BESSEMER TRUST

Section 199A—Qualified Business Income Deduction Including Highlights of Final and Newly Proposed Regulations

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A. Overview

The top corporate tax rate is 21% under the Tax Cuts and Jobs Act (the "2017 Tax Act"), effective beginning in 2018. This reduced top income tax rate applies to any entities that are subject to income taxation under Subchapter C.

A complicated provision in new §199A provides tax-favored treatment of business income from passthrough entities (sole proprietorships, partnerships, limited liability companies, or S corporations) that are not subject to taxation under Subchapter C and that will be taxed at the individual tax rates of the owners, which could be as high as 37%. The deduction under §199A reduces the wide discrepancy (21% vs. 37%) in the top rates at which business income would be taxed, depending on whether the business is taxed as a C corporation or as a proprietorship or passthrough entity. Very generally (but with various limitations and exceptions), the §199A deduction is a deduction for the individual owner's tax calculation equal to 20% of the individual's qualified business income; the 20% deduction results in an effective top rate of (1 – 0.20) x 37%, or 29.6%. This deduction is subject to various limitations, the most important of which apply to taxpayers with taxable income over a certain threshold amount and are (1) based on the wages paid by the business or wages plus the basis of its property, or (2) in certain specified service businesses (designed to prevent converting what would otherwise be normal service compensation income into business income). The deduction is allowed to individuals, trusts and estates.

The IRS estimates that 22-24 million taxpayers will be eligible for the §199A deduction, and that 95% of those eligible taxpayers will fall below the $157,500/$315,000 threshold and will not be subject to the wage and capital limitation or the specified service business restriction. *See* Robert Lee, *IRS Sheds Light on Pass-Through Deduction*, BLOOMBERG DAILY TAX REPORT (Nov. 14, 2018).

B. Temporary, Through 2025

The §199A provision is in the Subtitle A of the 2017 Tax Act addressing individual tax reform, and like most of the individual tax provisions in the Act, applies only through 2025.

C. Regulations Overview

The IRS on August 8, 2018 issued 184 pages of proposed regulations (including a 104 page preamble) to §199A and the multiple trust rule under §643. The proposed regulations were published in the Federal Register on August16, 2018. In addition, Notice 2018-64 was issued in conjunction with the proposed regulations and addresses alternative methods for calculating W-2 wages as used in the computations under §199A. The issuance of complicated detailed proposed regulations to this complex Code section within only about eight months of the passage of the Act was amazingly fast.

A short comment period was established and a hearing regarding comments was held in early October. The goal was to finalize the regulations as early as possible so that taxpayers preparing their 2018 returns could use the final regulations.

Final regulations were issued on January 18, 2019, and a slightly revised version making a few corrections was issued on February 1, 2019. In addition, Rev. Proc. 2019-11 was issued concurrently to provide additional guidance on the definition of wages, and Notice 2019-07 was issued concurrently to provide a safe harbor in a proposed Revenue Procedure under which a rental real estate enterprise may be treated as a trade or business for purposes of §199A. New proposed regulations were issued to address various issues not addressed in the August proposed regulations or final regulations (including treating a trust with separate shares as one trust for purposes of applying the threshold amount, Prop. Reg. §1.199A-6(d)(3)(iii), and governing the treatment of annuity or unitrust distributions to recipients of charitable remainder trusts as qualifying for the §199A deduction, Prop. Reg. §1.199A-6(d)(3)(v).

The separate sections of the final regulations cover the following general topics-

§1.199A-1 Definitions and operational rules-General rules for computation of deduction, trade or business, loss carryover rules

§1.199A-2 W-2 wages and unadjusted basis immediately after acquisition

§1.199A-3 Guidance regarding various terms including qualified business income, allocation among multiple trades or businesses

§1.199A-4 Aggregation

§1.199A-5 Specified service trades or businesses and performing services as employee

§1.199A- 6 Guidance regarding computational and reporting rules for "relevant passthrough entities," publicly traded partnerships (PTP), and trusts and estates (including an anti-abuse rule)

§1.643(f)-1 Multiple trusts.

D. Abbreviations

The proposed regulations employ a number of abbreviations, which no doubt will become part of tax lingo, and are used in this summary. The abbreviations include the following:

QBI	Qualified business income
RPE	Relevant passthrough entity (which includes certain partnerships, S corporations, and trusts and estates; this term is used *repeatedly* throughout the regulations and throughout this summary)
SSTB	Specified service trade or business
UBIA	Unadjusted basis immediately after acquisition (of "Qualified Property")
PTP	Publicly traded partnership
REIT	Real estate investment trust

E. Highlights of Changes Made by Final Regulations

Changes made by final regulations include the following:

(1) "Net capital gain" includes qualified dividend income (which is important because the QBI deduction is limited to the amount of a taxpayer's taxable income less net capital gains), see Item G.2 below;

(2) The computations of the QBI deduction for taxpayers having taxable income in the phase-in range are clarified for the treatment of QBI from an SSTB, and SSTB limitations apply to income from a PTP, see Item G.3 below;

(3) Trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of §199A, see Item H.5 below;

(4) Replacement property received in a like kind exchange will have a UBIA based on the transferee's unadjusted basis in the relinquished property (i.e., the UBIA will not be reduced by depreciation or other adjustments to basis after the relinquished property was acquired and before it was exchanged) but "decreased by excess boot or increased by the amount of money paid or the fair market value of property not of a like kind to the relinquished property" and the portion of the replacement property having UBIA greater than that of the relinquished property will be treated as separate property placed into service on the date that the replacement property is placed into service, see Item J.5 below;

(5) Property contributed to a partnership or S corporation will have a UBIA based on the transferee's unadjusted basis in the contributed property (less money received by the transferee or plus money paid by the transferee in the transaction) (i.e., the UBIA will not be reduced by depreciation or other adjustments to basis after the property was acquired and before it was contributed to the partnership or S corporation), see Item J.7 below;

(6) If a §754 election is in effect, §743(b) basis adjustments (at the death of a partner or upon the sale of a partnership interest) are treated as qualified property to the extent that the adjustment reflects an increase in the fair market value of the underlying qualified property), see Item J.8 below;

(7) A taxpayer who transfers his or her interest in an RPE prior to the close of the RPE's taxable year is not entitled to a share of UBIA from the RPE, see Item J.2 below;

(8) The UBIA of property acquired from a decedent will be the fair market value of the property on the date of the decedent's death (§1014) and the depreciable period (for §199A purposes) will begin on the date of death, see Item J.10 below;

(9) Aggregation will be allowed only if the 50% common ownership exists on the last day of the taxable year (as well as for a majority of the taxable year), see Item K.2.(ii) below;

(10) The attribution rule for the common ownership test in the aggregation requirements will be under §267(b) or §707 (which includes family attribution from siblings and attribution from trusts having the same grantors and attribution between a trust and beneficiaries of the trust), see Item K.4 below;

(11) Examples clarify when real estate businesses can satisfy the aggregation requirements, see Item K.7 below;

(12) An RPE can elect to aggregate separate trades or businesses that are operated directly or through lower-tier RPEs (which election shall be binding on the RPE's owners but which election, if made, will eliminate the complexity of how individual owners determine if separate businesses have 50% common ownership with attribution and satisfy the other aggregation requirements), see Item K.3 below;

(13) A taxpayer's failure to aggregate certain businesses will not preclude later aggregation of those businesses, see Item K.5 below;

(14) If a business has SSTB activities and if the non-SSTB activities do not satisfy the de minimis rule (i.e., they are not less than 10% of the gross receipts if gross receipts are $25 million or less and are not less than 5% of the gross receipts if gross receipts are in excess of $25 million), the entire business is treated as an SSTB rather than treating only a pro rata part of the business as an SSTB, see Item L.2 below;

(15) The "anti-cracking and packing" rule is revised to eliminate the 80% test (i.e., that the business provides 80% or more of its goods or services to a commonly owned SSTB); instead, if a business provides property or services to a 50% or more commonly owned SSTB, the portion of the business providing property or services to the SSTB will be treated as a separate SSTB with respect to related parties, see Item L.3 below;

(16) The "incidental to an SSTB" rule is eliminated, meaning that a business (that would not otherwise be an SSTB) that is 50% or more commonly owned with an SSTB does not have to worry that it will become an SSTB if it shares expenses with the SSTB and has gross receipts representing more than 5% of the combined gross receipts of the business and SSTB, see Item L.4 below;

(17) The presumption that an employee who becomes an independent contractor while providing substantially the same services is nevertheless an employee is relaxed somewhat, see Item H.2 below;

(18) The reporting rules are relaxed by providing that *all* of an RPE's items related to §199A (including QBI, wages and UBIA) should not be presumed to be zero because of a failure to report one item; instead only the *unreported* item of positive QBI, wages or UBIA is presumed to be zero, see Item O.2 below;

(19) ESBTs may continue to qualify for the §199A deduction (as in the proposed regulations) but the separate S and non-S portions of the ESBT are not treated as two separate trusts for purposes of applying the income threshold test, see Item M.5 below;

(20) A trust's taxable income, for purposes of determining whether the trust's taxable income exceeds the threshold amount, is calculated after deducting any distribution deduction under §§651 or 661, see Item M.1 below;

(21) The §199A Anti-Abuse Rule applies if a trust (even a single trust) was created with a principal (rather than significant as in the proposed regulation) purpose of avoiding or using more than one threshold amount, and the effect is that the trust will be aggregated with the grantor or other trust(s) from which it was funded for purposes of determining the threshold amount, see Item M.6 below;

(22) The multiple trust rule regulation is revised by eliminating a definition that converted principal purpose to avoid income tax into a significant non tax (or non-income tax) purpose that could be achieved only with creation of the separate trusts and by eliminating two examples of trusts bearing on when trusts have substantially the same beneficiaries, see Item M.7 below.

F. Effective Date of Final Regulations

The §199A regulations *apply* to taxable years ending after the date of publication in the Federal Register (which presumably will be sometime in late January or early February, 2019). However, the preamble to the final regulations provides that for taxable years ending in 2018 taxpayers have an option either to rely on the final regulations in their entirety or to rely on the proposed regulations that were proposed on August 16, 2018 in their entirety. Preamble to Final Regulations at 2, 117-118. Presumably this rather unusual option is allowed in light of the fact that some taxpayers may have relied on the proposed regulations in the course of their planning in 2018, and advisors may have already started preparing compliance reports based on the proposed regulations.

Various anti-abuse rules apply to taxable years ending after December 22, 2017, the date of enactment of the 2017 Tax Act (these are the regulations addressing UBIA property acquired at the end of a year, Reg. §1.199A-2(c)(1)(iv),certain REIT dividends, Reg. §1.199A-3(c)(2)(ii), anti-cracking and packing rule, Reg. §1.199A-5(c)(2), the presumption that former employees are still employees, Reg. §1.199A-5(d)(3), creation of a trust to avoid §199A, Reg. §1.199A-6(d)(3)(vii), and the multiple trust rule, Reg. §1.643-1). The preamble to the proposed regulations explains that §7805(b)(3) provides that any regulation may take effect or apply retroactively to prevent abuse.

G. General Computation Formula for Deduction

1. **Threshold Amount.** Special limitations on the amount of the §199A deduction (the "W-2 wages and capital limitation" and the limitation for SSTBs, both of which are discussed below) apply to taxpayers having taxable income above a specified threshold amount. The threshold amount is taxable income determined without considering the §199A deduction itself, of $157,500 for taxpayers other than joint return filers and $315,000 for married couples filing joint returns, indexed for inflation for tax years beginning after 2018. Prop. Reg. §1.199A-1(b)(12). (For 2019, the indexed threshold amounts are $160,700 for single and head of household taxpayers, $160,725 for married filing separate returns, and $321,400 for married taxpayers filing joint returns, Rev. Proc. 2018-57, §3.27.) The $157,500 (indexed) threshold is *taxable* income, which would be calculated after considering the individual's allowable deductions or the $24,000 standard deduction, if a larger amount (and all adjustments allowed in arriving at

adjusted gross income, which would include 50% of self-employment tax). Tax-exempt income obviously is not included. Low income taxpayers (with taxable income below the threshold amount) are not subject to the "W-2 and UBIA limitation" or the SSTB limitation (both of which are described below). Those limitations are phased in for the next $50,000 /$100,000 (i.e., other than joint return/joint return taxpayers) of taxable income.

Anything that drives down taxable income (other than the §199A deduction itself) helps in getting below the threshold amount. This could include strategies such as making additional charitable contributions or IRA contributions, or shifting the investment mix toward investments producing tax-exempt income.

2. Individuals with Taxable Income Not Exceeding Threshold Amount.

Deduction = Lesser of:

(1) 20% of QBI {including QBI of SSTBs} + 20% of (qualified REIT dividends + qualified PTP income); or

(2) 20% x (taxable income – net capital gain). Reg. §1.199A-1(c).

The last element means that the deduction cannot exceed taxable income reduced by the taxpayer's net capital gain for the year. In effect, the 20% deduction cannot exceed 20% of the taxpayer's ordinary income. That same overall limit on the deduction applies for individuals with taxable incomes exceeding the threshold amount (described immediately below). The final regulations add that net capital gain means net capital gain as defined in §1221(11) plus any qualified dividend income for the taxable year. Reg. §1.199A-1(b)(3).

3. Individuals with Taxable Income Exceeding Threshold Amount.

Deduction = Lesser of:

(1) QBI component + 20% of (qualified REIT dividends + qualified PTP income); or

(2) 20% x (taxable income – net capital gain). Prop. Reg. §1.199A-1(d)(1).

QBI component = sum of the following for each separate trade or business--

Lesser of:

(1) 20% of QBI for that trade or business, or

(2) What is referred to in this outline as the "W-2 wages or UBIA limitation" (or sometimes as the "W-2 wages or capital limitation"), which is the greater of the individual's allocable share of

(i) 50% of W-2 wages for that trade or business, or

(ii) 25% of W-2 wages for that trade or business + 2.5% of UBIA of qualified property for that trade or business, The QBI component is the sum of the formula amounts (i.e., the lesser of 20% of QBI or the "W-2 wages or capital limitation") for *each* separate trade or business. See Item H.6 below.

The formula is subject to a special rule for SSTBs, which is that QBI, W-2 wages, and UBIA of qualified property of a SSTB are not taken into account, Reg. §1.199A-1(d)(2)(i), and

Subject to a phase-in rule if taxable income is in the "phase-in range." Reg. §1.199A-1(d)(2)(iv)(B).

Even if a taxpayer has no QBI component, qualified REIT dividends or PTP income can still result in a §199A deduction, and the deduction attributable to REIT dividends or PTP income is not limited based on whether the taxpayer's taxable income exceeds the threshold amount.

Phase-In Range. For taxpayers with up to $50,000 ($100,000 for joint returns) over the threshold amount, the W-2 wages or UBIA limitation is applied proportionately by the amount that the excess bears to $50,000 (or $100,000, as appropriate). Reg. §1.199A-1(d)(iv)(B). As an example, if a married/joint return taxpayer has taxable income that is $30,000 over the threshold amount, the QBI deduction will be reduced by 30% of the difference between 20% of QBI and the amount of the "W-2 wages or capital limitation" amount. In this simple example, the "applicable percentage" as used in the calculations would be 70%. Reg. §1.199A-1(b)(2). The actual calculation process is rather tedious, and the final regulations made some modifications regarding the treatment of REIT dividends, PTP income, and PTP income generated by an SSTB in the phase-in range computations. Reg. §1.199A-1(d)(iv)(B)(3).

The REIT dividends and PTP income provisions in the first element of the basic deduction formula in effect means that the W-2 wages and capital limitation and the limitation of SSTB income do not apply to those types of income.

H. Qualified Business Income

QBI "means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of §1.199A-3(b) [which also requires that the income be effectively connected with a U.S. trade or business]." Reg. §1.199A-1(b)(5). (Observe that credits attributable to trades or businesses are not considered.)

1. **Trade or Business.** Section 199A(d)(1) describes a "qualified trade or business" as any trade or business other than an SSTB or the trade or business of performing services as an employee. (The exception for an SSTB does not apply to taxpayers with taxable income under the threshold amount. §199A(d)(3)(A)(i).)

   Real Estate. The regulations adopt the definition of a trade or business under §162. Substantial case law and rulings have developed regarding whether the management of real estate rental property constitutes a trade or business. Operating under a triple net lease typically would not qualify as a trade or business. (The proposed regulations refer to an example of an individual leasing land to suburban airports for parking lots with no suggestion that it may not be a trade or business, Prop. Reg. §1.199A-1(d)(4)Ex.1). The example was revised to delete the reference to land, and the preamble to the final regulations made clear that the examples "were not intended to suggest that the lease of the land is or is not a trade or business for purposes of section 199A." Preamble to Final Regulations at 18. *See* Alan Gassman and Kelsey Weiss, *Is it Possible for a Triple Net Lease to be Considered a "Trade or Business" for Section 199A Purposes*, LEIMBERG INC. TAX PL. NEWSLETTER #161 (Nov. 8, 2018) ("under the classic definition of a triple net lease, the lessor would not qualify for the 199A deduction" but the lessor could do things to increase its level of activity with the rental in ways that might cause the arrangement to qualify).

"Self-Rental" Exception for Real Estate. The regulations add a helpful special rule for purposes of §199A—the rental of property to a related trade or business that is "conducted by the individual or an RPE" (added in the final regulation that the related business cannot be a C corporation) is treated as a separate trade or business if the two separate businesses are commonly controlled, meaning the same persons directly or indirectly own 50% or more of each business (applying broad attribution rules attributing ownership from an individual's siblings, spouse, ancestors, and lineal descendants as well as trust/trust, trust/grantor, and trust/beneficiary attribution). Reg. §1.199A-1(b)(14), referring to §1.199A-4(b)(1)(i), which refers to §§ 267(b) or 707(b). The exception is very helpful because business owners often segregate rental property from operating businesses. (If desired, the taxpayer could aggregate the two businesses under the aggregation rules of §1.199A-4 if the requirements of that section are satisfied.)

Rental Real Estate Safe Harbor, Notice 2019-7. Rental real estate that is not rented to a commonly controlled individual or RPE can nevertheless qualify for a safe harbor to be treated as a trade or business for purposes of §199A by meeting the requirements described in Notice 2019-7, which proposes a Revenue Procedure but that can be relied on currently for any taxable year ending after 2017.

The safe harbor applies to a "real estate enterprise" defined as an interest in rental real property owned by an individual or RPE directly or in a disregarded entity and may consist of a single property or multiple similar properties. Certain rental real estate arrangements are excluded, however, including property used as a residence for any part of the year, or real estate rented under a triple net lease.

A rental real estate enterprise qualifies for the safe harbor if (A) separate books and records are maintained to reflect income and expenses for each enterprise; (B) for taxable years beginning prior to January 1, 2023, 250 or more hours or rental services (specifically defined) are performed annually, and in taxable years beginning after 2022, 250 hours of service are performed in three of five consecutive taxable years ending with the taxable year in question; and (C) the taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services (but the contemporaneous records requirement does not apply to taxable years beginning before January 1, 2019).

For a summary of planning considerations for using this safe harbor, see Alan Gassman, John Beck, & Brandon Ketron, *One Particular Harbor, New Regulatory Guidance on If and When a Rental Real Estate Activity Can Qualify for the 20% Section 199A Deduction*, LEIMBERG INC. TAX PL. NEWSLETTER #170 (Jan. 21, 2019).

2. **Trade or Business of Performing Services as an Employee.** A business of serving as an employee is not eligible for the §199A deduction. §199A(d)(1)(B). The proposed regulations include several special rules to discourage current employees from becoming independent contractors in an attempt to qualify for the deduction. First, the employer's Federal employment tax classification of the employee as a non-employee is immaterial. Reg. §1.199A-5(d)(2). Second, if an employee becomes an independent contractor while providing substantially the same services as before, a presumption arises that the person is an employee for purposes of §199A, and the final regulations add that this presumption continues for three years after ceasing to be treated as an employee. Reg. §1.199A-5(d)(3)(i). The presumption may be rebutted by showing that the individual is performing services in a capacity other than as an employee, *Id.*, which may be demonstrated by "providing records, such as contracts or partnership agreements that provide sufficient evidence to corroborate the individual's status as a non-employee." Reg. §1.199A-5(d)(3)(ii). The proposed regulations contained three rather detailed examples, and the final regulations add a fourth example of rebutting the presumption by an employee who became a partner, thus sharing the profits of the firm and materially modifying the relationship with the firm. This presumption provision is one of the anti-abuse provisions that applies to taxable years ending after December 22, 2017. Reg. §1.199A-5(e)(2)(i). Observe that no contrary presumption exists providing that an independent contractor is presumed to remain an independent contractor, leaving open the possibility of an independent contractor converting to employee status if more W-2 wages are needed for owners to be able to use the §199A deduction.

3. **Specific Items Included and Excluded from QBI.** QBI is generally the net amount of income, gain, deduction, and loss from an active trade or business within the United States, including §751 gain, but not including certain types of investment income (short or long term capital gains or losses including gains or losses that are treated as capital gains or losses under other Code sections such as under §1231, dividends or interest unless the interest is allocable to a trade or business but interest attributable to the investment of working capital is not included in QBI), annuity income not received in connection with the business, net gain from foreign currency transactions and commodities transactions, and income from notional contracts. The final regulations are clarified and the preamble specifically summarizes that items treated as capital gain or loss under any Code section are not included in QBI but items not treated as capital gain or loss under other Code sections are included in QBI unless otherwise excluded by §199A or the regulations. For example, the preamble notes that net §1231 losses are

characterized as ordinary so are included in QBI. Preamble to Final Regulations at 54-55. In addition, QBI does not include reasonable compensation paid to the taxpayer, any guaranteed payment under §707(c), or payment to a partner for services under §707(a). Reg. §1.199A-3(b).

4. **No Imputed Reasonable Compensation From Partnerships.** Reasonable compensation concepts are applied to S corporations to prevent avoidance of self-employment tax abuses, but no tax rules require partnerships to pay their active owners a guaranteed payment (treated as compensation). The proposed regulations do not require a partnership to pay reasonable compensation for purposes of §199A. Preamble to August 2018 Proposed Regulations at 39-40.

5. **Disregarded Entities.** Trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of §199A. Reg. §1.199A-1(e)(2).

6. **Losses; Multiple Businesses.** If a taxpayer has multiple businesses, the QBI must be determined for each separate business. The preamble to the final regulations noted that some commenters requested more guidance in determining when separate trades or businesses exist in an entity or when an entity's combined activities should be considered a single §162 trade or business. The IRS declined to provide additional guidance but observed that under Reg. §1.446-1(d) separate trades or businesses will not exist within an entity unless a complete and separable set of books and records is kept for each trade or business and accounting methods are not used to create or shift profits or losses between the businesses so that income of the taxpayer is not clearly reflected. Preamble to Final Regulations at 19-20.

   If any business has a negative QBI, that loss is netted against the QBI from businesses with positive QBI. The loss is allocated across businesses with positive QBI proportionately based on the amount of QBI in each such business with positive QBI, and that allocation is made before the individual applies the limitations based on W-2 wages and UBIA of qualified property. The net QBI of each business, after considering apportioned losses is then compared with the W-2 wages and UBIA limitation for each business. The W-2 wages and UBIA from a business with a negative QBI are not taken into account for other businesses and are not carried over to subsequent years for that business. Reg. §1.199A-1(d)(2)(iii)(A).

   If the net QBI for all businesses in a year is a negative number, the negative amount is treated as QBI from a separate business, and is carried over to subsequent years to offset the positive QBI of businesses in subsequent years. Reg. §1.199A-1(d)(2)(iii)(B).

   Previously disallowed losses that are allowed in the current taxable year are taken into account in computing QBI, and the final regulations add that such prior disallowed losses will be used, for §199A purposes, in order from oldest to the most recent on a FIFO basis. Reg. §1.199A-3(b)(1)(iv).

Net operating losses are generally not considered attributable to a trade or business and are not taken into account in computing QBI because the items giving rise to the loss were allowed in computing taxable income in the year incurred. If some losses that were disallowed by §461(l) in determining income give rise to an NOL, the disallowed deductions will not be included in the QBI computation in the year incurred, and the NOL attributable to that business will constitute QBI in later years. Reg. §1.199A-3(b)(1)(v).

I. W-2 Wages

The taxpayer's pro rata share of the total W-2 wages paid by the business (including wages paid to the taxpayer) is considered in determining the W-2 wages or UBIA limitation.

1. **General Rules.** W-2 wages includes wages as defined in §3401(a) subject to wage withholding, and also include elective deferrals (under §402(g)(3)), and deferred compensation (under §457), and Roth contributions. Reg. §1.199A-2(b)(2)(i). Amounts are considered only if they are properly included on a Form W-2 and W-3 filed with the Social Security Administration by the 60th day after the due date (generally January 31 of the following calendar year), including extensions, for such returns. §199A(b)(4)(C). If a corrected return is filed after that 60th day date, any increase in reported wages is ignored but any decrease must be taken into account in determining the business's W-2 wages. Reg. §1.199A-2(b)(2)(iii)(B). One aspect of being able to show that W-2 wages are attributable to QBI is that the wages should have been deducted in calculating QBI. Reg. §1.199A-2(b)(4).

   Procedures are included for determining W-2 wages for short years (arising from the acquisition or disposition of a business interest by the taxpayer). Reg. §1.199A-2(b)(2)(iv)(C).

   Three alternative methods were provided for calculating W-2 wages in Notice 2018-64, issued in conjunction with the proposed regulations, and are now included in Rev. Proc. 2019-11, issued in conjunction with the final regulations. These are (i) the unmodified box method (lesser of Boxes 1 and 5 for all employees' W-2 forms, the simplest approach, but that may not be as large a number as the other approaches), (ii) the modified Box 1 method (Box 1 less some amounts that are not wages for withholding purposes and totals in Box 12, Code D, E, F, G, and S relating to elective deferrals), and (iii) the tracking wages method (all wages subject to withholding and totals in Box 12, Code D, E, F, G, and S relating to elective deferrals). The effect is that W-2 wages include most pension plan contributions (including elective deferrals), health insurance costs, and various other items of compensation.

2. **Management Company Exception.** The regulations add a regulatory rule providing relief for situations in which the employees for various separate businesses are employed by a central management company. For example, real estate investors often form separate LLCs to own separate real estate investments, and each separate business pays a management fee to a central management company that hires employees to provide management services for all of the separate businesses.

Reg. §1.199A-2(b)(2)(ii). Without this rule, the businesses would have no W-2 wages to apply for determining the W-2 wages and UBIA limitation applicable to those businesses. The proposed regulation is very succinct, simply providing that a taxpayer can take into consideration any W-2 wages paid by another person "provided the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE." *Id*.

3. **Allocation of Wages among Businesses and to QBI.** If an employee is used in multiple businesses, the W-2 wages are allocated among those businesses in the same manner that expenses are allocated among the businesses under §1.199A-3(b)(5). The wages allocated to each business is then further allocated to determine the wages properly allocated to QBI for each business. Reg. §1.199A-2(b)(3)-(4). (An RPE must identify and report associated wages to its partners or shareholders. Reg. §1.199A-6(b)(3)(i)(A).)

4. **Guaranteed Payments Not W-2 Wages**. For S corporations, compensation paid to shareholders is treated as W-2 wages. Owners of partnerships or LLCs, however, receive guaranteed payments rather than wages. Guaranteed payments are deductible, so reduce QBI (and therefore reduce the 20% of QBI deduction), but do not count as W-2 wages.

   The preamble to the final regulations (at p. 51-52) noted that the reasonable compensation requirement for S corporations could be advantageous for purposes of the W-2 limitation, and some commenters "suggested that the final regulations should strive for equity between taxpayers operating businesses in different entity structures," but the IRS responded the §199A(c)(4) clearly excludes reasonable compensation from QBI.

   For §199A purposes, guaranteed payments are not desirable and result in a whipsaw of reducing QBI but not being counted as wages to help in satisfying the wage limitation to take full advantage of the 20% deduction that is available from the remaining QBI. A possible alternative is to contribute the partnership interest into an S corporation and have wages paid by the S corporation. Or perhaps have the owners of another entity drop their interests into a lower-tier entity and have the lower-tier entity pay wages to the employee and get W-2 treatment at the lower level. The *owner* of a partnership does not receive W-2 wages but instead receives K-1 income; to avoid that result have wages paid from an entity not owned by the employee.

5. **Balancing.** The optimal amount of compensation for §199A purposes is a balancing act. Wages reduce QBI (and therefore reduce the 20% of QBI deduction), but for taxpayers with taxable income over the threshold amount, additional wages can help satisfy the wage or capital limitation.

J. UBIA Limitation (Sometimes Referred to as the "Capital Limitation")

1. **Code Description.** The wages limitation was relaxed in the Conference Agreement for the 2017 Tax Act by adding that the wage limitation is the greater of (a) 50% of W-2 wages, or (b) the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of qualified property (generally meaning all tangible property subject to depreciation) for the useful life of such property. This separate "real estate exception" based largely on the basis of property in the business could be very beneficial to real estate companies.

2. **Qualified Property.** Qualified property is tangible depreciable property held at the close of the tax year that is used at any time during the year for the production of QBI and for which the depreciable period has not ended before the close of the individual's or RPE's taxable year. Reg. §1.199A-2(c)(1)(i). Raw land and inventory are not depreciable, so do not count. The preamble to the final regulations (at p. 38) clarifies that if the individual taxpayer and the RPE have different taxable years, the qualified property must be held at the close of the RPE's tax year.

   An addition or improvement to property is treated as separate qualified property placed into service on the date of the addition or improvement. (This is important for purposes of determining how long the basis of the property can be counted as UBIA.) Reg. §1.199A-2(c)(1)(ii).

   Businesses cannot simply acquire property briefly at the end of the year to "beef up" the UBIA amount. Property that is acquired within 60 days of year-end and disposed of within 120 days without being used in the business at least 45 days is not qualified property. Reg. §1.199A-2(c)(1)(iv). This end-of-the-year provision is one of the anti-abuse rules that has an immediate effective date from the date of enactment of §199A, applying to taxable years ending after December 22, 2017. Reg. §1.199A-5(d)(2)(i).

3. **Depreciable Period.** The depreciable period starts when the property is placed in service and ends on the later of (i) 10 years later, or (ii) the end of last full year of the applicable recovery period under §168(c). Reg. §1.199A-2(c)(2). The business will need to keep track of this period as well as the period of actual depreciation.

4. **Unadjusted Basis Immediately After Acquisition.** Using the "unadjusted" basis means that depreciation, bonus depreciation, §179 depreciation etc. have no impact on this number.

   Substantial UBIA may be needed to avoid a reduction of the 20% QBI deduction. For example, if a business has no wages, the UBIA would need to be 8 times the amount of QBI in order to take advantage of the full 20% of QBI deduction. (Calculation: .20 x QBI = .025 x 8 x QBI.)

5. **Like-Kind Exchanges**. For like-kind exchanges, the date of service of the relinquished property applies, but under the proposed regulations the adjusted basis at the time of the exchange (which may reflect depreciation or other downward basis adjustments during the intervening period) becomes the new unadjusted basis, in effect applying the worst rule for both issues from the taxpayer's perspective (but exceptions to that

general rule applied). Prop. Reg. §1.199A-2(c)(2)(iii). That result was controversial leading some commentators to suggest that the "real estate exception" (i.e., the capital limitation) will not be helpful to many real estate owners who have participated (or will participate) in like-kind exchanges. Joe Light, *Tax Break Seen Helping Trump Isn't as Sweet Thanks to IRS Rules*, BLOOMBERG DAILY TAX REPORT HIGHLIGHTS (Oct,. 12, 2018). The issue was noted in various comments to the IRS, and the final regulations change the result.

The final regulations provide that the replacement property received in a like-kind exchange will have a UBIA based on the transferee's unadjusted basis in the relinquished property. (i.e., not reduced by depreciation or other adjustments to basis after the relinquished property was acquired and before it was exchanged), but "decreased by excess boot or increased by the amount of money paid or the fair market value of property not of a like kind to the relinquished property." Reg. §1.199A-2(c)(3)(ii). To the extent that the UBIA of the replacement property is greater than that of the relinquished property (reflecting increases in UBIA due to money paid or non like-kind qualified property received in the exchange), the excess is treated as separate qualified property that is placed into service on the date that the replacement property is placed into service.

The final regulations have helpful examples illustrating these rules. One of the examples provides that A purchased Real Property X for $ 1 million and placed it into service on January 5, 2012. Real Property X appreciated to $1.3 million by January 15, 2019 and had an adjusted basis on that date of $820,482. A exchanged Real Property X plus $200,000 cash for Real Property Y, valued at $1.5 million, on January 15, 2019. The result for purposes of §199A is as follows:

> A's UBIA in Real Property Y is $1.2 million as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X plus $200,000 cash paid by A to acquire Real Property Y). Because the UBIA of Real Property Y exceeds the UBIA of Real Property X, Real Property Y is treated as being two separate qualified properties for purposes of applying paragraph (c)(2)(iii)(A) of this section. One property has a UBIA of $1 million (the portion of A's UBIA of $1.2 million in Real Property Y that does not exceed A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A. The other property has a UBIA of $200,000 (the portion of A's UBIA of $1.2 million in Real Property Y that exceeds A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 15, 2019, which is the date on which Real Property Y was first placed in service by A. Reg. §1.199A-2(c)(4)(iv)(B).

6. **Involuntary Conversions**. Similar rules apply for involuntary conversions. Reg. §§1.199A-2(c)(2)(iii) (depreciable period) & 1.199A-2(c)(3)(iii) (unadjusted basis immediately after acquisition).

7. **Non-Recognition Contributions to an RPE**. Similar to the like-kind exchange rules, if assets are contributed to a new taxable entity in a nontaxable exchange (for example contributions to a partnership under §721 or contributions to an S corporation under §351), the worst of both worlds applied under the proposed regulations–the original life continued but the adjusted basis at the time of the contribution (which may reflect prior depreciation deductions or other downward basis adjustments) became the new

unadjusted basis. Prop. Reg. §§1.199A-2(c)(2)(iv); 1.199A-2(c)(3) (in conjunction with the additional explanation in the Preamble); 1.199A-2(c)(4)(Ex.3). Comments from ACTEC to the IRS and Treasury about the proposed regulations recommended that the UBIA of property contributed to a partnership or S corporation be determined without regard to §723 for a partnership or §362 for an S corporation "so that the UBIA of the qualified property in the hands of the contributing partner or shareholder will carry over to the RPE."

The final regulations change the result. For property contributed to a partnership or S corporation in nonrecognition transactions (under §§721 or 351, respectively), the transferor's UBIA will be the UBIA of the contributed property (i.e., not reduced by depreciation deductions or other downward adjustments before the date of the contribution), "decreased by the amount of money received by the transferee in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction." Reg. §1.199A-2(c)(3)(iv). *See* Reg. §1.199A-2(c)(4)(viii)-(ix) (Exs. 8-9).

8. **Section 754 Election**. Basis adjustments under §§734(b) and 743(b) of property held in an RPE with a §754 election in effect were not counted in determining UBIA under the proposed regulations. Prop. Reg. §1.199A-2(c)(1)(iii). Many comments were submitted to the IRS about this provision and pointing out various alternatives. This final regulations change the result, explained in the preamble as follows:

> The Treasury Department and the IRS agree that section 743(b) basis adjustments should be treated as qualified property to extent the section 743(b) basis adjustment reflects an increase in the fair market value of the underlying qualified property. Accordingly, the final regulations define an "excess section 743(b) basis adjustment" as an amount determined with respect to each item of qualified property equal to the excess of the partner's section 743(b) basis adjustment with respect to each item over an amount that would represent the partner's section 743(b) basis adjustment with respect to the property, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property. The excess section 743(b) basis adjustment is treated as a separate item of qualified property placed in service when the transfer of the partnership interest occurs. This rule is limited solely to the determination of the depreciable period for purposes of section 199A and is not applicable to the determination of the placed in service date for depreciation or tax credit purposes. The recovery period for such property is determined under §1.7431(j)(4)(i)(B) with respect to positive basis adjustments and §1.743-1(j)(4)(ii)(B) with respect to negative basis adjustments. Preamble to Final Regulations at 36.

9. **Allocation of UBIA Based on Depreciation Allocation**. UBIA is allocated among the owners of an RPE based on how depreciation is allocated. The final regulations make a technical change in the way that the allocation is made, as summarized by the preamble:

> The Treasury Department and the IRS agree with the commenters that relying on section 704(c) to allocate UBIA could lead to unintended shifts in the allocation of UBIA. Therefore, the final regulations provide that each partner's share of the UBIA of qualified property is determined in accordance with how depreciation would be allocated for section 704(b) book purposes under §1.704-1(b)(2)(iv)(g) on the last day of the taxable year. To the extent a partner has depreciation expense as an ordinary deduction and as a rental real estate deduction, the allocation of the UBIA should match the allocation of the expenses. The Treasury Department and the IRS request comments on whether a new regime is necessary in the case of a partnership with qualified property that does not produce tax depreciation

during the taxable year. In the case of qualified property held by an S corporation, each shareholder's share of UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation. Preamble to Final Regulations at 28-29.

10. **Property Acquired From a Decedent.** The preamble to the proposed regulations stated that the UBIA of property acquired from a decedent will generally be the fair market value at the date of death, but that was not included in the actual regulations. The final regulations add a provision that for qualified property acquired from a decedent and immediately placed into service, the UBIA will generally be the fair market value at the date of the decedent's death under §1014. For purposes of §199A, a new depreciable period begins on the date of death. Reg. §1.199A-2(c)(3)(v).

K. Aggregation

1. **Significance.** The preamble to the final regulations summarizes that that the aggregation rules "are optional and are intended to assist taxpayers in applying the W-2 wage and UBIA of qualified property limitations in situations in which a unified business is conducted across multiple entities." Preamble to Final Regulations at 22. The regulations adopt an approach of allowing taxpayers (and, added in the final regulations, sometimes the passthrough entity) to aggregate separate businesses that meet certain tests, which results in combining the QBI, W-2 wages and qualified property of the aggregated separate businesses. This can be very helpful, for example, if some businesses have little wages or qualified property (for the UBIA limitation) and other businesses have a relative abundance of W-2 wages or qualified property. This is somewhat similar to the concept of "grouping" under the passive activity loss rules, but the rules are different, and a particular taxpayer may choose to aggregate businesses for purposes of §199A in a different manner than the same taxpayer groups businesses for passive activity loss purposes. Aggregation is at the option of the taxpayer, and all of the owners of a business do not have to make the same aggregation decision (except in situations in which an RPE makes the aggregation election).

   Under the proposed regulations, aggregation is allowed at the individual owner level. Commentators have strongly encouraged the IRS to allow aggregation at the entity level to simplify compliance, and the final regulations add that flexibility.

2. **Requirements.** Businesses may be aggregated if--

   (i) The same person or group of persons, directly or indirectly, owns 50% or more of each business being aggregated (i.e., 50% or more of the shares of an S corporation or 50% of more of the capital or profits of a partnership);

   (ii) The ownership exists for a majority of the taxable year (and the final regulations add that the ownership requirement must be satisfied on the last day of the taxable year);

   (iii) All of the items attributable to each business are reported on returns having the same taxable year, not considering short taxable years;

   (iv) None of the businesses is an SSTB; and

(v) The businesses satisfy at least two of the following three factors (based on all the facts and circumstances):

(A) The businesses provide products, property, or services that are the same or are customarily offered together;

(B) The businesses share facilities or significant centralized business elements (such as personal, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); and

(C) The businesses "are operated in coordination with, or reliance upon, one or more businesses in the aggregated group (for example, supply chain interdependencies)." Reg. §1-199A-4(b)(1).

The regulations provide an additional example satisfying the (C) category of a movie theater business and food service business that operate in coordination and in reliance on each other. Reg. §1.199A-4(d)(15)(Ex. 15).

3. **Election to Aggregate at Entity Level**. Multiple commenters recommended that RPEs be permitted to aggregate at the entity level to reduce reporting requirements, to avoid the necessity for non-majority owners to know ownership information, and for simplification purposes. The final regulations permit an RPE to aggregate separate businesses that it operates directly or through lower-tier RPEs. If the election is made, the aggregation must be reported by the RPE and all owners of the RPE, and if an election is not made at the entity level, the individual owners may (or may not) elect to aggregate businesses of the RPE and do not have to make the same election. An upper-tier RPE must maintain aggregation made at the lower-tier level (i.e., it cannot subtract from the businesses aggregated at the lower-tier level), but an upper-tier RPE may aggregate additional businesses with the lower-tier RPE's aggregation if the aggregation requirements are otherwise satisfied. Reg. §1.199A-4(b)(2)(ii).

4. **Common Ownership Test.** Common ownership is determined after applying an attribution rule attributing ownership under §§267(b) or 707(b) (applying broad attribution rules attributing ownership from an individual's siblings, spouse, ancestors, and lineal descendants as well as trust/trust, trust/grantor, and trust/beneficiary attribution). Reg. §1.199A-4(b)(1)(i). The proposed regulations had a much more limited attribution rule, including only family attribution by or for an individual's spouse, children, grandchildren, or parents. Prop. Reg. §1.199A-4(b)(3). Under the proposed regulations there was no attribution between siblings or from non-grantor trusts to a beneficiary (as there is under the common ownership rule for purposes of the anti-cracking and packing rule for SSTBs). The failure to provide for attribution among siblings created a huge problem for second generation businesses in which the business has been divided among more than two children, with none of them owning 50% of the business. Comments from ACTEC to the IRS and Treasury about the proposed regulations recommend that the broader attribution rule of §267(b) or 707(b) be applied for this purpose, and the IRS adopted that approach in the final regulations.

   The taxpayer does not have to own more than 50% of each aggregated business, as long as *someone* owns 50% or more of the aggregated businesses.

5. **Consistency.** Once the taxpayer elects to aggregate businesses, the taxpayer must consistently report the aggregated businesses in all subsequent years. A newly created or newly acquired business may be added to the aggregated group assuming the requirements are satisfied; or if facts have changed significantly so that a prior aggregation no longer satisfies the requirements, the aggregation will no longer apply and the individual may determine a new permissible aggregation (if any). Reg. §1.199A-4(c)(1).

   The final regulations add that a failure to aggregate will not be considered to be an aggregation (meaning that the aggregation election could be made in later years). An aggregation election generally cannot be made for a prior year by filing an amended return, but initial aggregation elections may be made on amended returns for the 2018 taxable year because many taxpayers may have been unaware of the aggregation rules when filing their 2018 returns. *Id*. Similar consistency requirements apply to aggregation at the entity level by an RPE. Reg. §1.199A-4(c)(3).

   This consistency requirement means that taxpayers must very carefully decide what businesses to aggregate. Conditions may change in the future making the aggregation undesirable (for example, if one of the aggregated companies has a loss that has the effect of offsetting the QBI of other businesses, in effect "wasting" use of some or all of the W-2 and UBIA of those other businesses).

6. **Disclosure.** The taxpayer must disclose the aggregation on each year's return by attaching a statement containing information required in the regulations, and the IRS may disaggregate the businesses if the taxpayer fails to attach the required disclosure statement (and the final regulations add that any such disaggregated businesses may not be aggregated again for the three subsequent taxable years). Reg. §1.199A-4(c)(2).

   RPEs that elect to aggregate businesses must also submit similar annual disclosure statements on each owner's Schedule K-1, identifying each business that is aggregated by the RPE or by any other RPE in which the RPE owns an interest, and including "[s]uch other information as the Commissioner may require in forms, instructions, or other published guidance." Reg. §1.199A-4(c)(4)(i). If such statements are not attached to the Schedule K-1, the IRS may disaggregate the businesses, and they may not be re-aggregated in the subsequent three taxable years. Reg. §1.199A-4(c)(4)(ii).

   If an entity level aggregation election is not made, the aggregation requirements would seem to necessitate that an RPE report sufficient information to all owners about who the other owners are and their relationships so that each owner can decide whether the entity qualifies for aggregation with other RPEs in which the owner has an interest. The regulations do not require that information to be reported, however, which leads to the practical problem of how an individual owner will know if multiple businesses will satisfy the 50% common ownership requirement.

7. **Examples.** The regulations contain 17 detailed examples illustrating the aggregation rules. Reg. §1.199A-4(d). The final regulations added three additional examples, two of which involve real estate businesses.

L. Specified Service Trades or Businesses (SSTBs)

The SSTBs rules are only relevant for taxpayers with taxable income over the threshold amount.

1. **General Rule.** The deduction does not apply for specified service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading services, dealing in securities, partnership interests, or commodities, or any business where the principal asset is the reputation or skill of one or more of its employees (by reference to §1202(e)(3)(A), except for engineering or architecture). §199A(d)(2); Reg. §1.199A-5(b)(2)(vii). This provision decreases the incentive of specified service businesses to pay low compensation income for the service-provider employees and claim that most of the income from the business is qualified business income entitled to the 20% deduction.

   The listed service fields are generally based on service fields in §1202 (for qualified small business stock), and almost no case law or rulings exist as to the meaning of those terms. The proposed regulations generally apply those terms broadly, but give specific examples of types of businesses that are or are not included. The proposed regulations do not apply a bright-line licensing rule.

   A few examples of the various service fields are summarized below.

   - Health – "means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such" but the final regulations omitted the phrase "who provide medical services directly to a patient (service recipient)." Reg. §1.199A-5(b)(2)(ii).
   - Law – "the performance of legal (that word was added in the final regulations) services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professional performing services in their capacity as such" but not for services not requiring skills unique to the field of law, such as services by printers, delivery services, or stenography services. Reg. §1.199A-5(b)(2)(iii).
   - Accounting – "the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professional performing services in their capacity as such." Reg. §1.199A-5(b)(2)(iv).
   - Reputation or Skill of Employee as Principal Asset**.** The proposed regulations interpret this term narrowly, as applying only to businesses receiving income from: (1) endorsing products or services, (2) using an individual's image, likeness, name, signature, voice, trademark, or other symbols associated with the individual, or (3) appearing at an event or on radio, television or other media format. Reg. §1.199A-5(b)(2)(xiv). This position avoids a concern that almost any business closely associated with a particular individual (such as "Tony's" restaurant) could be treated as an SSTB.

The SSTB rules are applied to each separate business; the presence of SSTB activity in one business will not cause the taxpayer's other businesses to be considered SSTBs (except as might be required by the "anti-packing and cracking" rule, described below). Preamble to Final Regulations, at 102.

2. **Mixed Activities–De Minimis Rule If Little SSTB Income and Effect of Flunking This De Minimis Test.** If a business has income from the specified service fields and also has other income, the business will not be treated as an SSTB if less than 10% of its gross receipts are from the specified service field (or 5% if it has gross receipts over $25 million). Prop. Reg. §1.199A-5(c)(1).

   Examples added to the final regulations help clarify this de minimis rule. In Example 1, an LLC sells lawn care and landscaping equipment and also provides landscape design services (which are SSTB "consulting" services). The LLC keeps one set of books and treats the sales and the design services as a single trade or business for purposes of §§162 and 199A. The design services gross receipts of $250,000 represents more than 10% of the $2 million gross receipts of the LLC, so "the entirety of Landscape LLC's trade or business is considered an SSTB." Reg. §1.199A-5(c)(1)(iii)(A) Ex. 1.

   Example 2 involves an LLC that provide veterinarian services (an SSTB activity in the health field) and sells its own line of organic dog food. The LLC separately invoices and keeps separate books and records for the veterinarian and sales activities, has separate employees unaffiliated with the veterinarian clinic that work on the dog food products, and treats the veterinarian practice and dog food development and sales as separate trades or businesses for purposes of §§162 and 199A. Even though the gross receipts of the veterinarian activity is 1/3 of the total gross receipts, "the dog food development and sales business is not considered an SSTB because the veterinarian practice and dog food development and sales are separate trades or businesses under section 162." Reg. §1.199A-5(c)(1)(iii)(B) Ex. 2.

   Comments from various groups recommended that the 10% (or 5%) tests not be applied as a cliff test, meaning that failing the test would cause *all* of the business to be an SSTB, but instead to allow the business to separate its SSTB and non-SSTB activities. The final regulations obviously do not adopt that recommendation, as evidenced by Example 1 above. As illustrated by Example 2, the key will be whether the SSTB and non-SSTB activities are conducted in separate *businesses*. If so, the SSTB activities of one business will not taint the non-SSTB activities of the other business—unless the businesses violate the "anti-cracking and packing" rule described below.

3. **Mixed Businesses—Cracking and Packing.** Soon after the passage of §199A, commentators discussed possible "cracking and packing" transactions in which business would be structured to "crack" apart as much ancillary activity income as possible (for example, for administrative functions) from the service business, or to "pack" other qualifying businesses into the service business to transform the business into one that is not primarily in the designated service field. *See* Avi-Yonah, Batchelder, Fleming, Gamage, Glogower, Hemel, Kamin, Kane, Kysar, Miller, Shanske, Shaviro, & Viswanathan, *The Games They Will Play: An Update on the Conference Committee Tax Bill* (December 22, 2017) (excellent discussion of specific strategies including

"cracking" and "packing" strategies for specified service companies). The proposed regulations limit this type of activity; planning alternatives remain but will require more maneuvering.

50% Test; Deletion of 80% Test in Final Regulations. The proposed regulations add that an SSTB includes any business (i) with 50% or more common ownership (directly or indirectly, with attribution), and (ii) that provides 80% or more of its property or services to an SSTB. Prop. Reg. §1.199A-5(c)(2)(i). For example, if the marketing, billing, and payroll administrative functions are structured in a separate entity to provide such activities for the service business in return for a fee, if 50% common ownership exists between the administrative entity and the service entity, and if the administrative entity provides at least 80% of its services to the service entity, the administrative entity would be treated as part of the service entity, and the entire entity will be an SSTB.

Various comments to the IRS pointed out that the 80% test is unnecessary "as there are not abuse concerns regarding the portions of goods or services provided to a third party." Preamble to Final Regulations at 104. The IRS agreed with those comments and deleted the 80% test, so that only the portion of the trade or business providing property or services to the 50 percent or more commonly-owned SSTB will be treated as a separate SSTB with respect to related parties. Reg. §1.199A-5(c)(2)(i).

Common Ownership. Common ownership is determined for purposes of this "anti-cracking and packing" rule after applying the attribution rules of §267(b) or §707(b). Prop. Reg. §1.199A-5(c)(2)(iii). Generally, this includes attribution among trusts and their grantors and beneficiaries, and includes family attribution among siblings, spouses, ancestors and lineal descendants. (The attribution rule applied for purposes of the aggregation rule discussed above was much narrower under the proposed regulations, but is the same as under this section under the final regulations.)

Effective Date. The anti-cracking and packing rule is one of the anti-abuse rules that has an immediate effective date from the date of enactment of §199A, applying to taxable years ending after December 22, 2017. Reg. §1.199A-5(e)(2)(i).

4. **Business Incidental to SSTB Test Deleted From Final Regulations**. Under the proposed regulations, if a non-SSTB business entity that would not otherwise be an SSTB (i) had 50% common ownership (applying attribution under §267(b) and §707(b)) with a separate SSTB entity, (ii) shared expenses with the SSTB, and (iii) accounted for 5% or less of the combined gross receipts of the business and SSTB, the business is treated as incidental to and part of the SSTB for purposes of §199A. Prop. Reg. §1.199A-5(c)(3) (including an example of a dermatologist that provides medical services through an LLC disregarded entity that also sells skin care products representing no more than 5% of the combined gross receipts of the LLC).

   Comments to the IRS included that this rule is unnecessary causes administrative difficulties for taxpayers who must determine whether a trade or business is incidental in order to apply the rule, and that much more detail would be needed if the rule were retained. The IRS agreed with the comments and deleted the rule. Preamble to Final Regulations at 104-105. Therefore if the non-SSTB activities and the SSTB activities are in separate trades or businesses, the fact that the businesses are commonly controlled and share expenses will not cause the non-SSTB business to be treated as part of the SSTB business. Of course, the separate businesses will need to properly allocate the shared expenses between the two businesses so that the SSTB business does not pay more than its reasonable portion of the shared expenses. (If the non-SSTB activities and the SSTB activities are part of the *same business*, the de minimis rule described above applies, and the entire business will be treated as an SSTB if the gross receipts from the SSTB activities are 10% or more of the total gross receipts (5% or more gross receipts exceed $25 million).

In order to qualify as separate businesses, some confusion exists over whether the businesses must maintain separate books and records. The preamble to the initial final regulations referred to having "a complete and **separate** set of books and records" but the revised final regulations as published in the Federal Register refers to "a complete and **separable** set of books and records." Examples in the regulations suggest that separate books and records would be needed. These examples are discussed in Item L.2 above.

5. **Planning Alternatives.** The primary planning alternatives for segregating some of the income of a service business to qualify as QBI will involve avoiding the 50% common ownership test. For example, three law firms might enter into a venture to have marketing, billing, and payroll services provided by a separate administrative company owned by the owners of the three firms, with each group owning far less than 50% of the administrative entity. The firms might have the separate entity hire all of the administrative employees and enter into an employee leasing arrangement. Such structures may be rather unwieldy.

M. Trusts

The deduction is available to non-corporate taxpayers, including trusts and estates. (The Senate version of §199A would not have made the deduction available to trusts and estates.) References to trusts below also apply to estates.

1. **Threshold Amount**. For trusts, the threshold amount (for purposes of determining whether and to what extent the W-2 wages and UBIA limitation and the SSTB limitation applies) is $157,500 in 2018. §199A(e)(2)(A); Reg. §1.199A-6(d)(3)(iv). (This indexed amount is increased under the indexing provision of Reg. §1.199A-1(b)(12), and is $160,700 in 2019, Rev. Proc. 2018-57, §3.27.)

   The proposed regulations took the position that in determining whether the trust's taxable income exceeds the threshold amount, the separate share rule is applied, but surprisingly, the distribution deduction was not considered. Prop. Reg. §1.199A-6(d)(3)(iii). Many comments were received about the unfairness of denying the distribution deduction (in part because it results in double counting income in both the trust and for beneficiaries and because §199A references the "taxable income" of the taxpayer and the Code very objectively defines taxable income of a trust to take the distribution deduction into consideration), and the IRS agreed as to the distribution deduction. Under the final regulations, for purposes of determining whether the trust's taxable income exceeds the threshold amount, the taxable income is determined *after* taking into account the distribution deduction. Reg. §1.199A-6(d)(3)(iv).

Being able to take the distribution deduction into account for purposes of determining whether a trust exceeds the threshold amount opens the door to planning distributions to leave the trust with taxable income below the threshold amount, if appropriate based on the trust's distribution standards. Distributions made within 65 days of the end of the taxable year, which will be March 6, 2019 for the 2018 taxable year, can be considered under the 65-day rule. §663(b) (distributions by an estate or trust within 65 days of the tax year can be treated as having been made on the last day of the prior tax year, March 5 in leap years and March 6 in non-leap years).

2. **Allocation Among Trust and Beneficiaries.** A trust computes its §199A deduction based on the QBI, W-2 wages, UBIA qualified REIT dividends and qualified PTP income that are allocated to the trust, and beneficiaries take into account their allocated share of such items in computing their deductions under §199A. Reg. §1.199A-6(d)(1).

   The QBI (including any negative amounts at the trust level), W-2 wages, UBIA of qualified property, qualified REIT dividend and qualified PTP income are allocated among the trust and the beneficiaries based on the relative proportion of the trust's DNI that is retained or distributed to each. For that purpose, the DNI is determined taking into account the separate share rule of §663(c) but is determined without regard to §199A. If a trust has no DNI for the year, all of those items are allocated entirely to the trust. Reg. §1.199A-6(d)(3)(ii).

3. **Calculation at Trust Level.** The regulations provide detail about how the trust calculates its QBI, including how to allocate qualified items of deduction for determining QBI. Reg. §1.199A-6(d)(3)(i). A very detailed two-page example of the rather complicated calculation process is provided. Reg. §1.199A-6(d)(3)(viii). The example was revised in the final regulations to clarify the allocation of QBI and depreciation to the trust and the beneficiaries.

4. **Grantor Trusts.** To the extent that the grantor (under §§671-677 & 679) or another person (under §678) is treated as owning all of part of the trust, such person computes its §199A deduction as if the person directly conducted the activities of the trust as to the portion owned by the grantor or other person. Reg. §1.199A-6(d)(2). Therefore, the grantor (or other deemed owner for a §678 trust) would include all attributable items directly in the grantor's or deemed owner's return in determining his or her QBI, W-2 wages, UBIA limitation, etc. This treatment suggests that the anti-abuse rules (described below), which are in a subparagraph (3) titled "Non-grantor trusts and estates," do not apply to grantor trusts. *See* Gassman Shenkman, Ketron, Denicolo & Crotty, *Proposed Regulations for 199A – The Good, The Bad, the Taxpayer-Unfriendly*, LEIMBERG INC. TAX PL. NEWSLETTER #152 (Aug. 13, 2018) ("This means that a grantor could establish a trust considered as owned by a named beneficiary pursuant to Section 678, and the individual beneficiary will be considered to be the owner of the Section 199A interest without application of the anti-abuse rules that would apply to a non-grantor ("complex") trust").

5. **ESBTs.** The statute and legislative history do not specifically address the availability of the §199A deduction for electing small business trusts (ESBTs). Uncertainty existed regarding the availability of the §199A deduction for ESBTs because §641(c) describes the manner in which the taxable income and the tax is determined for ESBTs, and §641(c)(2)(C) states that only certain items of income, loss, deduction, or credit may be considered in determining the tax for ESBTs. The few allowed items include "[t]he items required to be taken into account under section 1366," and §1366 describes the passthrough of items to S corporation shareholders, which would include the passthrough of business income that would be reported on the Schedule K-1 from the S corporation. Therefore, an argument can be made that ESBTs are entitled to the deduction under the statutory provisions, but the answer is far from clear.

   Without even referring to this statutory ambiguity, the proposed regulations provided that ESBTs are entitled to the §199A deduction. Prop. Reg. §1.199A-6(d)(v). The final regulations continue that position but also address whether the S and non-S components of the ESBT (for example if the trust owns an S corporation with a business and owns other businesses in partnerships) are treated as two separate trusts for purposes of applying the threshold amount. The preamble to the final regulations acknowledges that the S and non-S components of an ESBT are treated as "separate trusts," §641(c)(1)(A) & Reg. §1.641(c)-1(a), but reasons that "[a]lthough an ESBT has separate portions, it is one trust." Preamble to Final Regulations at 112-113. The final regulations clarify that the S and non-S portions of an ESBT are treated as a single trust for purposes of determining the threshold amount. Reg. §1.199A-6(d)(3)(vi).

6. **Section 199A Anti-Abuse Rule for Trusts.** The statute authorizes the IRS and Treasury to adopt regulations implementing certain aspects of §199A, but none of those provisions specifically refers to the treatment of trusts. Nevertheless, the regulations adopt an anti-abuse rule for trusts specifically with respect to §199A (and, as discussed below, also adopt a separate general multiple trust rule under regulations to §643).

   The proposed regulations included the following short (but very important) anti-abuse rule for trusts (which, as discussed above, likely applies only to non-grantor trusts). "Trusts formed or funded with *a significant* purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A. See also §1.643(f)-1 of the regulations." Prop. Reg. §1.199A-6(d)(3)(v) (emphasis added).

   Comments pointed out the inconsistency of applying a "significant" purpose test under this provision vs. the "principal" purpose test in the §643 multiple trust rule. Comments also asked for clarification about what "not respecting" the trust means, and whether the rule applies only to multiple trusts or whether it could apply to a single trust. The final regulations clarify all of those issues. This anti-abuse rule is changed from a significant purpose test to whether the trust is formed or funded with a "principal purpose of avoiding, or of using more than one, threshold amount," it can apply to a single trust, and the effect is that the trust is not respected "as a separate trust entity for purposes of determining the threshold amount." Reg. §1.199A-6(d)(3)(vii).

The anti-abuse rule saying a trust will not be respected if a principal purpose is to receive a §199A deduction could apply to situations not covered by §643(f). For example, it could apply to the creation of a single trust, or it could apply to multiple trusts that clearly have different primary beneficiaries and therefore would not be covered by §643(f).

An individual with income above the threshold amount may own interests in businesses that do not have sufficient W-2 wages or UBIA of qualified property to qualify for any §199A deduction to the individual; alternatively, the individual may own interests in SSTBs for which no §199A deduction would be available to the individuals with taxable income over the threshold amount. The individual may want to give interests in the business to a trust for the individual's child, but the individual is motivated to "pull the trigger" and make the transfer now in large part so that the trust could be structured to have taxable income under $157,500 and therefore not be subject to W-2 and UBIA limitation or the limitation on SSTBs. The IRS may argue in such a fact situation that a "principal" purpose is of the trust receiving a §199A deduction, so the regulation might apply, despite the fact that §643(f) clearly does not apply. The maximum tax savings from the §199A deduction alone would not exceed approximately $157,500 (the threshold amount for the trust is $157,500 in 2018) times a 20% §199A deduction times a 37% rate, or $11,655. In 2019, the maximum savings is $160,700 x 20% x 37%, or $11,892. (In round figures, the savings for the trust would be about $150,000 x 20% x 40%, or $12,000.)

The individual may have a number of children and grandchildren. If the individual transfers interests in the businesses to 5 separate trusts, each having a different primary beneficiary, the savings could be 5 times $11,655, or $58,275 in 2018.

The trust anti-abuse rule for §199A described above to avoid exceeding the threshold amount applies to taxable years ending after the date of enactment of the statute, December 22, 2017 Reg. §1.199A-6(e)(2)(i).

From a planning perspective, this anti-avoidance rule should not apply to a trust that was funded before the enactment of §199A (such a trust obviously was not formed or funded to obtain a deduction under a Code section that was not even in existence). If such a trust has taxable income below the threshold amount, consider having the trust purchase business interests that have "insufficient" W-2 wages or UBIA as long as the trust would still have taxable income under the threshold amount. The §199A anti-abuse rule should not apply even though a purpose for the purchase is to obtain a §199A deduction. *See* Alan Gassman & Brandon Ketron, *What the Final 199A Regulations Say Regarding Trust Planning*, LEIMBERG INC. TAX PL. NEWSLETTER #169 (Jan. 21, 2019)("When subsequent Section 199A opportunities arise or become apparent, and the trust can purchase interests in a business or entity by making a capital contribution or buying an interest therein, the anti-abuse rule would not seem to apply").

7. **Regulations Regarding Multiple Trusts Under §643(f).** As discussed above, §643(f) authorizes the IRS to adopt regulations treating two or more trusts as one trust if certain conditions are satisfied. However, §643(f) applies "under regulations prescribed by the Secretary" and no such regulations have ever been issued, even though the statute was passed in 1984 – 34 years ago. In *SIH Partners v. Commissioner*, 150 T.C. No. 3

(January 18, 2018), the Tax Court addressed the validity of regulations that were adopted in response to §956(d) referring to a tax effect for controlled foreign corporations that would apply "under regulations prescribed by the Secretary" and §956(e) providing that "[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section …." In that case the taxpayer "contends, and respondent does not dispute" that §956(d) "is not self-executing" and that the amount of income inclusion at issue "can be determined only by reference to regulations…." Without regulations, does §643(f) have any substantive effect? Final regulations have now been issued.

Paragraph (a) of the proposed regulations reiterate the general rule of §643(f) that two or more trusts will be aggregated and treated as a single trust (i) if they have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (ii) if a principal purpose for establishing the trusts or for contributing additional property to the trusts is the avoidance of Federal income tax. Prop. Reg. §1.643(f)-1(a).

Paragraph (b) of the proposed regulation addresses the principal purpose requirement and provides that "[a] principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts." Prop. Reg. §1.643(f)-1(b). The proposed regulation also had two examples illustrating this "significant income tax benefit" test. While the two examples are based on examples in the legislative history, they create confusion with respect to what having the "same primary beneficiary" means. The two examples, and the ambiguity created by them, are discussed in Item 2.f.(11)(g) of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **https://www.bessemertrust.com/for-professional-partners/advisor-insights**.

This conversion of the "principal" purpose test into a "significant" purpose test unless the taxpayer could prove the existence of a "significant non tax (or non-income tax) purpose" achievable *only* with the separate trusts was roundly criticized as being inconsistent with the statutory language. Subparagraph (b), which stated this special rule for applying the principal purpose test that is in the statute and the two examples were omitted from the final regulations. The §643 final regulation is left with just a general rule that restates the statute, adding the following underlined phrase to what was in the proposed regulation – ""if a principal purpose for establishing <u>one or more of</u> such trusts...." However, the preamble to the final regulations says that the IRS and Treasury "are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as 'principal purpose' and 'substantially identical grantors and beneficiaries' should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms." Preamble to Final Regulations at 116.

The §643(f) multiple trust regulation applies to taxable years ending after the date that the proposed regulation was published in the Federal Register (August 16, 2018). Reg. §1.643(f)-1(b). Applying the regulation retroactively to taxable years ending after August 18, 2018 at this point is rather meaningless in light of the fact that the final regulation merely restates the statute.

For multiple trusts entered into or modified before the effective date of the regulations, the preamble to the final regulations states that "the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f)." Preamble to Final Regulations at 116-117.

The preamble to the proposed regulation had added that the Treasury and the Service contend that "the rule in proposed §1.643(f)-1 generally reflects the intent of Congress regarding the arrangements involving multiple trusts that are appropriately subject to treatment under section 643(f)," Preamble to August 2018 Proposed Regulation at 78. The net effect might have been interpreted to apply the reasoning of the proposed regulation (with its greatly expanded definition of the principal purpose test and the two examples) to multiple trusts existing before August 16, 2018. That additional clause was deleted from the preamble to the final regulations, but the deletion of the principal purpose definition and the two examples from the final regulation makes that possible interpretation rather meaningless.

N. Fiscal Year Entities

Planners have wondered how income from a fiscal year entity with a fiscal year that ended in 2018 would be treated for QBI purposes. Section 199A applies to taxable years beginning after 2017 and before 2026. The regulations generally apply for fiscal years ending after the date they are published in the Federal Register (sometime in 2019). *E.g.,* Reg. §1.199A-6(e)(1)(similar to effective date general rule provisions of the end of each of the six sections of the §199A final regulations). The regulations take the very taxpayer friendly position that "[f]or purposes of determining QBI, W-2 wages, and UBIA of qualified property …, if an individual receives any of these items" from a fiscal year entity with a fiscal year ending after 2017, "such items are treated as having been incurred during the individual's taxable year in which or with which such RPE taxable year ends." Reg. §1.199A-6(e)(2)(ii).

The phrase "receives any of these items" is ambiguous, but presumably that refers to income and expenses reported to the owner on the Schedule K-1 from the entity for the fiscal year ending after 2017. This means that income actually earned by an entity in 2017 but during the fiscal year ending in 2018 will qualify as QBI in 2018 for which the owner may receive a 20% deduction. This good news will lead to some practical problems in implementation, particularly for fiscal years ending in 2018.

This means that an individual could receive a 2017 Schedule K-1 from a passthrough entity whose fiscal year ends on January 31, 2018 and the individual can include the entire 12 months income from the passthrough entity as QBI on his or her 2018 Form 1040, despite that 11 months of the income was earned before January 1, 2018.

> The IRS's decision was probably based on a desire for simplicity and administrability. However, the proposed regulations failed to address how the individual would determine its share of QBI, W-2 wages, or UBIA of qualified property from the passthrough entity's Schedule K-1 when the entity is not required to report those items to its partners and shareholders until years beginning on or after the date the final regulations are published in the Federal Register. Until further guidance is issued, partners and shareholders of fiscal year passthrough entities may just have to use any reasonable method to determine their share of these QBI items." Carol Cantrell, *Mastering the New Qualified Business Income (QBI) Rules and Avoiding Penalties*, TEXAS SOC'Y OF CPAS 2018 ADV. EST. PL CONF. at 21-22 (August 2018).

O. Reporting Requirements for Passthrough Entities

1. **Reporting Requirements**. Partnerships and S corporations involved in any trade or business will have to make additional computations and provide additional information to their owners. The §199A deduction is not available to the RPE, but applies to the owners of the RPE on their individual returns. Each RPE must determine and separately report QBI, W-2 wages, UBIA of qualified property, and whether the trade or business is an SSTB for each of the RPE's trades or businesses (or report combined QBI, W-2 wages and UBIA of qualified property for businesses that the RPE elects to aggregate). The RPE must report that information on the Schedule K-1 issued to each of its owners, Reg. §1.199A-6(b)(3)(i), and report on a statement attached to Schedule K-1 those items reported to it by another RPE in which the RPE owns an interest. Reg. §1.199A-6(b)(3)(ii).
2. **Effect of Failure to Report**. If the RPE fails to "identify or report" that information on the Schedule K-1, the owner's share of *any* QBI, W-2 wages and UBIA of qualified property was presumed to be zero under the proposed regulations, Prop. Reg. §1.199A-6(b)(3)(iii), but final regulations relaxed this harsh rule to provide that only "each unreported item" is presumed to be zero. Reg. §1.199A-6(b)(3)(iii).
3. **Reporting on Amended or Late Return.** The final regulations also add a somewhat relaxed rule allowing items to be reported on "an amended or late filed return to the extent that the period of limitations remains open." The preamble states that rule generally with respect to all of the information that an RPE is required to report: "The final regulations also provide that such information can be reported on an amended or late filed return for any open tax year." Preamble to Final Regulations at 109-110. Nothing else in the paragraph containing that sentence refers to flow-through information that an RPE must report from another RPE that it owns. The actual substantive regulation, however, includes the ability to report information on an amended or late filed return only in subparagraph (ii) of Reg. §1.199A-6(b)(3) titled "Other items" and referring to reporting flow-through from another RPE in which the reporting RPE owns a direct or indirect interest. It is not also included in subparagraph (i) titled "Trade or business directly engaged in" regarding information that an RPE must report with respect to its directly owned businesses.
4. **IRS Forms**. The draft instructions to Schedule K-1 for Forms 1065, 1041, and 1120A for 2018 provide that the 199A related information will be reported under various Codes. For example to Schedule K to Form 1065 has the §199A information reported on Box 20 code Z, section 199A income; code AA, section 199A W-2 wages; code AB, section 199A unadjusted basis; code AC, section 199A qualified REIT dividends; code AD, section 199A qualified PTP income. The instructions have detailed information about

each of those, with particular reference to various schedules of the Publication 535 Worksheet if the business is an SSTB or if the RPE is electing to aggregate separate businesses.

The Schedule K-1 for Form 1120S reports the §199A information in Codes V-Z for Box 17, and the Schedule K-1 for Form 1041 reports the information in a statements attached in conjunction with Code I for Box 14.

The IRS announced on January 29, 2019 that the instructions for 2018 Form 1040, Form 1065 Schedule K-1, Form 1120S Schedule K-1, Form 1041 and Form 1041 Schedule K-1 a will soon be updated to reflect changes as a result of the §199A final regulations.

5. **Substantial Reporting Obligations**. In summary, each partnership or S corporation engaged in a trade or business has a serious responsibility to determine and report information to owners so that they have the information to claim the §199A deduction with respect to the entity's trade or business activities. These additional reporting requirements at the entity level will likely result in K-1s being received later in the year than usual.

P. Impact of §199A on Tax Calculation and Other Taxes; IRS Forms

1. **No Reduction of AGI; Deduction Available to Non-Itemizers; Form 1040 and Relevant Worksheets**. The deduction reduces taxable income, but not AGI (so the deduction does not affect limitations throughout the Code based on AGI). The deduction is available to both itemizers and non-itemizers. (In other words, the deduction is available in addition to the standard deduction.)

   On the draft Form 1040 for 2018, the qualified business income deduction appears at the on Line 9 of Form 1040 after Line 7 for adjusted gross income and after Line 8 for the standard deduction or itemized deductions. It is neither an "above the line" deduction in arriving at adjusted gross income nor an itemized deduction. The amount to enter on Line 9 can be determined from the "Qualified Business Income Deduction—Simplified Worksheet" in the Instructions to Form 1040 for individual taxpayers below the taxable income threshold and for taxpayers with taxable income over the threshold, using Worksheet 12-A "Qualified Business Income Deduction Worksheet" and accompanying Schedules A-C as appropriate in Publication 535, Business Expenses. For further information, the instructions to Form 1040 refer to Publication 535, which was published in final form on January 25, 2019.

   The IRS announced on January 29, 2019 that the instructions for 2018 Form 1040, Form 1065 Schedule K-1, Form 1120S Schedule K-1, Form 1041 and Form 1041 Schedule K-1 a will soon be updated to reflect changes as a result of the §199A final regulations. New Form 8995, Qualified Business Income Deduction Simplified Computation was released February 13, 2019. It applies for taxpayers under the taxable income threshold.

2. **Effect of Deduction for Partners or S Corporation Shareholders.** The §199A deduction is applied in the calculation of the owner's individual income tax, not at the partnership or corporation level. It has no effect on the adjusted basis of partner's interest, the adjusted basis of an S corporation shareholder's stock, or an S corporation's accumulated adjustments account. Reg. §1.199A-1(e)(1).

3. **Disregarded Entities**. Trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of §199A. Reg. §1.199A-1(e)(2).
4. **Self-Employment Tax.** The §199A deduction does not reduce self-employment income under §1402. §199A(f)(3); Reg. §1.199A-1(e)(3).
5. **Net Investment Income.** The §199A deduction does not reduce net investment income under §1411. §199A(f)(3); Reg. §1.199A-1(e)(3).
6. **Alternative Minimum Tax.** The QBI deduction is the same for both regular tax and AMT purposes. Reg. §1.199A-1(e)(5).

Q. Penalties

The 2017 Tax Act amended §6662 to provide that the 20% penalty for substantial understatement of income tax will apply if the understatement exceeds the greater of $5,000 or 5% (rather than 10%) of the tax required to shown on the return if the individual claims a §199A deduction. §6662(d)(1)(C). Therefore, if an individual claims merely $1 of deduction under §199A, the standard for applying the understatement penalty is 5% rather than 10%, regardless of whether the understatement is attributable to QBI. As always, the penalty does not apply if the taxpayer has "substantial authority," Reg. §1.6662-4(d)(3)(i), or if the taxpayer has a "reasonable basis" for the position. §6662(d)(2)(B).