades or businesses of the taxpayer in the calculation of the Aggregate Deductible Amount for a taxpayer's qualified trades or businesses.

There is a rule for carryover of losses. That rule states that if the net amount of qualified items of income, gain, deduction, and loss of qualified trades or businesses of a taxpayer for a taxable year is less than zero, that net amount is to be treated as a loss from a qualified trade or business in the following year.[116]

> *Example*
>
> A taxpayer with two qualified trades or businesses has QBI of $10,000 from one of those businesses and a qualified business loss of ($20,000) from the other qualified trade or business. This taxpayer has taxable income before the QBI deduction of $100,000 for the taxable year. No limitations apply in determining the taxpayer's deductible amount for each trade or business. The net amount of QBI from all of the

[112] §199A(c)(3)(B)(vii).
[113] §461(l)(3)(A).
[114] Joint Statement, 29.
[115] §199A(c)(1).
[116] §199A(c)(2).

taxpayer's qualified trades or businesses ($10,000) is less than zero. The taxpayer is not allowed a QBI deduction.[117] The taxpayer has a carryover of a qualified business loss of ($10,000), which is calculated by offsetting the qualified business loss ($20,000) from one business with the QBI of $10,000 for the other business. In the following year, one business has QBI of $20,000 and the other business has QBI of $30,000. The taxpayer's taxable income before the §199A deduction is $125,000. There are no limitations that apply in determining the taxpayer's deductible amount for each trade or business. To calculate the QBI deduction for the following year, 20% of the QBI of $50,000 for both businesses is offset by 20% of the $10,000 carryover of a qualified business loss.[118]

In effect, the carryover business loss is treated as a qualified business loss from a separate qualified trade or business. This same treatment applies when a taxpayer has QBI from one or more qualified trades or businesses and qualified business losses from one or more trades or businesses in the same year.

W-2 Wages Limit And W-2 Wages/Property Limit

The §199A deductible amount for each trade or business is limited to the greater of two amounts that the author has named the W-2 Wages Limit and the W-2 Wages/Property Limit. The W-2 Wages Limit is 50% of the W-2 wages with respect to the qualified trade or business.[119] The W-2 Wages/Property Limit is the total of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property of that qualified trade or business.[120] Neither of these limits apply to a taxpayer with taxable income before the QBI deduction that does not exceed a threshold amount of $157,500 in the case of a single individual or $315,000 (200% of $157,500) in the case of a joint return.[121]

W-2 Wages

The W-2 wages taken into consideration include only W-2 wages that are properly allocable to the QBI of the qualified trade or business for which the deductible amount under §199A(b)(2) is being determined.[122] This rule will be fairly easy to follow in the case of a sole proprietorship that is reported on a separate tax return schedule. Partnerships and S corporations that engage in multiple activities that they have not elected to treat as one activity are required to furnish each partner with a schedule of activities with their Form 1065 or Form 1120S Schedule K-1. Each partner or shareholder is considered as having W-2 wages equal to that person's "allocable share of the W-2 wages" of the partnership or S Corporation.[123] A partner's or a shareholder's allocable share of W-2 wages is to be determined in the same manner as that owner's allocable share of the entity's wage expenses.[124]

An S corporation shareholder's allocable share of an S corporation's wage expenses would be that shareholder's pro rata share of those expenses, which is calculated under the provisions of §1377(a)(1). Under these provisions, each shareholder's share of the S corporation's wage expense would be

[117] This example is based on one in Joint Statement, 29.
[118] *Id.*
[119] §199A(b)(2)(B)(i).
[120] §199A(b)(2)(B)(ii).
[121] §199A(b)(3)(A), §199A(e)(2)(A).
[122] §199A(b)(4)(B).
[123] §199A(f)(1)(A)(iii).
[124] §199A(f)(1)(A).

calculated by: (1) assigning an equal portion of the wage expense to each day in the taxable year; (2) dividing that portion pro rata among the S corporation's shares of stock outstanding on that particular day; and (3) then totaling those daily amounts for each shareholder.[125]

A partner's allocable share of a partnership's wage expense is normally determined by the partnership agreement.[126] As a result, a partner's allocable share of a partnership's wage expense may be determined by special profit and loss allocation provisions contained in the partnership agreement. However, a partner's share of a partnership's allocable wage expense could be determined in accordance with a partner's interest in the partnership, taking into account facts and circumstances, if the partnership agreement either does not provide for the partner's share of partnership wage expense or the allocation of wage expense under the provisions in the partnership agreement does not have substantial economic effect as described in the §704(b) regulations.[127] The parenthetical phrase "(as determined under regulations prescribed by the Secretary)" that is contained in §199A(f)(1)(A)(iii) may indicate that the IRS will prescribe regulations in this area.

The term "W-2 wages" is defined by §199A(b)(4)(A) and includes amounts described in §6051(a)(3) and §6051(a)(8) paid by a taxpayer or pass-through entity with respect to the employment of employees by that person or entity during the calendar year that ends during the taxpayer's taxable year.[128] The wages described in §6051(a)(3) are wages defined by §3401(a), which basically include all amounts paid by employers to employees for services rendered by those employees in their employee capacities. There are a number of exclusions from the term "wages" contained in §3401(a).[129] If a taxpayer has QBI from Puerto Rico sources that is taxable under §1 for a taxable year and is considered effectively connected with a U.S. trade or business, the taxpayer's W-2 wages with respect to any qualified trade or business conducted in Puerto Rico are to be calculated without regard to any exclusion under §3401(a)(8) for remuneration paid for those services in Puerto Rico.[130] The wages described in §6051(a)(8) include amounts that are elective deferrals under §402(g)(3) (these deferrals include §401(k) cash or deferred arrangements, a §403(b) salary reduction arrangement, and other salary reduction plans described in §402(g)(3)), §457 deferred compensation arrangements, and designated contributions to a qualified Roth contribution program described in §402A.[131] The term "W-2 wages" is not to include any amounts that are not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date, including extensions, for that return.[132]

In general, the IRS is supposed to issue regulations concerning how to apply §199A(b) for short taxable years as well as for acquisitions or dispositions by a taxpayer of either a major portion of a trade or business or a major portion of a separate unit of a trade or business.[133] However, Joint Statement concerning §199A did express its intentions as to how certain amounts contained in the definition of W-2 wages are to be treated for a short taxable year.[134] Generally, the intention expressed in that Joint Statement is that only those wages actually paid to employees of the qualified trade or business during the short taxable year are to be treated as W-2 wages. In addition, only §402(g)(3) elective deferrals actually made by the qualified trade or business's employees during the short taxable year are to be considered W-2 wages. Similarly, W-2 wages should only include compensation that is actually deferred

[125] §1377(a)(1).
[126] §704(a).
[127] §704(b)(1)–§704(b)(2).
[128] §199A(b)(4)(A).
[129] This description may also be found in Kehl, *Practical Guide to the Sec. 199 Deduction*, p. 45.
[130] §199A(f)(1)(C)(ii).
[131] §6051(a)(8).
[132] §199A(b)(4)(C).
[133] §199A(b)(5).
[134] Joint Statement, 32, n.51.

under §457 during the short taxable year concerning employees of the qualified trade or business. Finally, the Joint Statement's intention is that any amounts considered W-2 wages for a short taxable year are not to be considered W-2 wages for any other taxable year.[135]

These rules are very similar to the rules contained in the recently repealed §199(b)(2) concerning the former Domestic Production Activities Deduction.[136] There are similarities between former §199(b)(2) and §199A(b)(4).[137] The definition of the term "W-2 wages" found in §199A(b)(4)(A) is basically the same as the definition of that term found in §199(b)(2)(A). W-2 wages for purposes of the former Domestic Production Activities Deduction had to be allocable to Domestic Production Gross Receipts.[138] W-2 wages for purposes of the §199A deduction must be allocable to QBI.[139] Finally, W-2 wages for purposes of both deductions had to be properly includable on a return filed with the Social Security Administration.

Further Guidance Needed: One area that could also generate some controversy concerns the requirement of §199A(b)(4)(A) that W-2 wages be "paid" by the taxpayer for the employment of employees. For purposes of former §199, employees of the taxpayer were those described in §3121(d)(1), which are corporate officers, and §3121(d)(1), which are individuals that have the status of employees under the common law rules that apply in determining employeremployee relationships.[140] Under the former §199 regulations, a taxpayer was permitted to determine W-2 wages by taking "into account any wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer."[141] If the taxpayer was treated as the employer merely because the taxpayer controlled the payment of wages and was not the common law employer, the taxpayer could not consider the wages as §199(b)(2) W-2 wages.[142] Similarly, if the taxpayer paid W-2 wages as the agent of some other entity to persons who were not the taxpayer's employees, those wages were not W-2 wages.[143] Hopefully, similar rules will be enacted for purposes of §199A. These rules could enable taxpayers that use a common paymaster for payment of wages but who are the common law employers of those employees to still have W-2 wages for purposes of §199A.

Many taxpayers that own qualified trades or businesses in controlled entities that are subject to this W-2 Wages Limit may already be planning to maneuver wages among those entities in order to avoid or minimize the limitations imposed on each qualified trade or business by §199A(b)(2)(B). The IRS is already empowered by §482 to make any reallocations that it deems necessary to clearly reflect income of the various trades or businesses. In addition, the IRS is also authorized by §199A(f)(4) to issue regulations that restrict the allocation of wages among entities to the extent the IRS deems those restrictions appropriate.

One can surmise that payment of W-2 wages to individuals is preferred for purposes of the QBI deduction over paying individuals as independent contractors. Many of these independent contractors may actually be employees under the control tests previously mentioned, so reclassification of these individuals as employees may result in a more accurate designation of their status.

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[135] *Id.*
[136] This was pointed out in Wimer, *Tax Reform: Form W-2 Significance for Pass-through 20% Section 199A Deduction*.
[137] *Id.* The rules under former §199(b)(2) and accompanying regulations were also discussed by Kehl, *Practical Guide to the Sec. 199 Deduction*, Chapter 3.
[138] §199(b)(2)(B).
[139] §199A(b)(4)(B).
[140] Reg. §1.199-2(a)(1).
[141] Reg. §1.199-2(a)(2).
[142] *Id.*
[143] *Id.*

Guaranteed payments to partners for services rendered are not W-2 wages. However, an S Corporation may pay wages to its shareholder-employees and have those amounts paid considered W-2 wages.[144] In addition, those S Corporations can also create W-2 wages by paying salaries to the spouses of owners and to other relatives. This was a technique employed to create wages under the now repealed §199.[145] Because incorporation of a sole proprietorship as an S Corporation has historically been a "plain vanilla" standard transaction, it is difficult to see any forthcoming regulations that would prevent this technique from being utilized in the future.

There have been discussions concerning the use of holding partnerships and operating partnerships in order to generate W-2 wages for partners instead of guaranteed payments for services rendered. In a simplified version of this scenario, the working partners who received §707(c) guaranteed payments for services would contribute their interests in the operating partnership (operating partnership) to a new partnership (holding partnership). Holding partnership would then become the partner in operating partnership. Because the working partners who formerly received guaranteed payments for services rendered would no longer be partners in operating partnership, the amounts paid to those individuals would be amounts paid to employees that would theoretically qualify as W-2 wages for purposes of §199A(b)(2)(B)(i). Would this scenario work? At this point, no one knows for sure. The statute states that the IRS is to prescribe regulations necessary to carry out the purposes of §199A, including regulations for the application of §199A in cases involving tiered entities.[146] This is in addition to the statutory mandate that the IRS is to issue regulations necessary to carry out the purposes of §199A that are to include regulations that restrict the allocation of wages. Anyone contemplating plans of this nature should take into consideration the possibility of future regulations that may restrict or limit the desired tax benefits.

Unadjusted Basis Immediately After Acquisition of Qualified Property

This definition is also being widely discussed by tax professionals. It was apparently enacted at the last minute so that owners of pass-through entities that are qualified trades or businesses that pay no W-2 wages, but own a large amount of fixed assets, may receive a §199A deduction. The example in the Conference Agreement seemed to indicate this.[147] Real estate entities that are qualified trades or businesses that pay management fees rather than W-2 wages may fit this description.

For purposes of §199A, qualified property is tangible property that is also depreciable property.[148] Qualified property must satisfy the following conditions: 1) the property must be held by and available for use in the qualified trade or business at the close of the taxable year;[149] 2) the property must be used at any point during the taxable year in the production of QBI;[150] and 3) the property's depreciable period, as defined by §199A(b)(6)(B), must not have ended before the close of the taxable year.[151] Apparently, the second requirement is satisfied if the property is used in the production of QBI for only the final days of a taxable year. Congress was also apparently concerned that businesses with a substantial amount of fixed assets with short MACRS recovery periods would not be able to include those assets in qualified property if the definition of a property's depreciable period was that property's MACRS recovery period. For that reason, §199A(b)(6)(B) defines the depreciable period for qualified property as the period that begins on the date the property was first placed in service by the taxpayer and ends on the date that is either

[144] Wimer, *Tax Reform: Form W-2 Significance for Passthrough 20% Section 199A Deduction*.
[145] Kehl, *Practical Guide to the Sec. 199 Deduction*, p. 47.
[146] §199A(f)(4)(B).
[147] Joint Statement, 38.
[148] §199A(b)(6)(A).
[149] §199A(b)(6)(A)(i).
[150] §199A(b)(6)(A)(ii).
[151] §199A(b)(6)(A)(iii).

1) 10 years after the placed-in-service date or 2) the last day of the last full year in the applicable recovery period for the property under §168, whichever date is later.[152] The last full day in the qualified property's applicable recovery period is to be determined without regard to any recovery periods that are part of the Alternative Depreciation System described in §168(g).[153] Taxpayers using the MACRS recovery period as the depreciable period for qualified property because the MACRS recovery period ends after the tenth anniversary of the property's placed in service date should note that this period ends with "the last full year in the applicable recovery period."[154] Similar to W-2 wages, each partner and S corporation shareholder is treated as having an amount of unadjusted basis immediately after acquisition of qualified property for the taxable year equal to that person's allocable share of the partnership's or S corporation's unadjusted basis immediately after acquisition of qualified property for the taxable year.[155] This amount is to be determined under future regulations.[156] However, the statute does contain one guideline for determining a partner's or an S corporation shareholder's allocable share of the partnership's or S corporation's unadjusted basis immediately after acquisition of qualified property for the taxable year. For an S corporation shareholder, this allocable share is to be determined in the same manner as the shareholder's allocable share of the S corporation's depreciation expense for the year.[157] Because an S corporation shareholder's allocable share of the S corporation's depreciation expense is that shareholder's pro rata share of that item as determined under the rules of §1377(a)(1), a shareholder's allocable share of the S corporation's unadjusted basis immediately after acquisition of qualified property is also that shareholder's pro rata share of that item as determined under the rules of §1377(a)(1).[158] Those rules were briefly described above under the caption titled "W-2 wages."

A partner's allocable share of the partnership's unadjusted basis immediately after acquisition of qualified property for the taxable year is also that partner's allocable share of the partnership's depreciation expense.[159] A partner's distributive share of a partnership's depreciation expense is also determined by provisions, including special allocation provisions, in the partnership agreement.[160] However, a partner's allocable share of a partnership's depreciation expense could also be determined in accordance with the partner's interest in the partnership if the partnership agreement either is silent concerning the allocation of depreciation expense or if the allocation of depreciation expense in the partnership agreement does not have the substantial economic effect required by §704(b) and its regulations. However, if any property contributed to the partnership by a partner has a tax basis to the partnership that is different than the contributed property's fair market value on the date of the partner's contribution, then a partner's share of the partnership's depreciation expense for a taxable year must be determined in accordance with the rules of §704(c) and Reg. §1.704-3. These include the rules for making §704(c) allocations contained in Reg. §1.704-3(b), §1.704-3(c), and §1.704-3(d), depending upon whether the traditional method, the traditional method with curative allocations, or the remedial allocation method for allocating depreciation expense among its partners has been elected by the partnership. If built-in loss property has been contributed by a partner to a partnership, then a partner's share of depreciation expense with respect to that built-in loss property may have to take the provisions of §704(c)(1)(C) into consideration.[161] All of the partnership rules that affect the determination of a partner's allocable

[152] §199A(b)(6)(B)(i)–§199A(b)(6)(B)(ii).
[153] §199A(b)(6)(B)(ii).
[154] *Id.*
[155] §199A(f)(1)(A)(iii).
[156] *Id.*
[157] §199A(f)(1)(A).
[158] *Id.*
[159] *Id.*
[160] §704(a).
[161] Prop. Reg. §1.704-3, REG-144468-05, 79 Fed. Reg. 3042 (Jan. 16, 2014).

share of a partnership's depreciation expense could affect the determination of a partner's allocable share of a partnership's unadjusted basis immediately after acquisition of qualified property.

There have been discussions about shifting property among entities in order to cope with the limit on a qualified trade or business's QBI deduction enunciated by §199A(b)(2)(B)(ii). There are anti-abuse rules contained in §199A that direct the IRS to apply rules that are similar to the provisions of §179(d)(2) for the purpose of preventing the manipulation of the depreciable period of qualified property by engaging in related party transactions.[162] The provisions of §179(d)(2) define a purchase of property for purposes of the §179 election to expense certain qualified property acquired for use in the active conduct of a trade or business. That paragraph excludes from the definition of purchase any acquisition of property from a related person that would result in a disallowance of losses under either §267 or §707(b).[163] In speculating on a similar regulation for §199A, it is not too hard to imagine that acquisitions of property from a related party described in §267(b) or §707(b) would be excluded from a taxpayer's unadjusted basis immediately after acquisition of qualified property for the taxable year. These regulations could also enact a rule similar to the rule of §179(d)(2)(C), which states that a purchase for purposes of §179 does not include the acquisition of property if the basis for that property is determined in whole or in part by the adjusted basis of that property in the hands of the person from whom it is acquired,[164] or if the basis of the property in the hands of the person acquiring the property is determined under the rules of §1014(a).[165]

Further Guidance Needed: The future §199A regulations may exclude property acquired under either of these situations from the unadjusted basis immediately after acquisition of qualified property for the taxable year. Any strategies that involve increasing the unadjusted basis immediately after acquisition of qualified property to its fair market value if that property is acquired from a decedent through inheritance should take into consideration the possibility of that increase in value being excluded from the unadjusted basis immediately after acquisition of qualified property by future IRS regulation. This caveat could also apply to any strategy involving a §754 election for an inherited interest in a partnership owning qualified property.

A concern has also arisen as to whether the unadjusted basis immediately after acquisition of qualified property may have to be reduced by the amount of that qualified property that the taxpayer has elected to expense under §179 and/or by the additional allowance for depreciation described in §168(k) taken on that property. This concern apparently arose from the definition of "unadjusted basis" contained in Prop. Reg. §1.168-2(d), which basically states that the unadjusted basis of an item of recovery property is its basis for determining gain under §1011–§1016 without regard to any adjustments for depreciation taken that are described in §1016(a)(2) and §1016(a)(3) minus any portion of the basis for which a taxpayer has elected to take §167(k) amortization or to expense under §179. The other source cited for the definition of the term "unadjusted basis" is the definition contained in IRS Publication 946, which is in the Glossary of terms section of that publication. That definition states that unadjusted basis is the basis of an item for purposes of figuring gain on sale that does not take into consideration depreciation taken in prior years but is adjusted for §179 depreciation and any special depreciation allowance, among other items.[166]

This concern does not seem to take certain matters into consideration. First, the definition of "unadjusted basis" in Prop. Reg. §1.168-2(d) is a definition for computing MACRS recovery depreciation and is not necessarily relevant to the §199A concept of unadjusted basis immediately after acquisition of qualified

[162] §199A(h)(1).
[163] §179(d)(2)(A).
[164] §179(d)(2)(C)(i).
[165] §179(d)(2)(C)(ii).
[166] IRS Publication 946, *How to Depreciate Property*, p. 111.

property. Second, the definition of unadjusted basis in IRS Publication 946 is for the purpose of determining gain on sale. It also does not seem to be relevant to §199A. The third and perhaps most important consideration is that §199A(b)(2)(B)(ii) states that the Property Limit is a percentage of "the unadjusted basis immediately after acquisition of all qualified property." The §179 election is an election that is made with the taxpayer's return. Similarly, §168(k) bonus depreciation is taken on a taxpayer's return for the year qualified property is placed in service. However, §199A(b)(2)(B)(ii) states that qualified property's unadjusted basis is "immediately after acquisition." Neither the §179 election nor the special allowance for depreciation has been taken with respect to an item of qualified property "immediately after acquisition." For that reason, it seems that the phrase "immediately after acquisition" should prevent a qualified property's unadjusted basis from being reduced by any §179 depreciation or bonus depreciation. Section 199A(b)(2)(B)(ii) definitely provides an incentive to qualified businesses to acquire and own depreciable property rather than lease it. As has been pointed out elsewhere, the 20% deduction for QBI will not be limited for a business that pays no W-2 wages as long as it owns qualified depreciable assets with an unadjusted basis immediately after acquisition in an amount that is sufficient to not limit the deduction.[167]

The anti-abuse rules of §199A(h) also contain a mandate to the IRS to set down rules for determining the unadjusted basis immediately after acquisition for any qualified property that is acquired in involuntary conversions or like-kind exchanges.[168] There could also be future regulations that restrict the transfer of property between related parties in order to avoid the limitation of a qualified business's 20% of QBI amount.

W-2 Wages Limit Amount and W-2 Wages/Property Limit Amount in Example

In Worksheet 2, for the Sample client, the W-2 Wages Limit Amount for the qualified trade or business of LLC No. 1 is 50% of the $1.625 million of W-2 wages allocated to that qualified trade or business and results in a W-2 Wages Limit Amount of $812,500. The W-2 Wages/Property Limit Amount for that trade or business is 25% of the $1.625 million of W-2 wages, or $406,250, plus 2.5% of the unadjusted basis immediately after acquisition of qualified property of $325,000, or $8,125, and results in a W-2 Wages/Property Limit Amount of $414,375. The W-2 Wages Limit Amount of $812,500 exceeds the total W-2 Wages/Property Limit Amount of $414,375 and is therefore the limitation on the §199A deductible amount for LLC No. 1's qualified trade or business. Because the 20% of QBI amount of $50,400 is less than the W-2 Wages Limit Amount for LLC No. 1 of $812,500, the deductible amount for LLC No. 1's qualified trade or business is $50,400.

The deductible amount for LLC No. 2's qualified trade or business is limited to that business's W-2 Wages Limit Amount because the W-2 Wages Limit Amount of $10,000, which is greater than the W-2 Wages/Property Limit Amount for that trade or business of $5,475, is less than the 20% of QBI Amount for that trade or business of $14,200. Therefore, the deductible amount for the trade or business of LLC No. 2 is $10,000.

The deductible amount for LLC No. 3's qualified trade or business results in a reduction of the taxpayer's Combined Qualified Business Income Amount. This reduction by 20% of the amount of a loss is an application of the mechanics for computing the §199A deduction and is appropriate because, in the case of a taxpayer subject to either the W-2 Wages Limit Amount or the W-2 Wages/

[167] Wimer, *Tax Reform: Form W-2 Significance for Passthrough 20% Section 199A Deduction*.
[168] §199A(h)(2).

Property Limit Amount, a negative number will always be less than zero or a positive number. If the qualified trade or business of LLC No. 3 had been the only business of the taxpayers, there would have been no QBI deduction for the taxpayers for the current year and that loss would have been carried over to subsequent years until 20% of that negative amount was used to reduce the taxpayer's Combined Qualified Business Income Amount for a future year.

The deductible amounts for each qualified trade or business are then combined to determine the aggregate deductible amount for the taxpayer's qualified trades or businesses of $52,600. The calculation of the Combined Qualified Business Income Amount is then completed by computing 20% of the total of the taxpayer's Qualified REIT Dividends ($25,000) and Qualified Publicly Traded Partnership Income ($10,000), which is $7,000 (20% × $35,000), and adding that amount to the aggregate deductible amount for the taxpayer's qualified trades or businesses. The result is that the taxpayer has a Combined Qualified Business Income Amount of $59,600, which consists of the aggregate deductible amount for the taxpayer's qualified trades or businesses of $52,600 plus 20% of the taxpayer's Qualified REIT dividends and Qualified Publicly Traded Partnership Income of $7,000.

Phase-In Limit for Certain Taxpayers

Taxpayers with taxable income before the §199A deduction in excess of a threshold amount of $157,500 ($315,000 for a joint return) plus $50,000 ($100,000 in the case of a joint return) are always subject to the W-2 Wages Limit or the W-2 Wages/Property Limit. Taxpayers with taxable income before the §199A deduction below the threshold amount will never be subject to those limits. There is a phase-in of the W-2 Wages Limit or W-2 Wages/Property Limit for taxpayers with taxable income before the QBI deduction that exceeds the threshold amount but is less than the threshold amount plus $50,000 ($100,000 in the case of a joint return).[169] This phase-in limit applies if the W-2 Wages Limit or W-2 Wages/Property Limit for a qualified trade or business is less than the 20% of QBI amount for a qualified trade or business.[170] If the W-2 Wages Limit Amount or W-2 Wages/Property Limit Amount for a qualified trade or business is equal to or greater than the 20% of QBI amount for that qualified trade or business, there is no limit that has to be phased in.

Taxpayers with taxable incomes within the applicable ranges ($157,501–$207,499 for single taxpayers, $315,001–$414,499 for joint returns) are subject to the phase-in of the W-2 Wages Limit and/or W-2 Wages/Property Limit.[171]

The limit that is phased in is termed the "Excess Amount" and is the amount by which 20% of a qualified trade or business's QBI exceeds the greater of (1) the W-2 Wages Limit Amount or (2) W-2 Wages/Property Limit Amount.[172] The 20% of QBI amount is reduced by an amount that bears the same ratio to the Excess Amount as the amount by which the taxpayer's taxable income before the QBI deduction for the taxable year in excess of the threshold amount bears to $50,000 for a single taxpayer or $100,000 for a joint return.

Example

Bob and Barbara file a joint return for 2018 and have taxable income before the QBI deduction of $355,000. Included in their taxable income is $100,000 of QBI. Bob

[169] §199A(b)(3)(B).
[170] §199A(b)(3)(B)(ii).
[171] §199A(b)(3)(B).
[172] §199A(b)(3)(B)(iii).

and Barbara's share of W-2 wages with respect to this qualified trade or business is $30,000 and their share of this business's unadjusted basis immediately after acquisition of qualified property applicable to this qualified trade or business is $60,000. The 20% of QBI amount for this qualified trade or business is $20,000 (20% × $100,000). The W-2 Wages Limit Amount is $15,000 (50% × $30,000) and the W-2 Wages/Property Limit Amount is $9,000 (25% of W-2 wages of $30,000 equals $7,500 plus 2.5% of the $60,000 of the unadjusted basis immediately after acquisition of qualified property equals $1,500). The limit on the deductible amount for this qualified trade or business is the W-2 Wages Limit Amount of $15,000 because this amount is greater than the W-2 Wages/Property Limit Amount of $9,000. The Excess Amount is $5,000 ($20,000 [20% of QBI amount] minus the W-2 Wages Limit Amount of $15,000). Bob's and Barbara's taxable income before their QBI deduction of $355,000 exceeds the threshold amount of $315,000 by $40,000. The ratio of this excess to $100,000 is .4 to 1. The amount that bears this .4 to 1 ratio to the $5,000 Excess Amount is $2,000 (.4 × $5,000 equals $2,000). Bob's and Barbara's 20% of QBI deductible amount for this trade or business must be reduced by $2,000. Bob's and Barbara's deductible amount for this trade or business is $18,000 (20% of QBI amount of $20,000 minus the reduction for the Excess Amount of $2,000).[173]

If a taxpayer's trade or business income is from a specified service trade or business, it is possible that the taxable income exception for specified service trades or businesses of §199A(d)(3) and the phase-in limit based on taxable income of §199A(b)(3)(B) could apply.

Example

Henry is a married doctor who has the following items applicable to his medical practice: $100,000 of QBI, $20,000 of W-2 wages, and $60,000 of unadjusted basis immediately after acquisition of qualified property. This medical practice is a specified service trade or business. The joint tax return of Henry and his wife indicate a taxable income before the QBI deduction of $375,000, which exceeds the threshold amount of $315,000 by $60,000. This excess amount bears a ratio of .6 to 1 to $100,000. The percentage equal to that ratio is 60%. Thus only 40% (100% minus 60%) of Henry's QBI, W-2 wages and unadjusted basis immediately after acquisition of qualified property are taken into account in computing Henry's QBI deduction with respect to his medical practice. The amount of QBI taken into account in computing 20% of this specified trade or business's QBI is $40,000 (40% × $100,000). The amount of W-2 wages taken into consideration is $8,000 ($20,000 × 40%). The amount of the unadjusted basis immediately after acquisition of this quali fied trade or business's qualified property taken into account is $24,000 (40% × $60,000).

The 20% of QBI amount for this specified service trade or business is $8,000, which is 20% of QBI of $40,000. The W-2 Wages Limit Amount is $4,000 (50% × $8,000) and the W-2 Wages/Property Limit Amount is $2,600 (25% of W-2 wages of $8,000 equals $2,000 plus 2.5% of the $24,000 of the unadjusted basis immediately after acquisition of qualified property equals $600). The W-2 Wages Limit Amount on the deductible 20% of QBI amount for this qualified trade or business is $4,000. The Excess Amount is $4,000

[173] This example is based on one found in the Joint Statement, 33.

(20% of QBI amount of $8,000 minus the W-2 Wage Limit Amount of $4,000). Henry and his spouse's taxable income before their Combined QBI deduction of $375,000 exceeds the threshold amount of $315,000 by $60,000. The ratio of this excess to $100,000 is .6 to 1. The amount that bears this .6 to 1 ratio to the $4,000 Excess Amount is $2,400 (.6 × $4,000 equals $2,400). Henry and his spouse's 20% of QBI deductible amount for this trade or business must be reduced by $2,400. Henry and his spouse's deductible amount for this trade or business is $5,600, which is the 20% of QBI amount of $8,000 minus the phase-in W-2 Wages Limit Amount of $2,400.

Estates and Trusts

As noted at the beginning of this article, estates and trusts are taxpayers that will qualify for the §199A deduction. Except as otherwise provided in Subchapter J, Part I of the Code, §641(b) states that "the taxable income of an estate or trust shall be computed in the same manner as in the case of an individual." Based on that provision, many tax advisors have concluded that a trust or estate has a threshold amount of taxable income before the §199A deduction for a taxable year of $157,500, the same amount as an individual taxpayer.[174] An estate or trust that has taxable income before the deduction for QBI that is equal to or less than the threshold amount would not be subject to the W-2 Wages Limit and W-2 Wages/Property Limit described in §199A(b)(2)(B)(i) and §199A(b)(2)(B)(ii) in determining its 20% deductible amount for each of its qualified trades or businesses. Furthermore, an estate or trust that has taxable income before the deduction for QBI that is equal to or less than the threshold amount would not be subject to the rules for specified service trades or businesses discussed above. If an estate's or trust's taxable income before the deduction for QBI is between $157,501 and $207,499, that estate or trust will be subject to the phase-in limit rules of §199A(b)(3)(B) and the phase-out rules for specified service trades or businesses contained in §199A(d)(3).

Rules similar to those contained in former §199(d)(1)(B)(i) as in effect on December 1, 2017, for the apportionment of W-2 wages are to be applied to the apportionment of a trust's or an estate's W-2 wages and unadjusted basis immediately after acquisition of qualified property.[175] The rules of former §199(d)(1)(B)(i) as in effect on December 1, 2017, stated that W-2 wages of a trust or estate for a taxable year were to be apportioned between the beneficiaries and the trust or estate under regulations prescribed by the IRS.[176] For purposes of former §199, an estate's or a trust's W-2 wages were to be allocated to each beneficiary of the estate or trust and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI) for a taxable year that is either distributed or required to be distributed to the estate's or the trust's beneficiaries or that is retained by the trust or estate.[177] For purposes of this rule, the trust's or estate's DNI was to be calculated by taking into consideration the separate share rule.[178] If a trust or an estate had no DNI for a taxable year, any W-2 wages were to be allocated entirely to the trust or estate.[179]

If future §199A regulations are to be based on the former §199 regulations with respect to estates or trusts, it is likely that QBI, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property will be allocated between a trust or estate and its beneficiaries based on the

[174] §199A(e)(2)(A).
[175] §199A(f)(1)(B).
[176] The apportionment of W-2 wages and other §199 items of an estate or trust is discussed in Kehl, *Practical Guide to the Sec. 199 Deduction*, pp. 310–318.
[177] Kehl, n.176, above, p. 312, and Reg. §1.199-9(e)(2)(i).
[178] Reg. §1.199-9(e)(2)(i).
[179] *Id.*

proportions of DNI that is either retained by the trust or estate or distributed or required to be distributed to the beneficiaries of the trust or estate. This seems like a reasonable approach.

Some tax advisors are currently recommending that a business owner with taxable income that greatly exceeds the threshold amount and/or owns interests in specified service trades or businesses consider creating trusts for the benefit of members of the business owner's family. This recommendation is based on the fact that each new trust and each of its individual beneficiaries have a threshold amount of $157,500. Transferring an interest in a specified service trade or business to a trust may result in the transformation of non- QBI income to QBI if the taxable income of the trust before the QBI deduction is equal to or less than the threshold amount. If the trust's taxable income is above the threshold amount and future regulations allocate QBI, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property among the trust and its beneficiaries based on the relative proportion of the trust's DNI retained by the trust and the DNI distributed to the beneficiaries, then trustees with discretionary distribution powers can manage the distributions in a manner that results in the trust's taxable income before the QBI deduction falling below the threshold amount. If the §199A deductible amount of an owner of an interest in a nonspecified service trade or business is limited by the W-2 Wages Limit or the W-2 Wages/Property Limit because that owner's taxable income before the QBI deduction is above the threshold amount, making gifts of a portion of that owner's interest to trusts may result in the owner's and the newly created trusts' taxable income falling below the threshold amount. As a result, the ownership group consisting of the owner and the trusts may receive higher §199A deductions than if the owner had retained ownership of the qualified business interest and not created these trusts.

The incentive to create trusts is also enhanced when one considers the increase in the basic exclusion amount for federal estate and gift tax purposes from $5 million to $10 million for gifts made and for the estates of decedents dying after December 31, 2017, and before January 1, 2026.[180] This amount is adjusted annually for inflation.[181] The basic exclusion amount for 2018 is $11.2 million for gifts made and for decedents dying in 2018. If proper estate planning is done, surviving spouses who die after December 31, 2017, and before January 1, 2026, may not only be able to utilize their own basic exclusion amount but also the deceased spousal unused exclusion amount.[182] Based on the 2018 amount for the basic exclusion amount, a married couple could transfer $22.4 million free of federal estate and gift transfer taxes with proper planning. Many individuals who had made gifts and had fully utilized their applicable exclusion amounts prior to 2018 now have an opportunity to use the increases in those amounts that were enacted by 2017 tax act to make future gifts during the years 2018 through 2025.

There are many valid reasons for creating trusts. A discussion of those reasons is far beyond the scope of this article. The potential of a trust to achieve income tax savings under §199A is one more reason for family planners and attorneys to utilize trusts in wealth management planning. However, potential income tax savings through §199A should not be the only consideration in the decision to utilize trusts in transferring family wealth among generations. The other tax and non-tax reasons for employing trusts that were valid planning considerations before the passage of the 2017 tax act remain as matters to be taken into consideration today.

[180] §2010(c)(3)(C), as amended by the 2017 tax act, §11061(a).
[181] §2010(c)(3)(B).
[182] §2010(c)(2).

§199A(G) Deduction For Specified Agricultural And Horticultural Cooperatives

Former §199A Deduction

As noted above, qualified dividends that are subject to reduced income tax rates (0%, 15%, or 20%) do not include dividends received from certain farmer's cooperatives that are exempt from tax by §521.[183] Congress apparently desired that certain payments received from specific types of cooperatives should qualify for the §199A deduction. These specific types of cooperatives were named "specified agricultural or horticultural cooperatives" and were described as organizations subject to the provisions of Part I of Subchapter T of the Code that were engaged in any of the following activities: (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product;[184] (b) the marketing of the agricultural or horticultural products that the cooperative's patrons have manufactured, grown, produced or extracted;[185] or (c) the provision of supplies, equipment or services to farmers or to organizations described in items (a) or (b) of this sentence.[186]

When §199A was originally enacted by the 2017 tax act, §199A(a)(2) allowed a taxpayer a deduction equal to the lesser of: (1) 20% of the aggregate amount of the taxpayer's qualified cooperative dividends for the taxable year, or (2) the taxpayer's taxable income minus the taxpayer's net capital gain (as defined for purposes of §199A) for the taxable year. The author of this article named this provision the Qualified Cooperative Dividend Component.

In general, a cooperative is a corporation that satisfies certain requirements for operating on a cooperative basis. A cooperative is owned or controlled by the persons for whom or with whom it transacts business. The persons who own or control a cooperative are its patrons. These patrons may produce commodities that they collectively sell through the cooperative. They may also collectively purchase commodities through a cooperative. The commodities purchased from the cooperative by its patrons may be manufactured, grown, produced, or extracted by the cooperative. Subject to certain exceptions, a cooperative is subject to the provisions of Part I of Subchapter T of the Code.[187] Farmers' cooperatives that are exempt from tax under §521 are also subject to the provisions of Part I of Subchapter T of the Code[188] and are subject to the corporate income tax of §11.[189]

However, the taxable income of a cooperative subject to the provisions of Part I of Subchapter T of the Code does not include, among other payments, amounts paid by the cooperative during the payment period for the taxable year as patronage dividends (as defined in §1388(a)) or as qualified written notices of allocation (as defined in §1388(c)) with respect to patronage that occurred during a taxable year.[190] The taxable income of a cooperative subject to the provisions of Part I of Subchapter T of the Code also does not include, among other things, amounts paid during the payment period for a taxable year as per-unit retain allocations (as defined in §1388(f)) to the extent paid in money with respect to marketing occurring during that taxable year).[191]

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[183] §1(h)(11)(B)(ii)(I).
[184] Former §199A(g)(3)(A) as originally enacted by the 2017 tax act.
[185] Former §199A(g)(3)(B).
[186] Former §199A(g)(3)(C).
[187] §1381(a)(2).
[188] §1381(a)(1).
[189] §1381(b).
[190] §1382(b)(1).
[191] §1382(b)(3).

For purposes of the §199A deduction, any patronage dividends (as defined in §1388(a)), any per-unit retain allocation (as defined in §1388(f)), and any qualified written notice of allocation (as defined in §1388(c)) or any similar amount that was received by a taxpayer was a ''qualified cooperative dividend'' provided it was includible in a taxpayer's gross income and was received from a certain type of organization.[192] The types of organizations that could pay a qualified cooperative dividend consisted of: (1) a cooperative described in §1381(a);[193] (2) a tax-exempt benevolent life insurance association of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations;[194] or (3) an organization that is a taxable cooperative governed by the tax rules applicable to cooperatives before Subchapter T of the Code was enacted.[195]

The Brief 'Grain Glitch'

The Qualified Cooperative Dividend Component of the §199A deduction resulted in an unintended tax incentive for farmers to sell their agricultural products through qualified cooperatives as opposed to directly selling those products.[196] This unintended tax incentive was termed the ''Grain Glitch.'' The reason for this glitch was because the Qualified Cooperative Dividend Component was 20% of the full amount of the Qualified Cooperative Dividends received and was not subject to the W-2 Wages Limitation and/or the W-2 Wages/Property Limitation. In contrast, if a farmer sold his agricultural products directly, that farmer's QBI deduction would have been based on the net amount of the QBI of the farm business and would have been subject to the W-2 Wages and W-2 Wages/Property limitations if the farmer's taxable income before the QBI deduction exceeded the threshold amount.

Example

Bill is a farmer who generates $500,000 of grain sales during 2018. Bill incurs expenses related to the production and sale of this grain of $400,000 and thus has a profit of $100,000 from his qualified farm business for 2018. Bill's QBI deduction for 2018 cannot exceed $20,000 (20% × $100,000) and, if Bill's taxable income before the QBI deduction exceeds the threshold amount, may be reduced further by the W-2 Wages and/or W-2 Wages/Property limitations. On the other hand, if Bill made his grain sales through a qualified cooperative and received a Qualified Cooperative Dividend of $500,000, his §199A deduction would have been $100,000 (20% × $500,000) and would not have been reduced by any W-2 Wages or W-2 Wages/Property limit.

The ''grain glitch'' was corrected by the Consolidated Appropriations Act.[197] This was basically accomplished by repealing the Qualified Cooperative Dividend Component.[198] In addition, §199A(g)(1), which previously allowed a §199A deduction for specified agricultural or horticultural cooperatives, was amended to allow those cooperatives a deduction for income attributable to their qualified production activities.[199]

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[192] Former §199A(e)(4) as originally enacted by the 2017 tax act.
[193] Former §199A(e)(4)(B)(i).
[194] Former §199A(e)(4)(B)(i) referring to tax-exempt organizations described in §501(c)(12).
[195] Former §199A(e)(4)(B)(ii).
[196] Laura Davison, Kaustuv Basu, and Allyson Versprille, *'Grain Glitch' Deal Akin to Whack-a-Mole Ahead of Omnibus Vote (Corrected)*, 50 Daily Tax Rep. 8 (Mar. 14, 2018).
[197] §199A(a), as amended by the Consolidated Appropriations Act, 2018, Div. T, §101(a)(1).
[198] Div. T, §101(b)(1) of the Consolidated Appropriations Act.
[199] Div. T, §101(a)(1) of the Consolidated Appropriations Act.

New §199A Deduction

Even though a cooperative is a corporation and §199A is to apply to "a taxpayer other than a corporation," [200] §199A(g) allows certain specified agricultural or horticultural cooperatives a deduction for taxable years of those specified cooperatives that begin after December 31, 2017. The definition of specified agricultural or horticultural cooperatives entitled to the new §199A(g) deduction was changed by the Consolidated Appropriations Act. The new definition clearly encompasses cooperatives that are directly engaged in the production of agricultural products as well as cooperatives that market agricultural or horti cultural products produced by a cooperative's patrons. For purposes of the new §199A, a specified agricultural or horticultural cooperative was redefined as an organization subject to the provisions of Part I of Subchapter T of the Code that is engaged in either (1) the manufacturing, production, growth, or extraction (MPGE) of an agricultural or horticultural product or (2) in the marketing of agricultural or horticultural products.[201] Marketing cooperatives described in item (2) of the preceding sentence are treated as having manufactured, produced, grown, or extracted in whole or in significant part any agricultural or horticultural products that the patrons of those marketing cooperatives have manufactured, produced, grown or extracted.[202]

The general rule of §199A(g)(1) is that a specified agricultural or horticultural cooperative is entitled to a deduction of 9% of the lesser of (1) the taxpayer's Qualified Production Activities Income (QPAI) for the taxable year or (2) the taxpayer's taxable income computed after taking any §199A(a) deduction into account and without regard to any §199A(g)(1) deduction for the taxable year.[203] The amount of this deduction cannot exceed 50% of the specified agricultural or horticultural cooperative's W-2 wages for the taxable year.[204] For purposes of this limitation, a specified agricultural or horticultural cooperative's W-2 wages are determined under §199A(b)(4) in the same manner as W-2 wages are for purposes of §199A's W-2 Wages Limit and W-2 Wages/Property Limit with certain modifications.[205] One modification is that the exclusion from W-2 wages of §199A(b)(4)(B) for wages not properly allocable to QBI does not apply. However, the rule of §199A(b)(5) for short taxable years and for acquisitions and dispositions of either a major portion of a trade or business or a major portion of a separate unit of a trade or business does apply. Another modification is that a specified agricultural or horticultural cooperative's W-2 wages cannot include any amount that is not properly allocable to the cooperative's Domestic Production Gross Receipts (DPGR).[206]

For purposes of the taxable income limit of §199A(g)(1)(A)(ii), the taxable income of a specified agricultural or horticultural cooperative is to be computed without deducting any patronage dividends or per unit retain allocations under §1382(b) or without deducting any non-patronage distributions permitted to be deducted by §1382(c).[207] For purposes of determining the tax imposed by §511, the term "unrelated business taxable income" is to be substituted for the term "taxable income" each place the term "taxable income" appears in §199A(g).[208] Section 199A(g) is to be applied by only taking into account items that are attributable to the actual conduct of a trade or business.[209]

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[200] §199A(a).
[201] §199A(g)(4)(A).
[202] §199A(g)(4)(B).
[203] §199A(g)(1)(A).
[204] §199A(g)(1)(B)(i).
[205] §199A(g)(1)(B)(ii).
[206] *Id.*
[207] §199A(g)(1)(C).
[208] §199A(g)(5)(D).
[209] §199A(g)(5)(C).

A specified agricultural or horticultural cooperative's QPAI for any taxable year is an amount equal to any excess of the specified agricultural or horticultural cooperative's DPGR for the taxable year over the sum of: (1) its cost of goods sold allocable to DPGR; (2) its other losses, expenses, or deductions (other than the §199A(g) deduction) that are properly allocable to DPGR.[210] The IRS is directed to prescribe rules for the proper allocation of cost of goods sold, expenses and other deductions for purposes of computing QPAI.[211] These rules are to properly allocate the items described in the preceding sentence even if those items are not directly allocable to DPGR.[212] It is reasonable to expect that future regulations may contain regulations for allocating cost of goods sold and other expenses that are similar to the rules for former §199.

Example

Albert Cooperative is a specified agricultural or horticultural cooperative that markets soybeans that are grown by its members to retail food outlets. For its 2018 tax year, Albert Cooperative has DPGR of $3 million that was entirely derived from sales of soybeans grown by its members. Albert Cooperative's W-2 Wages allocable to this DPGR total $380,000 and it pays $620,000 for its members' soybeans. Simone is a cash basis taxpayer who is a member of Albert Cooperative. During 2018, all of the soybeans grown by Simone were sold through Albert Cooperative and she is eligible to share in any patronage dividends paid by Albert Cooperative. Albert Cooperative decides not to declare any patronage dividends for 2018 and to retain its §199A deduction. Albert Cooperative's QPAI and taxable income for 2018 is $2 million and is computed by subtracting its expenses of $1 million ($380,000 of wages plus $620,000 for its soybeans) from its DPGR of $3 million. Albert Cooperative's tentative §199A deduction for 2018 is $180,000 (9% × $2 million). This amount is less than 50% of Albert Cooperative's W-2 wages of $190,000 (50% × $380,000). Albert Cooperative's §199A deduction for 2018 is $180,000.

The legislators who amended §199A(g) felt it was necessary to include special rules for purposes of determining DPGR. By definition, DPGR are gross receipts of a taxpayer that are derived from any lease, rental, sale, exchange, license, or other disposition (Qualifying Disposition) of agricultural or horticultural products manufactured, produced, grown or extracted (MPGE) by the taxpayer in whole or in significant part within the United States.[213] Any gross receipts of a taxpayer that are derived from a lease, rental, sale, license, exchange, or other disposition of land are statutorily excluded from DPGR.[214] Furthermore, DPGR does not include any gross receipts derived from property rented, leased, or licensed by a taxpayer if that property is to be used by a related person.[215] The term related person is very broadly defined. Persons are treated as related to each other if those persons would be treated as a single employer under the controlled group of corporations rules of §52(a), the commonly controlled organization rules of §52(b), or the affiliated service group rules of §414(m) or §414(o).[216] In applying the §52(a) controlled group of corporations rules and the §52(b) commonly controlled organization rules, the component member rules of §1563(b) are not to be taken into consideration.[217]

[210] §199A(g)(3)(A).
[211] §199A(g)(3)(B).
[212] *Id.*
[213] §199A(g)(3)(D)(i).
[214] *Id.*
[215] §199A(g)(3)(D)(ii)(I).
[216] §199A(g)(3)(D)(ii)(II).
[217] *Id.*

There is also a special rule that effectively excludes gross receipts from a disposition of property or services brought into the United States from DPGR. This rule relates to the fact that DPGR by definition can only include gross receipts from a Qualifying Disposition of agricultural or horticultural products MPGE by the taxpayer in whole or in significant part within the United States. Under this special rule, any item or service brought into the United States is treated as acquired by purchase for a cost that is not less than its value immediately after the property entered the United States.[218] Because this property or service was acquired by purchase from outside the United States, any gross receipts up to the value of this property when it was brought into the United States are excluded from DPGR. The cost of that property should also be charged against gross receipts that are not DPGR. A similar rule applies for determining the adjusted basis of leased or rented property where the lease or rental generates DPGR. There is a related rule that applies if that property is exported again for further manufacture. If that situation occurs, the increase in the property's cost or adjusted basis may not exceed the difference between the property's value when it was exported and the value of the property when it was brought back into the United States after that manufacturing was completed.[219]

Future Regulations: The IRS is to prescribe regulations that are necessary to carry out the purposes of §199A(g).[220] These regulations are to be based on the regulations that applied to cooperatives and their patrons under former §199 (as in effect before repeal by the 2017 tax act). The primary regulation that applied to cooperatives under former §199 was Reg. §1.199-6. Many of the rules for cooperatives contained in that regulation are also contained in the new §199A(g). These future regulations are to prevent more than one taxpayer from being allowed a §199A(g) deduction with respect to any activity that generates DPGR.[221]

New §199A(g) Deduction May Be Passed Through to Patrons

A specified agricultural or horticultural cooperative may elect to pass through all or part of its §199A(g)(1) deduction by making qualified payments to its patrons who are eligible taxpayers.[222] For this purpose, an eligible taxpayer is either another specified agricultural or horticultural cooperative or a taxpayer that is not a corporation.[223] A qualified payment is an amount paid to an eligible taxpayer that meets all of the following conditions: (1) the payment is a patronage dividend paid in money, a qualified written notice of allocation or other property described in §1385(a)(1) or a per-unit retain allocation paid in qualified per-unit retain certificates described in §1385(a)(3);[224] (2) the payment is received by the eligible taxpayer from a specified agricultural or horticultural cooperative;[225] and (3) the payment is attributable to QPAI with respect to which a §199A(g) deduction is allowed to the specified agricultural or horticultural cooperative.[226] The eligible taxpayer who receives the qualified payment from the specified agricultural or horticultural cooperative is allowed a deduction for the taxable year in which that qualified payment is received for an amount equal to the portion of the §199A(g)(1) deduction of that cooperative that is allowed with respect to the portion of the QPAI that the payment is attributable to and that is identified by the specified agricultural or horticultural cooperative in a written notice mailed to the eligible taxpayer during the payment period (the period that begins with the first day of that taxable year and ends with the fifteenth day of the ninth month following the close of that year) specified in §1382(d).[227] The deduction

[218] §199A(3)(C)(i).
[219] §199A(3)(C)(ii).
[220] §199A(g)(6).
[221] *Id.*
[222] §199A(g)(2).
[223] §199A(g)(2)(D).
[224] §199A(g)(2)(E)(i).
[225] §199A(g)(2)(E)(ii).
[226] §199A(g)(2)(E)(iii).
[227] §199A(g)(2)(A).

allowed to any taxpayer by §199A(g)(2) cannot exceed the taxpayer's taxable income after the §199A(a) deduction but is calculated without regard to the §199A(g)(2) deduction.[228]

A patron of a specified agricultural or horticultural cooperative who is an eligible taxpayer engaged in a qualified trade or business may include the payments received from that cooperative in the QBI of that trade or business for purposes of determining the §199A(b)(2)(A) deductible amount for that trade or business. At the same time, this patron may receive an allocated portion of the deduction allowed to the specified agricultural or horticultural cooperative. This could result in a double tax benefit to the patron due to the inclusion of the patronage dividends in QBI plus the allocated amount of the cooperative's §199A(g)(1) deduction. For this reason, §199A(b)(7) states that the §199A(b)(2)(A) deductible amount for any qualified trade or business of a patron of a specified agricultural or horticultural cooperative is to be reduced by the lesser of the following amounts: (1) 9% of so much of the QBI of that trade or business that is properly allocable to qualified payments received from the cooperative;[229] or (2) 50% of so much of the W-2 wages with respect to that qualified trade or business that are allocable to the qualified payments received from the cooperative.[230] The taxable income of a specified agricultural or horticultural cooperative that makes qualified payments to patrons who are eligible taxpayers is not reduced under §1382 by the portion of any qualified payments that do not exceed the §199A(g)(2)(A) deduction that is permitted for the patrons of the cooperative who receive the qualified payments.[231] The following example is an illustration of how the author believes §199A(g)(2) will work.

Example

This is a continuation of the previous example. For 2019, Albert Cooperative has DPGR of $2 million that was entirely derived from sales of soybeans grown by its members. Albert Cooperative's W-2 Wages allocable to this DPGR total $210,000 and it pays $790,000 for its members' soybeans. Simone is a cash basis taxpayer who is a member of Albert Cooperative. During 2019, all of the soybeans grown by Simone were sold through Albert Cooperative. Simone is eligible to share in any patronage dividends paid by Albert Cooperative. Albert Cooperative's QPAI and taxable income for 2019 is $1 million and is computed by subtracting its expenses of $1 million from its DPGR of $2 million. Albert Cooperative's §199A(g)(1) deduction is $90,000, which is less than the $105,000 amount that is 50% of its W-2 wages allocable to its DPGR (50% × $210,000).

Albert Cooperative decides to declare a patronage dividend for 2019 in an amount equal to its $1 million profit and to pass the entire amount of its §199A(g)(1) deduction to its patrons. Albert Cooperative's deduction for patronage dividends under §1382 is $910,000, which reflects a $90,000 reduction for the §199A(g)(1) deduction allowed to its patrons ($1 million patronage dividend minus $90,000). Simone receives a patronage dividend of $100,000 from Albert Cooperative along with a written notice that was mailed to her during Albert Cooperative's payment period. The notice informs her that she is allowed a $9,000 §199A(g)(1) deduction with respect to the $100,000 of QPAI to which her patronage dividend is attributable. Simone includes the $100,000 patronage dividend in the QBI for her own qualified trade or business. After including this amount,

[228] §199A(g)(2)(B).
[229] §199A(b)(7)(A).
[230] §199A(b)(7)(B).
[231] §199A(g)(2)(C).

Simone has total gross income from her qualified trade or business of $500,000. She has W-2 wages for that qualified trade or business of $200,000, which includes $40,000 of W-2 wages allocable to the $100,000 patronage dividend received from Albert Cooperative. Simone's other expenses of her qualified trade or business are $100,000. She thus has QBI of $200,000 ($500,000 of gross income minus $300,000 of expenses).

Simone's tentative §199A(b)(2) deductible amount for her trade or business is $40,000 (20% of that qualified business' $200,000 QBI). This tentative amount is less than Simone's W-2 Wages limit for her trade or business in the amount of $100,000, which is 50% of Simone's W-2 wages of $200,000. However, Simone's tentative §199A(b)(2) deductible amount for her trade or business must be reduced by $9,000, which is 9% of the business' qualified business income that is properly allocable to the qualified payments received from Albert Cooperative. This reduction is made because it is less than the $20,000 amount that represents 50% of Simone's W-2 wages properly allocable to the qualified payments from Albert Cooperative.

Simone's §199A(b)(2) deduction for her qualified trade or business is $31,000 ($40,000 minus $9,000). Simone's total §199A deduction is $40,000, which consists of the $9,000 §199A(g)(1) deduction plus the $31,000 §199A(b)(2) deduction. If the rule of §199A(b)(7) was not enacted, Simone would have had a total §199A deduction of $49,000, which would have consisted of her §199A(a) deduction of $40,000 plus the deduction passed to her from the cooperative of $9,000.

There is a transition rule for qualified payments received by taxpayers from specified agricultural or horticultural cooperatives in taxable years that begin after December 31, 2017, that are attributable to QPAI activities with respect to which a §199 deduction was allowed to those cooperatives for taxable years of those cooperatives that began before January 1, 2018.[232] That transition rule states that no deduction is allowed under §199A for any of these qualified payments.[233]

Expanded Affiliated Groups

Section 199A(g)(5)(A) contains special rules for affiliated groups of specified agricultural or horticultural cooperatives. These rules are similar to the Expanded Affiliated Group (EAG) rules of former §199, before the 2017 tax act.[234] The purpose of these rules is to prevent an affiliated group of specified agricultural or horticultural cooperatives from creating DPGR through transactions among related taxpayers. This purpose is reflected in the general rule of §199A(g)(5)(A)(i), which states that all members of an EAG are treated as a single corporation for purposes of §199A(g). This rule prevents specified agricultural or horticultural cooperatives that are members of an EAG from creating DPGR through transactions with each other because those transactions are deemed not to exist for tax purposes. Furthermore, for purposes of determining DPGR under §199A(g)(3)(D), if all interests in the capital and profits of a partnership are owned by members of a single EAG at all times during a partnership's taxable year, that partnership and all members of the EAG are treated as a single taxpayer during that taxable year.[235] This effectively excludes from DPGR all revenues generated by sales of this partnership to its EAG partners as well as all sales by the EAG members to this partnership during that taxable year.

[232] §199A(a), as amended by Div. T, §101(c) of the Consolidated Appropriations Act.
[233] *Id.*
[234] For a discussion of those rules, see Kehl, *The Practical Guide to the Code Section 199 Deduction*, Chapter 8.
[235] §199A(g)(5)(A)(ii).

The definition of an EAG for purposes of §199A(g) relies on the definition of an affiliated group of corporations contained in §1504(a) with certain modifications. An affiliated group of corporations under §1504(a)(1) consists of one or more chains of includible corporations that are connected through stock ownership with a common parent corporation that is also an includible corporation.[236] The common parent must own directly stock that meets certain stock ownership requirements in at least one of the other includible corporations.[237] Stock that meets the stock requirements in each of the includible corporations (except the common parent) must be owned directly by one or more of the other includible corporations.[238] The stock ownership requirements referred to are those contained in §1504(a)(2) that are modified to at least 50% for purposes of §199A(g) by §199A(g)(5)(A)(iii)(I). This means that the ownership of stock of any corporation meets the stock ownership requirements of a §199A(g) EAG if that ownership possesses at least 50% of the total voting power of the stock of that corporation and has a value equal to at least 50% of the total value of the stock of that corporation. Finally, the definition of an includible corporation contained in §1504(b) is modified for purposes of §199A(g) by including insurance companies subject to tax under §801 and corporations with respect to which a §936 election is in effect for a taxable year in that definition.[239]

Except as provided by future regulations, the §199A(g)(1) deduction is to be allocated among members of an EAG in proportion to each member's respective amount of QPAI.[240] The following example demonstrates how the author believes these EAG provisions will work. In the example, specified agricultural or horticultural cooperatives D, O, and N are members of the same EAG. For 2018, these cooperatives have the following amounts of QPAI, taxable income and W-2 wages:

Entity	QPAI	Taxable Income	W-2 Wages
D	$3,000	$5,000	$6,000
O	($1,000)	$2,000	$8,000
N	$3,000	$4,000	$9,000
Totals	$5,000	$11,000	$23,000

Because all members of an EAG are treated as a single taxpayer, the §199A(g)(1) is computed as if these cooperatives were a single taxpayer. The §199A(g)(1) deduction is $450 (9% × $5,000, the lesser of the EAG's QPAI of $5,000 or the EAG's taxable income of $11,000). All of the EAG'sW-2Wages of $23,000 are properly allocable to DPGR. The §199A(g)(1) deduction is limited to 50% of those W-2 wages of $11,500 (50% × $23,000). Because the calculated §199A(g)(1) deduction of $450 does not exceed 50% of the EAG's W-2 wages, $450 is the amount of this EAG's §199A(g)(1) deduction. This deduction is allocated to each EAG member in proportion to each member's QPAI. Because O has a negative QPAI of ($1,000), no portion of the §199A(g)(1) deduction is allocated to O. Total QPAI for purposes of this allocation is $6,000 (D's QPAI of $3,000 plus O's QPAI of $0 plus N's QPAI of $3,000). D's allocated amount of the §199A(g)(1) deduction is $225 ($450 × 3,000/$6,000) and N's allocated amount of the §199A(g)(1) deduction is also $225 ($450 × $3,000/$6,000).

[236] §1504(a)(1)(A).
[237] §1504(a)(1)(B)(i).
[238] §1504(a)(1)(B)(ii).
[239] §199A(g)(5)(A)(iii)(II).
[240] §199A(g)(5)(A)(iv).

If a specified agricultural or horticultural cooperative is a partner in a partnership, then the partnership rules of §199A(f)(1), which were discussed in this article, apply for purposes of §199A(g).[241]

Oil Related QPAI

If a specified agricultural or horticultural cooperative has ''oil related QPAI'' for a taxable year, its §199A(g)(1) deduction is 6% of the lesser of the following amounts: (1) the cooperative's oil related QPAI for that taxable year; or (2) the cooperative's total QPAI for that taxable year; or (3) the cooperative's taxable income for that taxable year.[242] Oil related QPAI is QPAI attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (within the meaning of §927(a)(2)(C), as in effect before its repeal).[243]

Conclusion

The §199A deduction is effective for taxable years that begin after December 31, 2017, and terminates for taxable years that begin after December 31, 2025.[244] There are many issues that have to be addressed and many questions that have to be answered with respect to this brand new deduction. Several of those issues and questions have been discussed in this article. Taxpayers should begin planning in these early days of 2018 to maximize this deduction. However, it may be prudent to wait for future income tax regulations and other guidance before finalizing those plans.

[241] §199A(g)(5)(B).
[242] §199A(g)(5)(E).
[243] §199A(g)(5)(E)(ii).
[244] §199A(i).

WORKSHEET 1

Summary of Taxpayer Information

Tax Return Information			LLC	LLC	LLC
Wages and Salaries	100,000	Other Data	No. 1	No. 2	No. 3
Non-Qualifying Dividends	7,000				
Qualified Dividends	3,000	Taxpayer's share of W-2 wages	1,625,000	20,000	0
Net Long-Term Capital Gain In Excess of Net Short-Term Capital Loss	24,000				
Qualified Publicly Traded Partnership Income	10,000	Taxpayer's Share of Unadjusted Basis of Qualified Property	325,000	19,000	420,000
Non-Business Interest Income	1,000				
Income-LLC No. 1	252,000				
Income-LLC No. 2	71,000				
Loss-LLC No. 3	(39,000)				
Qualified REIT Dividends	25,000				
Gross Income and Adjusted Gross Income	454,000				
Itemized Deductions					
Taxes	10,000				
Mortgage Interest	5,000				
Charitable Contributions	10,000				
Total Itemized Deductions	25,000				
Taxable Income Before QBI Deduction	429,000				
QBI Deduction – See Schedule	(59,600)				
Taxable Income	369,400				

This taxpayer is a married couple filing a joint return.

WORKSHEET 2

Determination of Deductible Amount For Each Qualified Trade or Business

	LLC No. 1	LLC No. 2	LLC No. 3	Aggregate Deductible Amount
QBI Amount:				
Partnership Income	252,000	71,000	(39,000)	
Guaranteed Payment to Partner	0	0	0	
Qualified Business Income (Loss)	252,000	71,000	(39,000)	
Percentage For Deduction	20%	20%	20%	
20% of QBI amount	50,400	14,200	(7,800)	
W-2 Wages Limit:				
W-2 wages	1,625,000	20,000	0	
Wage Percentage	50%	50%	50%	
W-2 Wages Limit Amount	812,500	10,000	0	
W-2 Wages/Property Limit				
W-2 Wages	1,625,000	20,000	0	
Wage Percentage	25%	25%	25%	
W-2 Wages for W-2 Wages/ Property Limit Amount	406,250	5,000	0	
Unadjusted Basis Immediately After Acquisition of Qualified Property	325,000	19,000	420,000	
Percentage Limit	2.50%	2.50%	2.50%	
Property Amount	8,125	475	10,500	
Total W-2 Wages/Property Limit Amount	414,375	5,475	10,500	
Greater of W-2 Wages Limit Amount or W-2 Wages/ Property Limit Amount	812,500	10,000	10,500	
Aggregate Deductible Amount for Each Trade or Business	50,400	10,000	(7,800)	52,600

WORKSHEET 2 (continued)

Determination of Deductible Amount For Each Qualified Trade or Business

	LLC No. 1	LLC No. 2	LLC No. 3	Aggregate Deductible Amount
Qualified REIT Dividends and Qualified Publicly Traded Partnership Income				
Qualified REIT Dividends			25,000	
Qualified Publicly Traded Partnership Income			10,000	
Total			35,000	
Percentage of Qualified REIT and Qualified Publicly Traded Partnership Income			20%	
REIT and Qualified Publicly Traded Partnership Income Portion				7,000
Combined Qualified Business Income Amount				59,600

WORKSHEET 3

Deduction For Qualified Business Income

	20% Excess Taxable Income Limit	Combined QBI Amount & Limit	QBI Deduction Components
Qualified Business Income Component:			
Combined Qualified Business Income Amount (See Schedule)		59,600	
20% Excess Taxable Income Limit:			
Taxable Income Before §199A(a) Deduction	429,000		
Less: Qualified Dividends	(3,000)		
Net long-term capital gain in excess of net short-term capital loss	(24,000)		
Taxable income in excess of qualified dividends and net long-term capital gain in excess of short-term capital loss	402,000		
Excess Percentage	20%		
Excess Taxable Income Amount		80,400	
§199A(a) Deduction – Lesser of Combined Qualified Business Income Amount or Excess Taxable Income Amount			59,600

What Gig Workers Need to Know About the New Tax Law: A Primer

By Laura Davison

Gig workers, sole proprietors, and independent contractors may see a tax cut under the tax overhaul, but the size of that reduction remains under debate as the Treasury Department works to implement the law.

Gig economy workers, popular with on-demand companies such as Lyft Inc., Uber Technologies Inc. and Postmates Inc., are often treated as independent workers. That means the workers don't qualify for traditional employee benefits like minimum wage, unemployment insurance, and tax withholding. But it does mean they'll be eligible for some of the tax breaks intended to help small businesses and sole proprietorships.

There are varying estimates about the size of the gig economy workforce. An October 2016 Federal Reserve study found that about 36 percent of the nation's workforce is part of the gig economy.

Here's what gig workers need to know as they earn money in 2018 under the new tax code.

How Does the Tax Law Affect Independent Contractors?

The 20 percent pass-through deduction under tax code Section 199A is also available to sole proprietors, which means workers who qualify may only have to pay taxes on 80 percent of their income.

For those making up to $157,500 as individuals or $315,000 as joint filers—which includes many gig economy workers—there are few rules restricting the deduction.

Above those thresholds, there are limits based on how much the entity pays in wages or how much equipment the entity invests in, both of which would severely limit the tax break for gig economy workers. The deduction is also restricted for those earning over the threshold in service businesses or activities where reputation or skill is an important factor. That could potentially exclude workers on platforms where they are rated by users based on the quality of their services.

Gig workers, particularly those who work for multiple on-demand services, should pay close attention to how each company pays them. Many issue Forms 1099, which list income that may qualify for the deduction. Others, such as home management service Hello Alfred, classify their workers as employees and pay them W-2 wages, which aren't eligible for the deduction, said Shu-Yi Oei, a professor at Boston College Law School.

Does the Deduction Apply to All Income Earned Via Gig Work?

The law doesn't appear to place any restrictions on the deduction for sole proprietors or partners earning less than $157,500 as individuals or $315,000 as a couple. However, it does require that S corporation shareholders calculate their "reasonable compensation" and exclude that from the qualified business income eligible for the tax break.

"I think the developing view of most tax people I've talked to is surely they can't mean to apply reasonable compensation to sole proprietors and partners," Oei said.

However, Treasury officials have said they've received questions about whether the government should apply reasonable-compensation rules—an idea used to keep S corporation owners from underpaying taxes—to partners and sole proprietors as well, in light of the 2017 tax act.

S corporations are required to have shareholders who also work in the business pay themselves a "reasonable" wage and the associated self-employment taxes.

If the government were to more broadly apply the reasonable compensation standard to other types of pass-through owners, it could further limit the value of the tax break for gig workers.

The reasonable-compensation rules for S corporations stem from the incentives their owners face to minimize the amount they pay themselves, so they can avoid self-employment taxes. The reasonable-compensation standard became widely known after former House Speaker Newt Gingrich (R-Ga.) and former Sen. John Edwards (D-N.C.) reportedly minimized their income to avoid taxes.

The deduction doesn't apply to all income a gig worker earns, said Melissa Labant, director of tax policy and advocacy for the American Institute of CPAs in Washington. Dividend income and capital gains are both ineligible for the deduction.

How Does Filing Your Taxes Change as a Sole Proprietor?

Self-employed individuals who calculate they will owe at least $1,000 in taxes are typically are required to pay estimated quarterly taxes during the current tax year.

These payments are comparable to the withholding and employment taxes that a wage-earning person might earn, Labant said.

Initial versions of the tax law included a provision from Sen. John Thune (R-S.D.) to lower the reporting threshold for Forms 1099 to make it easier for gig workers to pay their taxes, but it was removed before the final bill was passed.

Should Employees Switch to Being Independent Contractors?

Some critical of the tax law have said the Section 199A deduction opens up potential for abuse for individuals who are now employees to cut their tax bills by becoming independent contractors so they can take advantage of the new deduction.

"At first glance, it is a really attractive deduction that could be an incentive for being an independent contractor," said Caroline Bruckner, managing director of the Kogod Tax Policy Center at American University.

However, the limits placed on the deduction—such as the restriction for service businesses and the requirement to pay wages or invest in equipment for those on the higher end—mean it isn't as lucrative as one might initially think, especially for gig workers, she said.

There are also non-tax factors one should consider before switching their employment status, Labant said. Being an employee offers certain securities and benefits, such as retirement and health benefits, she said.

"You're ultimately responsible to the creditors, clients, and ultimately responsible for your own financial situation," Labant said. "There are a lot of things unrelated to tax that need to be taken into consideration."

With assistance from Tyrone Richardson in Washington.

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Checklist: Section 199A

Pass-through Entities: Understanding the 20% Pass-Through Entity Deduction (§199A)			
Client/Project:			
Prepared By:			
Reviewed By:			
Please consult the Bloomberg Tax Practice Guide on this topic for additional details and comments on each item.			
Item		**Applicable**	Non-Applicable
1. Has the taxpayer determined the allowable amount of the deduction for qualified business income from pass-through entities? The deduction is equal to:			
	1.1. The lesser of: (a) The taxpayer's combined qualified business income; or (b) an amount equal to 20% of the excess (if any) of the taxpayer's taxable income over net capital gain		
2. Has the taxpayer determined the combined qualified business income amount? The combined qualified business income is equal to:			
	2.1. The sum of the deductible amount for each qualified trade or business held by the taxpayer, plus		
	2.2. 20% of qualified REIT dividends and qualified publicly traded partnership income.		
3. Has the taxpayer determined the deductible amount for each qualified trade or business?			
	3.1. Is the business a "qualified trade or business?"		
	3.2. Determine "qualified business income" for each qualified trade or business.		
	3.3. Apply the wage and qualified property limitations, as applicable.		
4. Is the taxpayer's business a "specified service trade or business" ineligible for the qualified business income deduction?			

	4.1. Ineligible specified trades or businesses include: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading or dealing securities, etc.		
	4.2. Also, a catchall definition: any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.		
5. Is the taxpayer able to deduct qualified business income from a specified service trade or business?			
	5.1. If a taxpayer's taxable income is below an applicable threshold amount (adjusted for inflation), the specified service trade or business exclusion does not apply, and the taxpayer is allowed a deduction with respect to the QBI of that trade or business.		
	5.2. For 2018 the threshold amount is $315,000 for joint filers and $157,500 for all other taxpayers. The threshold amounts are subject to phase-out.		
6. Has the taxpayer computed "qualified business income" for each qualified trade or business?			
	6.1. Items of income, gain, deduction, and loss are included.		
	6.2. Such items only are included to the extent that (1) they are allowed in the taxpayer's taxable income for the tax year, and (2) they are effectively connected with the conduct of a trade or business within the United States or Puerto Rico.		
7. Has the taxpayer properly excluded the following items from qualified business income?			
	7.1. Short-term or long-term capital gain or loss.		
	7.2. Dividends or payments equivalent to dividends.		
	7.3. Interest income not allocable to the trade or business.		
	7.4. Gain or loss on commodities transactions.		
	7.5. Foreign currency gains.		
	7.6. Income or loss from notional principal contracts.		

	7.7. Annuities not received in connection with the trade or business.		
	7.8. Any item of deduction allocable to an amount described above.		
	7.9. Reasonable compensation of owners.		
	7.10. Guaranteed payments to partners in exchange for services.		
	7.11. As provided in future regulations, service payments made to a partner in a capacity other than a partner.		
8. Does the taxpayer have any passive income from a trade or business activity?			
	8.1. Whether the taxpayer's income is active or passive, it can be qualified business income eligible for the Section 199A deduction.		
9. Is the taxpayer's net amount of qualified business income from all qualified trades or businesses less than zero?			
	9.1 Any excess loss amount is carried forward and treated as a loss from a qualified trade or business in the succeeding tax year.		
	9.2. If the owners have outside basis, any net loss would reduce their outside basis to zero in the year the loss items are incurred.		
	9.3. At the entity level, for an S corporation, the accumulated adjustments account would be reduced by the net loss items in the year incurred.		
	9.4. The carryforward of net losses to succeeding taxable years reduces the potential for claiming the §199A deduction.		
10. Is the taxpayer's deduction limited by the W-2 wage and the qualified property limitations on qualified business income?			
	10.1. The W-2 wage and qualified property limitation essentially limits a taxpayer's deductible amount with respect to a qualified trade or business to the lesser of (1) 20% of the taxpayer's qualified business income; or (2) the greater of (a) 50% of the W-2 wages with respect to the trade or business, or (b) the sum of (i) 25% of the W-2 wages with respect to the trade or business, plus (ii) 2.5% of the unadjusted basis (immediately after acquisition) of all qualified property.		

	10.2. W-2 wages are defined as the total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the tax year of the taxpayer.		
	10.3. Qualified property is defined as tangible property of a character subject to depreciation (1) that is held by, and available for use in, the qualified trade or business at the end of the tax year, (2) that is used in the production of QBI, and (3) for which the depreciable period has not ended before the end of the tax year.		
11. Is the taxpayer's taxable income below an applicable threshold amount, such that the W-2 wage and qualified property limitations do not apply to §199A deduction?			
	11.1. For 2018 the threshold amount is $315,000 for joint filers and $157,500 for all other taxpayers subject to phase-out rules.		
12. Has the taxpayer adopted any business or tax planning to mitigate the wage and qualified property limitation for the §199A deduction?			
	12.1. Increasing payroll in a qualified trade or business can increase the amount of the §199A deduction amount. But adding employees is first and foremost a business decision. Increasing the deduction, reduces taxable income by 20 cents for every dollar of increased wages.		
	12.2. Consider whether independent contractors would be better reclassified as employees. This needs to be considered carefully because it can have extenuating impacts on a myriad of tax and non-tax matters.		
	12.3. Grouping of certain trades or businesses together, separating them, could help to increase the §199A deduction.		
13. Did the taxpayer properly claim the §199A deduction on the business owners' income tax returns?			
	13.1. The §199A deduction is calculated and claimed at the partner/S corporation shareholder level.		

	13.2. The pass-through entity will need to give its owners enough information for them to calculate and claim the credit.		
	13.3. The IRS will need to issue guidance on whether or not the business owners of pass through entities can group or separate certain trades or businesses for purposes of increasing the §199A deduction.		
14. Did the taxpayer receive qualified REIT dividends or qualified publicly traded partnership (PTP) income?			
	14.1. If so the W-2 wage and qualified property limitation does not apply.		
	14.2. 20% of qualified REIT dividends and qualified PTP income is allowed as a deduction subject to taxable income limits		
15. Is the taxpayer a trust or an estate, and if so, can it claim the §199A deduction for qualified business income from pass-through entities?			
	15.1. Trusts and estates can claim the §199A deduction.		
	15.2. For purposes of the W-2 wage limitation, rules similar to the rules under former §199 apply for apportioning any W-2 wages and unadjusted basis of qualified property between fiduciaries and beneficiaries		
16. Is the taxpayer an electing small business trust (ESBT) shareholder of an S corporation? Can it claim a §199A deduction?			
	16.1. It is not clear how the §199A deduction will apply to electing small business trusts (ESBTs). The legislative history broadly states that trust and estates are eligible for the deduction.		
	16.2. §641(c) may present some technical issues. There are limited adjustments that can be made to the S corporation portion of an ESBT, and the §199A deduction is not one of the enumerated items.		
	16.3. A technical correction is needed to resolve the conflict in the §199A legislative history and §641(c).		
17. Is the taxpayer a specified agricultural or horticultural cooperative? If so how does the §199A(g) deduction apply?			

	17.1. A deduction is allowed to any specified agricultural or horticultural cooperative equal to 9% of the lesser of (1) the qualified production activities income of the cooperative for the taxable year, or (2) the taxable income of the taxpayer for the taxable year. The deduction cannot exceed 50% of wages of the taxpayer for the taxable year.		
18. Is the taxpayer a patron of a specified agricultural or horticultural cooperative? If so how does the §199A(g) deduction apply?			
	18.1 An agricultural cooperative may pass through to its patrons all, some, or none of the §199A deduction.		
	18.2 A patron who receives a qualified payment is allowed, for the tax year in which such payment is received, a deduction equal to the portion of the cooperative's §199A(g) deduction that is allowed with respect to the portion of the qualified production activities income to which such payment is attributable, provided that the cooperative identifies such portion by written notice as described in §1382.		
	18.3 The patron must reduce the deductible amount of QBI with respect to the cooperative by the lesser of (1) 9% of the QBI with respect to the trade or business that is properly allocable to qualified payments, or (2) 50% of the W-2 wages that are properly allocable to qualified payments.		
19. Has the taxpayer considered the substantial understatement threshold for claiming the §199A deduction for qualified business income of pass-through entities?			
	19.1. The tax code generally levies a penalty if taxes are understated by 10% or more under §6662.		
	19.2. However, if a taxpayer claims the §199A deduction for qualified business income of pass-through entities, the penalty, which can be 20% of the unpaid tax, kicks in if the tax is understated by 5%.		

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Client Letter – Qualified Business Income Deduction

4040.200. Client Letter – Qualified Business Income Deduction

Last week you called with questions regarding the § 199A deduction for qualified business income (QBI). Specifically, you requested that I send you a letter explaining under what circumstances you may be eligible for this deduction.

If you have income from a pass-through entity (or sole proprietorship) you may be entitled to a deduction equal to the lesser of the deductible amount of your QBI (generally 20% subject to the W-2 wage limitation) or 20% of your taxable income. You may also be able to deduct 20% of your qualified REIT dividends and qualified publicly traded partnership income. Special rules apply for these additional items. The deduction applies to reduce your taxable income and is available whether or not you itemize.

QBI is your net amount of qualified items of income, gain, deduction, and loss with respect to each of your "qualified trades or businesses." Qualified items are items that are allowed in the determination of your taxable income for the tax year, and are effectively connected with the conduct of a trade or business within the United States or Puerto Rico. Many items of income, gain, deduction, and loss are not qualified items. These items generally include capital gains and loss, dividends, interest, etc. In the case of a partnership or S corporation, your net amount of qualified items is the net amount your allocable share of each qualified item. QBI does not include any amount paid by a business to its owner that is treated as reasonable compensation, or any guaranteed payment by a partnership to a partner for services rendered with respect to the trade or business. Finally, the IRS may issue regulations providing that any amount paid by a partnership to a partner who is not acting in his or her capacity as a partner for services rendered to the partnership is not QBI. Note that the trade or business of being an employee is not a qualified trade or business and, therefore, no deduction is allowed for your income from the trade or business of being an employee.

If your net amount of QBI from all qualified trades or businesses during the tax year is a loss, it is carried forward as a loss from a qualified trade or business in the next tax year and reduces your deduction in a subsequent year (but not below zero) by 20% of any such carryover loss.

Calculation of the deduction is a fact intensive inquiry. If you claim the deduction and you understate the amount of tax required to be shown on your return by 5% or more, you could be subject to the substantial understatement of tax penalty.

If your taxable income does not exceed a threshold of $315,000 (joint filers), or $157,500 (all other taxpayers), your deduction is generally the lesser of 20% of your QBI or 20% of your taxable income.

If your taxable income exceeds the threshold there are two additional rules you need to be aware of.

Is your pass-through income from a "qualified trade or business"?

A qualified trade or business is defined as any trade or business other than a specified service trade or business or the trade or business of being an employee. While no deduction is allowed for your income from the trade or business of being an employee, a deduction is allowed for your income from a specified service trade or business to the extent that your taxable income does not exceed the threshold amount. However, as your taxable income exceeds the threshold amount, your specified service trade or business income is partially or fully excluded from the deduction. The exclusion phases in based on the ratio of your table income in excess of the threshold amount to $100,000 (joint filers) and $50,000 (all other taxpayers). Thus, no deduction is allowed for your income from a specified service trade or business if your taxable income is more than $415,000 (joint filers) or $207,500 (all other taxpayers).

A specified service trade or business generally involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Application of the W-2 wage limitation

If your taxable income exceeds the threshold amount, the deductible amount of your QBI is equal to the lesser of 20% of your QBI with respect to the trade or business or the W-2 wage limitation. As your taxable income exceeds the threshold above, the W-2 wage limitation phases in and you will reduce the excess amount of your deduction based on the ratio of your table income in excess of the threshold amount to $100,000 (joint filers) and $50,000 (all other taxpayers).

The W-2 wage limitation is equal to the greater of (1) 50% of the business's W-2 wages, or (2) the sum of (a) 25% of the business's W-2 wages, plus (b) 2.5% of the unadjusted basis (immediately after acquisition) of all qualified property.

In the case of a partnership or S corporation, you take into account your allocable share of W-2 wages and unadjusted basis (immediately after acquisition) of qualified property for the tax year.

W-2 wages are the total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the tax year of the taxpayer. W-2 wages do not include (1) any amount that is not properly allocable to the QBI as a qualified item of deduction, and (2) any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions). Amounts paid to independent contractors are not W-2 wages.

Qualified property is tangible property of a character subject to depreciation (1) that is held by, and available for use in, the qualified trade or business at the end of the tax year, (2) that is used in the production of QBI, and (3) for which the depreciable period has not ended before the end of the tax year. The depreciable period with respect to qualified property is the period

beginning on the date the property is first placed in service by the taxpayer and ending on the later of (1) the date 10 years after that date, or (2) the last day of the last full year in the applicable recovery period that applies to the property.

While I recognize that the issues reviewed above are complex, I nevertheless hope that this letter provides a useful introduction to some of the hurdles that you may encounter in calculating your qualified business income deduction. I would be happy to discuss these issues in more detail, as well as various planning ideas, at your convenience.

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2017 Tax Act Frequently Asked Questions (FAQs)

2017 Tax Act Frequently Asked Questions (FAQs)

Deduction for Qualified Business Income of Pass-Through Entities

1. **How is the overall amount of the deduction for qualified business income from pass-through entities calculated?**

The deduction is equal to the lesser of

- The lesser of:
  a. the taxpayer's combined qualified business income amount, or
  b. an amount equal to 20% of the excess (if any) of the taxpayer's taxable income of the taxpayer over the net capital gain of the taxpayer.

This combined amount cannot exceed the taxpayer's taxable income (reduced by net capital gain). [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

2. **What is the combined qualified business income amount?**

There are two categories that make up "combined qualified business income ." The first category is equal to the sum of the deductible amounts for each of the taxpayer's qualified trades or businesses (which is equal to 20% of the "qualified business income" from each of the taxpayer's qualified trades or businesses (subject to certain limitations) . The second category is equal to 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income . Thus, combined qualified business income is equal to:

- The sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer; plus
- 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer . [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

3. **How does a taxpayer determine the deductible amount for each qualified trade or business?**

First, the taxpayer determines whether a particular trade or business is a "qualified trade or business ." Second, the taxpayer computes "qualified business income" for each qualified trade or business for the tax year . Third, the taxpayer applies the W-2 wages and qualified property limitation (if applicable) . [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

4. **What is a "qualified trade or business" for purposes of §199A?**

A qualified trade or business is any trade or business other than (1) a specified service trade or business" or (2) the trade or business of performing services as an employee . [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

5. **What businesses are "specified service trades or businesses" ineligible for the deduction for qualified business income?**

A specified service trade or business is any trade or business involving the performance of services in the fields of:

- health;
- law;
- accounting;
- actuarial science;
- performing arts;
- consulting;
- athletics;
- financial services;
- brokerage services; and
- any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

However, the performance of services in the fields of architecture and engineering have been specifically excluded from this list.

A specified service trade or business also includes a trade or business that involves the performance of services that consist of:

- investing and investment management;
- trading or dealing in securities;
- trading or dealing in partnership interests; and
- trading or dealing in commodities .

[IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

6. **Are there any circumstances in which a taxpayer is able to deduct qualified business income from a specified service trade or business?**

If a taxpayer's taxable income does not exceed an applicable threshold amount (adjusted for inflation), the specified service trade or business exclusion does not apply and the taxpayer is allowed a deduction with respect to the QBI of that trade or business . For 2018 the threshold amount is $315,000 for joint filers and $157,500 for all other taxpayers . The specified service trade or business exclusion phases in for taxpayers with taxable income in excess of the applicable threshold amount and is fully phased in for taxpayers with taxable income in excess of the applicable threshold amount plus $100,000 for joint filers and $50,000 for other taxpayers . The exclusion is phased in based on the ratio of taxable income in excess of the threshold amount to $100,000 or $50,000, whichever is applicable. [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

7. **Is a rental real estate activity considered a qualified trade or business for purposes of the §199A deduction?**

There is no specific definition of a "trade or business" for purposes of §199A. Section §199A does not specifically refer to §162 but the phrase "trade or business" in §199A most likely refers to a §162 trade or business (regular, continuous and substantial). If this is the case, then a rental real estate activity that rises to the level of a §212 activity but not a §162 trade or business would not be a qualified trade or business for purposes of the deduction . There is currently no guidance on the circumstances under which a rental real activity rises to the level of a §162 trade or business for purposes of the §199A deduction. The §1411 (net investment income tax) regulations provide some guidance, but it is not technically applicable to §199A. Additional guidance from the IRS is needed. [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.a.]

8. **How does a taxpayer compute "qualified business income" for each qualified trade or business? –**

For each qualified trade or business, qualified business income is equal to the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business . Items of income, gain, deduction, and loss are qualified items only to the extent that (1) they are included or allowed in the determination of the taxpayer's taxable income for the tax year, and (2) they are effectively connected with the conduct of a trade or business within the United States or Puerto Rico . [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.a.]

9. **What is excluded from "qualified business income"?**

QBI does not include:

- short-term or long-term capital gain or loss;
- interest income (other than interest income properly allocable to a trade or business);
- gain or loss described in §954(c)(1)(C)(commodities transactions) or §954(c)(1)(D) (foreign currency gains);
- income, gain, deduction, or loss taken into account under §954(c)(1)(F)(income from notional principal contracts);
- amounts received from annuities that are not received in connection with the trade or business; and
- any item of deduction or loss properly allocable to an amount described above .

In addition, QBI also does not include:

- any amount paid by a qualified trade or business for services rendered that is treated as reasonable compensation of a taxpayer;
- any guaranteed payment by a partnership to a taxpayer for services rendered with respect to the trade or business; and
- to the extent provided in future regulations, any amount paid by a partnership to a taxpayer acting other than in his or her capacity as a partner for services .

[IRC §199A; Act §11011; 701 T.M., I.B.2.]

10. Does the §199A deduction apply to both passive and active income?

Yes. The deduction applies to "qualified business income" and there is no requirement that qualified business income be active income . Thus, a passive investor can claim the §199A deduction. [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

11. What happens if a taxpayer's net amount of qualified business income from all of the taxpayer's qualified trades or businesses is less than zero?

If a taxpayer's net amount of qualified business income with respect to all of its qualified trades or business is less than zero, that amount is carried forward and treated as a loss from a qualified trade or business in the succeeding tax year, which means that it reduces the available deduction in that year. [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

12. What is the W-2 wage and qualified property limitation on qualified business income?

The W-2 wage and qualified property limitation essentially limits a taxpayer's deductible amount with respect to a qualified trade or business to the lesser of (1) 20% of the taxpayer's qualified business income, or (2) the greater of (a) 50% of the W-2 wages with respect to the trade or business, or (b) the sum of (i) 25% of the W-2 wages with respect to

the trade or business, plus (ii) 2 .5% of the unadjusted basis (immediately after acquisition) of all qualified property . W-2 wages are defined as the total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the tax year of the taxpayer .

W-2 wages do not include (1) any amount that is not properly allocable to the QBI as a qualified item of deduction, and (2) any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for filing such return . Qualified property is defined as tangible property of a character subject to depreciation (1) that is held by, and available for use in, the qualified trade or business at the end of the tax year, (2) that is used in the production of QBI, and (3) for which the depreciable period has not ended before the end of the tax year . The depreciable period with respect to qualified property is defined as the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (1) the date 10 years after that date, or (2) the last day of the last full year in the applicable recovery period that would apply to the property under §168 (without regard to §168(g)). [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

13. Are there taxpayers who are excluded from the W-2 wage and qualified property limitation on qualified business income?

If the taxpayer's taxable income is below an applicable threshold amount (adjusted for inflation), the W-2 wage limitation does not apply to limit the taxpayer's deduction for QBI . For 2018 the threshold amount is $315,000 for joint filers and $157,500 for all other

taxpayers . The W-2 wage limitation phases in for a taxpayer with taxable income in excess of the applicable threshold amount and is fully phased in for a taxpayer with taxable income in excess of the applicable threshold amount plus $100,000 for joint filers and $50,000 for other taxpayers . The limitation is phased in based on the ratio of taxable income in excess of the threshold amount to $100,000 or $50,000, whichever is applicable. [IRC §199A; Act §11011; 701 T.M., I.B.2.]

14. How does the "W-2 wage" and qualified property limitation for the 20% deduction for pass-through entity income work in practice, and what sort of planning can be done to minimize its impact?

The special definition of "W-2 wages" for the limitation on the 20% deduction for pass-through entity income in §199A partially mirrors language in the former §199 domestic production activities deduction, so some helpful guidance on this issue can be found in Rev. Proc. 2006-22 and in the §199 regulations. For §199A, the W-2 wage limitation depends on a variety of factors, including the type of business the taxpayer operates, the taxpayer's taxable income, and the unadjusted basis of the business's depreciable assets .

For a discussion of this topic and ideas on how to begin planning, see Ruth M . Wimer, "Tax Reform: Form W-2 Significance for Pass-Through 20% Section 199A Deduction," 10 Daily Tax Report J-1 (Jan . 16, 2018). [IRC §199, §199A; Act §11011; 701 T.M., I.B.2. .]

15. Does the W-2 wage and qualified property limitation apply to real estate investment trusts (REITs) or publicly traded partnerships (PTPs)?

No . Qualified REIT dividends are generally any dividends received from a REIT other than any portion of a dividend that is a capital gain dividend or a qualified dividend under §1(h)(11).Qualified publicly traded partnership income is generally, with respect to any qualified trade or business, the sum of (1) the net amount of the taxpayer's allocable share of qualified items, and (2) gain recognized by the taxpayer on the disposition of its interests in the PTP that is treated as ordinary income . A taxpayer is allowed to deduct 20% of qualified REIT dividends and 20% of qualified publicly traded partnership income, subject only to the overall taxable income limitations provided in §199A(a) . [IRC §199A ; Act §11011 ; 701 T.M., I.B.2.]

16. Are trusts and estates able to claim the §199A deduction for qualified business income from pass-through entities?

Yes . Trusts and estates are eligible for the deduction . For purposes of the W-2 wage limitation, rules similar to the rules under former §199A apply for apportioning any W-2 wages and unadjusted basis of qualified property between fiduciaries and beneficiaries . [IRC §199A; Act §11011; 701 T.M., I.B.2.]

17. How will the §199A deduction for qualified business income of pass-through entities apply to electing small business trusts?

It is not clear how the §199A deduction will apply to electing small business trusts (ESBTs). The legislative history broadly states that trust and estates are eligible for the deduction. But 641(c) may present some technical issues. There are limited adjustments that can be made to the S corporation portion of an ESBT. However, it is clear Congress intended the 20% deduction would be available to ''trusts,'' which include ESBTs. Guidance from the IRS would be useful. [IRC §199A ; Act §11011 ; H.R. Conf. Rep. No 115-466 224; 701 T.M., I.B.2. .]

18. Will the state and local tax (SALT) deduction limit also apply to property taxes/ income taxes paid by a pass-through? If so, it is expected that these items will now be "separately stated items"?

The limitation applies to individuals but does not apply to property taxes paid or accrued in a trade or business or a §212 expense. Accordingly, property taxes paid, for example, in a real estate partnership entered into for profit would not be subject to the limitation. This exception does not apply to income taxes. It is not clear what the result would be if, for an example, a corporation that was an S corporation for federal purposes but not for state purposes were to pay state income tax. It is also not clear whether SALT would be treated as separately stated items. [IRC §164 ; Act §11042 ; 525 T.M., II.A.]

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