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The Most Important Deduction in the 2017 Tax Act: §199A

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INTRODUCTION

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

TAXPAYER ENTITLED TO THE QBI DEDUCTION

The two components of the QBI deduction and the limitation on the amount of that deduction are summarized in §199A(a). Except for §199A(g)–§199A(i), the remainder of §199A is an explanation of various aspects of the Combined Business Income Amount component of the §199A deduction. The QBI deduction is allowed to a taxpayer ''other than a corporation.''[4] A taxpayer ''other than a corporation'' includes individual taxpayers[5] and trusts and estates.[6] Partnerships and S corporations do not take a QBI deduction; instead, this deduction is taken at the partner or shareholder level.[7] At that level, each partner or shareholder takes into account that owner's allocable share of the qualified items of income, gain, deduction, and loss of the partnership or S corporation.[8] There is a deduction allowed to specified agricultural or horticultural cooperatives, which are corporations, by §199(g). This deduction is briefly described near the end of this article. In the remainder of this article, the term taxpayer should be understood to denote a taxpayer who is not a corporation and who is eligible for the §199A deduction.

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

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

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

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

[4] §199A(a).

[5] Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st. Sess. (2017) (hereinafter Joint Statement), 28.

[6] Joint Statement, 40.

[7] §199A(f)(1)(A)(i).

[8] §199A(f)(1)(A)(ii).

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

The calculation of the QBI deduction is perhaps the final calculation that will be made on the taxpayer's tax return. This is because some of the limits of the components of the QBI deduction are based on taxable income. When the term ''taxable income'' is used in §199A, it refers to taxable income that is calculated without regard to the QBI deduction.[9] The §199A deduction is neither a deduction in computing the adjusted gross income of individual taxpayers[10] nor is it an itemized deduction for those taxpayers.[11] However, the QBI deduction is a deduction from taxable income for individual taxpayers who take the standard deduction[12] and for individual taxpayers who itemize their deductions.[13] In the example for this article, the QBI deduction is shown as the last deduction in the computation of the taxable income of the fictitious taxpayers.

COMPONENTS OF THE QBI DEDUCTION

Perhaps the best way to understand the QBI deduction is to think of it as a deduction that consists of two component amounts: 1) the Qualified Business Income Component and 2) the Qualified Cooperative Dividend Component. These two components are shown on Worksheet 3 entitled ''Deduction for Qualified Business Income.''

Qualified Business Income Component

The Qualified Business Income Component consists of the Combined Qualified Business Income Amount[14] to the extent that amount does not exceed 20% of the excess of a taxpayer's taxable income for the year before the QBI deduction over the sum of: 1) the taxpayer's net capital gain (as defined by §1(h); plus 2) the total amount of the taxpayer's qualified cooperative dividends for the taxable year.[15] The Combined Qualified Business Income Amount is defined by §199A(b)(1) as the sum of the deductible amounts for each qualified trade or business of the taxpayer plus 20% of the total amount of a taxpayer's qualified REIT dividends and qualified publicly traded partnership income for the taxable year. The §199A Deductible Amount for each qualified trade or business of the taxpayer is illustrated on Worksheet 2, titled ''Determination of Deductible Amount for Each Qualified Trade or Business.'' The deductible amount for each of the taxpayer's qualified trades or businesses is calculated in accordance with the provisions of §199A(b)(2). The Combined Qualified Business Income Amount is computed by totaling the deductible amounts for each of the taxpayer's qualified trades or businesses and adding 20% of the aggregate amount of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income to that total.[16]

The amount of the Qualified Business Income Component of the §199A deduction is limited by §199A(a)(1)(B) to an amount that the author has chosen to describe as the ''20% Excess Taxable Income Limit'' on Worksheet 3, titled ''Deduction for Qualified Business Income.'' Certain categories of taxable income are part of this §199A(a)(1)(B) limitation. The first phrase used in §199A(a)(1)(B) to describe this limitation is ''an amount equal to 20 percent of the excess (if any) of the taxable income of the taxpayer for the taxable year.''[17] The words ''taxable income'' as used in that phrase refer to a taxpayer's taxable income computed without regard to the §199A deduction for QBI.[18] The next words of §199A(a)(1)(B) are ''over the sum of any net capital gain (as defined in §1(h).'' The term ''net capital gain'' is defined by §1222(11) as the ''excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.'' However, the parenthetical phrase of §199A(a)(1)(B)(ii) states that net capital gain is ''as defined in §1(h).'' The definition of ''net capital gain'' for purposes §1(h) is delineated by §1(h)(11)(A), which states that ''the term 'net capital gain' means net capital gain (determined without regard to this paragraph) increased by qualified dividend income.'' Thus for purposes of §199A(a)(1)(B)(ii), net capital gain consists of the excess of a taxpayer's net long-term capital gain for the taxable year over that taxpayer's short-term capital loss for that taxable year (the definition of net capital gain contained in §1222(11) plus the taxpayer's qualified dividend income for the year (the additional amount included in net capital gain by §1(h)(11)(A)).

[9] §199A(e)(1).
[10] §62(a).
[11] §63(d)(3), as amended by the 2017 tax act, §11011(b)(3).
[12] §63(b)(3).
[13] Joint Statement, 39.
[14] §199A(a)(1)(A).
[15] §199A(a)(1)(B).
[16] §199A(b)(1).
[17] §199A(a)(1)(B)(i).
[18] §199A(e)(1).

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Generally, qualified dividend income consists of dividends received by a taxpayer during a taxable year from domestic corporations and qualified foreign corporations[19] but does not include any dividend distributions from corporations which, for the taxable year in which the distribution is made or for the preceding taxable year, are exempt from tax under §501 (certain tax-exempt organizations and qualified pension, profit-sharing, and stock bonus plans) or that are certain farmers' cooperatives exempt from tax under §521.[20] Qualified dividends also do not include any dividends that are deductible under §591[21] nor any dividends described in §404(k).[22] Certain dividends on shares of stock not owned for certain required periods of time cannot be qualified dividends.[23] Finally, qualified dividends are not dividends on any shares of stock to the extent a taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.[24] For this reason, the calculation of a taxpayer's 20% Excess Taxable Income limit must include a reduction of a taxpayer's taxable income before the QBI deduction by: 1) the amount of a taxpayer's regular qualified dividends; 2) the amount of a taxpayer's qualified cooperative dividends; and 3) the amount of a taxpayer's net long-term capital gain in excess of the taxpayer's net short-term capital loss. In our example, the taxpayer's 20% Excess Taxable Income Amount of $80,000 exceeds the taxpayer's Combined Qualified Business Income Amount of $59,600. Therefore, the taxpayer's Qualified Business Income Component of the QBI Deduction is $59,600.

Qualified Cooperative Dividend Component

As noted above, qualified dividends that are subject to reduced income tax rates (0%, 15%, or 20%) do not include dividends received from certain farmer's cooperatives that are exempt from tax by §521.[25] Congress apparently desired that certain dividends received from specific types of cooperatives should qualify for the QBI deduction. As a result, what the author has termed the Qualified Cooperative Dividend Component was made a part of the QBI deduction by §199A(a)(2), which states that this component of the QBI deduction is the lesser of: 1) 20% of the aggregate amount of the taxpayer's qualified cooperative dividends for the taxable year, or 2) the taxpayer's taxable income minus the taxpayer's net capital gain (as defined for purposes of §199A) for the taxable year.

In general, a cooperative is a corporation that satisfies certain requirements for operating on a cooperative basis that is owned or controlled by the persons for whom or with whom it transacts business. The persons who own or control a cooperative are its patrons. These patrons may produce commodities that they collectively sell through the cooperative. They may also collectively purchase commodities through a cooperative. Subject to certain exceptions, a cooperative is subject to the provisions of Part I of Subchapter T of the Code.[26] Farmers' cooperatives that are exempt from tax under §521 are also subject to the provisions of Part I of Subchapter T of the Code[27] and are subject to the corporate income tax of §11.[28] However, the taxable income of a cooperative subject to the provisions of Part I of Subchapter T of the Code does not include, among other payments, amounts paid by the cooperative during the payment period for the taxable year as patronage dividends (as defined in §1388(a)) or as qualified written notices of allocation (as defined in §1388(c)) with respect to patronage that occurred during a taxable year.[29] The taxable income of a cooperative subject to the provisions of Part I of Subchapter T of the Code also does not include, among other things, amounts paid during the payment period for a taxable year as per-unit retain allocations (as defined in §1388(f)) to the extent paid in money with respect to marketing occurring during that taxable year).[30]

For purposes of the QBI deduction, any patronage dividends (as defined in §1388(a)), any per-unit retain allocation (as defined in §1388(f)), and any qualified written notice of allocation (as defined in §1388(c)) or any similar amount that is received by a taxpayer is a "qualified cooperative dividend" provided it is includible in a taxpayer's gross income and is received from a certain type of organization.[31] The types of organizations that the qualified cooperative dividend must be received from are: 1) a cooperative described in §1381(a);[32] 2) a tax-exempt benevolent life insurance association of a purely local character, mutual ditch or irrigation companies, mutual or cooperative

[19] §1(h)(11)(B)(i)(l)–§1(h)(11)(B)(i)(1l).
[20] §1(h)(11)(B)(ii)(l).
[21] §1(h)(11)(B)(ii)(ll).
[22] §1(h)(11)(B)(ii)(lll).
[23] §1(h)(11)(B)(iii)(l).
[24] §1(h)(11)(B)(iii)(ll).
[25] §1(h)(11)(B)(ii)(l).
[26] §1381(a)(2).
[27] §1381(a)(1).
[28] §1381(b).
[29] §1382(b)(1).
[30] §1382(b)(3).
[31] §199A(e)(4).
[32] §199A(e)(4)(B)(i).

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telephone companies, or like organizations;[33] or 3) an organization that is a taxable cooperative governed by the tax rules applicable to cooperatives before Subchapter T of the Code was enacted.[34]

The amount of the Qualified Cooperative Dividend Component may not exceed the taxpayer's taxable income minus the taxpayer's net capital gain (as defined for purposes of §199A) for the taxable year.[35] This amount appears on Worksheet 3 under the caption titled ''Taxable Income In Excess of Net Capital Gain Limit.'' It is the taxpayer's taxable income before the QBI deduction minus the taxpayer's net capital gain (as defined in §1222(11)) and minus the taxpayer's qualified dividends for the taxable year. The calculation of the taxpayer's Taxable Income in Excess of Net Capital Gain Limit begins with the taxpayer's taxable income before the QBI deduction of $429,000 and subtracts from that amount the taxpayer's qualified dividends of $3,000 and the taxpayer's net long-term capital gain in excess of net short-term capital loss of $24,000. The result is that the taxpayer's Taxable Income in Excess of Net Capital Gain is $402,000, which exceeds 20% of the taxpayer's Qualified Cooperative Dividends for the year of $400. The amount of the taxpayer's Qualified Cooperative Dividend Component of the QBI deduction is thus $400.

If a taxpayer does not have any Qualified Cooperative Dividends for a taxable year, then there will be no Qualified Cooperative Dividend Component of the §199A deduction.

Total Deduction for Qualified Business Income

The amount of the taxpayer's QBI Deduction is $60,000, which is the sum of the Combined Qualified Business Income Amount of $59,600 plus the Qualified Cooperative Dividend Component of $400. The last sentence of §199A(a) imposes a final limitation on the QBI deduction by stating that a taxpayer's QBI deduction may not exceed the taxpayer's taxable income before the QBI deduction minus the taxpayer's net capital gain (as defined for purposes of §199A) for the taxable year. In calculating this final limitation in the example for this article, the taxpayer begins with taxable income before the QBI deduction of $429,000 and subtracts from that amount the taxpayer's qualified dividends of $3,000 and the taxpayer's net long-term capital gain in excess of net short-term capital loss of $24,000. Because the result of this calculation is a limit of $402,000, which exceeds the taxpayer's QBI deduction of $60,000, the taxpayer's QBI deduction for the year is $60,000.

Combined Qualified Business Income Amount

The Combined Qualified Business Income Amount concept is the centerpiece of §199A and is the sum of two amounts. The first amount is the sum of the deductible amounts for each qualified trade or business that is carried on by the taxpayer.[36] The second amount is 20% of the taxpayer's aggregate amount of qualified REIT dividends plus qualified publicly traded partnership income for the taxable year.[37]

The word ''each'' indicates that the deductible amount for a qualified trade or business must be separately determined on an individual basis for every trade or business of the taxpayer. These separately determined amounts for all of the taxpayer's qualified trades or businesses are then totaled. A taxpayer must first decide whether an activity is a ''trade or business.'' If an activity constitutes a trade or business, it must then be determined whether that trade or business is a ''qualified'' trade or business carried on by the taxpayer.

TRADE OR BUSINESS

The Conference Agreement and the Senate Amendment of the Committee Reports to the 2017 tax act do not discuss the meaning of a ''trade or business.''[38] The House Bill, which was not adopted by the Conference Agreement, states that ''a business activity means an activity that involves the conduct of any trade or business.''[39] For purposes of this definition, the House Bill states that ''an activity has the same meaning as under the present-law passive loss rules (§469).''[40] Even though Reg. §1.469-4 is titled ''Definition of Activity,'' it does not define the word ''activity.'' Instead, Reg. §1.469-4(b)(1) contains a definition of trade or business activities. That definition states that trade or business activities are neither rental activities nor activities incidental to holding property for investment. Trade or business activities are activities

[33] §199A(e)(4)(B)(i) referring to tax-exempt organizations described in §501(c)(12).

[34] §199A(e)(4)(B)(ii).

[35] §199A(a)(2)(B).

[36] §199A(b)(1)(A).

[37] §199A(b)(1)(B).

[38] Many of the cases, concepts, and other guidance presented in this section are also discussed in ¶15.04[B] and ¶19.11[C][1] of CCH's Partnership Tax Treatise entitled ''Federal Taxation of Partnerships & Partners,'' by Patricia Hughes-Mills, Thomas Humphreys, James Kehl, and Stuart Rosow.

[39] Conf. Rep. to Acc. H.R. 1, 26.

[40] *Id.*

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that: "i) involve the conduct of a trade or business (within the meaning of §162); ii) are conducted in anticipation of the commencement of a trade or business; or iii) involve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)."[41]

Whether an activity involves "the conduct of a trade or business within the meaning of §162" was an issue that arose in connection with the publication of the §1411 Final Regulations. These regulations state that "the term trade or business refers to a trade or business within the meaning of section 162."[42] There is no definition of the term "trade or business" in §162. However, the IRS stated that the reference to §162 in the definition of a trade or business "incorporates case law and administrative guidance applicable to §162."[43]

In an old case, the Supreme Court stated that whether a taxpayer's activities constitute "carrying on a business requires an examination of the facts in each case."[44] The Supreme Court discussed the characteristics of a trade or business for purposes of §162 in *Commissioner v. R. P. Groetzinger*.[45] In that case, the Supreme Court stated that a taxpayer had to be engaged in an "activity with continuity and regularity" with a primary purpose of earning income or profit in order to be conducting a trade or business.[46] "Sporadic" activities that are either hobbies or engaged in for amusement are not trades or businesses.[47] In *Stanton v. Commissioner*,[48] the Fifth Circuit opined that "regularity" would involve devoting substantial time to the activity that is alleged to be a trade or business. In *Nieman v. Commissioner*,[49] the Tax Court stated that "a taxpayer is 'continually' and 'regularly' involved in a business activity only if he can show extensive business activity over a substantial period."[50] In *Douglas v. Commissioner*,[51] the Tax Court ruled that a taxpayer who bought 11 properties, renovated seven of those properties and sold two of them in past years was not engaged in the business of developing real property "on a regular and continuous basis" because he failed to sell any of those properties during the years being litigated. Two cases decided by the Eighth Circuit opined that a profit motive evidenced by a genuine intention to make a profit is perhaps the most important factor in determining the existence of a trade or business.[52] In summary, these cases seem to indicate that a §162 trade or business activity is an activity engaged in on a regular, continuous, and substantial basis with the primary objective of earning a profit.

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

In *Edward R. Curphey v. Commissioner*,[53] a dermatologist who worked 40 hours a week at a hospital also owned and managed six rental properties. The Tax Court had to decide whether the ownership and management of these rental properties constituted a trade or business. The Tax Court acknowledged its history of ruling in several cases that the rental of only a single piece of real estate constituted a trade or business. However, the Tax Court refused to conclude that the ownership and management of rental properties either did constitute or did not constitute a trade or business, as a matter of law, in every case. In this case, the Tax Court held that the taxpayer's efforts in finding new tenants, supplying furnishings, and making the units ready for new tenants "were sufficiently systematic and continuous to place him in the business of real estate rental."[54]

In the Preamble to the §1411 Final Regulations, commentators cited old cases where the courts had decided that the rental of a single property could rise to the level of a trade or business.[55] The IRS acknowledged that there may have been situations where the rental of a single property required sufficient regular and continuous involvement so that the rental activity was a §162 trade or business. However, the IRS did not believe that, as a matter of law, the rental of a

[41] Reg. §1.469-4(b)(1).

[42] Reg. §1.1411-1(d)(12).

[43] T.D. 9644, 78 Fed. Reg. 72,393 (Dec. 2, 2013). See Summary of Comments and Explanation of Provisions, Section 5, B, ii, a.

[44] *Higgins v. Commissioner*, 312 U. S. 212 (1941).

[45] 480 U.S. 23 (1987).

[46] *Id.*

[47] *Id.*

[48] *Stanton v. Commissioner*, 399 F.2d 326, *aff'g* T.C. Memo 1967-137.

[49] T.C. Memo 2016-11.

[50] *Id.*

[51] T.C. Memo 1998-165, *aff'd*, 181 F.3d 87 (4th Cir. 1999) in an unpublished *per curiam opinion*.

[52] *American Academy of Family Physicians v. United States*, 91 F.3d 1155 (8th Cir. 1996), and *DKD Enterprises, Inc. v. Commissioner*, 685 F.3d 730 (8th Cir. 2012), *aff'g in part, rev'g and rem'g in part*, T.C. Memo. 2011-29.

[53] 73 T.C. 766 (1980).

[54] *Id.*

[55] T.D. 9644. These cases were *Fackler v. Commissioner*, 45 B.T.A. 708 (1941) *aff'd*, 133 F.2d 509 (6th Cir. 1943); *Hazard v. Commissioner*, 7 T.C. 372 (1946); and *Lagreide v. Commissioner*, 23 T.C. 508 (1954).

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single property was a trade or business in every case.[56] The IRS cited an example in Reg. §1.212-1(h) as an example of a rental property that was not a trade or business.[57]

In the Committee Reports to the Revenue Act of 1980, Congress stated that ''an activity is not considered to be a trade or business activity solely because the property used in the activity may be eligible for special capital gain or ordinary loss treatment under §1231. Further, in the case of rental activities, there must be significant furnishing of services incident to the rentals to constitute an active business (within the meaning of §162) rather than an investment. Thus, a rental activity is not considered to be an active trade or business solely because deductions attributable to it are allowable in computing adjusted gross income (§62(5)). In general, the operation of an apartment complex, an office building, or a shopping center would constitute an active trade or business.''[58] From this it can be deduced that it is unlikely the lessor in a triple net lease arrangement would be considered to be involved in a trade or business because that lessor is not furnishing significant services to the lessee.

Whether a rental of a single property is considered a trade or business for purposes of the QBI deduction will probably be a source of contention between taxpayers and the IRS. In T.D. 9644, the IRS stated that ''within the scope of a §162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a §162 trade or business, bright-line definitions are impractical and would be imprecise.''[59] The IRS thus did not provide a definition of a §162 trade or business for purposes of §1411. However, in Reg. §1.1411-5(b)(3), Ex. 1, the IRS held that the rental of a commercial building by an unmarried individual to another entity did not involve the conduct of a trade or business because that unmarried individual was ''not involved in the activity of the commercial building on a regular and continuous basis.''[60]

Further Guidance Needed: Until further guidance is received, it would seem that a trade or business for purposes of the §199A deduction would be an ''activity conducted on a regular, continuous and substantial basis''[61] that has the objective of making a profit. A rental activity will have to be carefully evaluated as to whether it constitutes a trade or business. Some tax advisors may feel that a rental of one property may constitute a trade or business based on the court decisions in some old cases. It may be prudent for those advisors to consider the IRS's comments concerning that issue with respect to §1411.

A Single Trade or Business Versus Several Trades or Businesses

It is customary for many real estate owners to conduct business through several entities. A homebuilder may build several developments located in different areas. The homebuilder may use a separate pass-through entity for each project. Does this homebuilder have one trade or business or several trades or businesses? Under the passive loss regulations of Reg. §1.469-4(c)(1), if the homebuilding activities constitute an appropriate economic unit, then they could be a single activity. That test is a facts and circumstances test whereby certain factors (common control, common ownership, interdependence, etc.) are weighed.[62] The passive activity regulations are not necessarily the primary authority for defining a trade or business, but they may provide guidance for making this determination.

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

Qualified Trade or Business

After it is determined that an activity or group of activities constitutes a trade or business, it must then be determined if the activity or group of activities is a ''qualified trade or business.'' For purposes of

[56] T.D. 9644.

[57] *Id.*

[58] Committee Reports on Pub .L. No. 98-605 (Miscellaneous Revenue Act of 1980).

[59] T.D. 9644.

[60] Reg. §1.1411-5(b)(3) *Ex.* 1.

[61] §1061(c)(2).

[62] Reg. §1.469-4(c)(2).

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§199A, a ''qualified trade or business'' is any trade or business that is neither a ''specified service trade or business'' nor a trade or business of performing services as an employee.[63]

Performance of services as an employee is a trade or business carried on by a taxpayer.[64] The performance of services as an employee is a separate trade or business from the business of an employer. Whether there is an employer-employee relationship in a specific situation is a question of fact that is usually determined by common law rules.[65] The relationship between a trade or business and a worker is usually dependent upon the degree of control that a business has over a person performing services for that business.[66] An employee receives a W-2 from the employer whereas an independent contractor receives a Form 1099.

Some commentators have suggested that employees of certain specified service trades or businesses can avoid classification as employees by forming a partnership with other employees. This partnership would be an independent contractor with respect to the trade or business and a partner's distributive share of the income from this partnership's trade or business could be QBI if the partner's taxable income does not exceed certain threshold amounts.[67] Anyone considering this strategy should be cognizant of the anti-abuse rule of Reg. §1.701-2(a)(1) and §1.701-2(a)(1)(2). Those provisions state that a partnership must be bona fide; furthermore, the partnership transactions must be undertaken for a substantial business purpose[68] and ''must be respected under substance over form principles.''[69] If the formation of this partnership is deemed to have a principal purpose of reducing the partners' federal tax liabilities in a manner that is contrary to the intent of Subchapter K of the Code, the IRS ''can recast'' or disregard the partnership form ''to achieve tax results that are consistent with the intent of Subchapter K.''[70] If these ''employees'' are admitted as partners to an established partnership and the purpose of their admission is to incentivize those individuals to remain with the partnership as owners, then this anti-abuse rule may not apply.

63 §199A(d)(1).

64 §62(a)(1).

65 *Weber v. Commissioner*, 103 T.C. 378 (1994).

66 FSA 200127004. This was discussed in Kehl, *Practical Guide to the Sec. 199 Deduction*, pp. 44–45.

67 Avi-Yonah et al., ''The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation,'' (Dec. 7, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3084187, updated at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423 (Dec. 18, 2017).

68 Reg. §1.701-2(a)(1).

69 Reg. §1.701-2(a)(2).

70 Reg. §1.701-2(b).

Specified Service Trade or Business

A ''specified service trade or business'' is any trade or business that involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business if the principal asset of that trade or business is the reputation or skill of one or more of its employees or owners.[71] A ''specified service trade or business'' also includes any trade or business involving the performance of investing and investment management services as well as trading or dealing in securities (as defined in §475(c)(2)), partnership interests, or commodities (as defined in §475(e)(2)).[72]

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

The footnotes to the Joint Explanatory Statement of the Committee of Conference on H.R. 1 with respect to §199A point out certain provisions in the Temporary Regulations under §448 that more closely define the services referred to in §199A(d)(2)(A) and §1202(e)(3)(A).[73] One of these footnotes states ''that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals'' but ''does not include the provision of services not directly related to a medical field.'' The operation of a health club or spa is not a service in the field of health.[74] The IRS has privately ruled that performing unique and patented lab tests and providing the results to healthcare providers was not a trade or business in the field of health.[75] However, the rendering of medical services by veterinarians was ruled to be a service in the field of health.[76] Similarly, a corporation that provided radiation therapy to its patients was deemed to be performing services in the field of health.[77] The performance of ultrasound services was deemed by the Tax Court to be services in the field of health.[78]

Another footnote in the Joint Statement concerning §199A points out that the §448 Temporary Regula-

71 §199A(d)(2)(A).

72 §199A(d)(2)(B).

73 Joint Statement, 30–31).

74 Joint Statement, 30–31, n.44, referring to §1.448-1T(e)(4)(ii).

75 PLR 201717010.

76 Rev. Rul. 91-30.

77 *W.W. Eure, M.D., Inc. v. Commissioner*, T.C. Memo 2007-124.

78 *Zia-Ahmadi v. Commissioner*, T.C. Summ. Op. 2017-39.

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tions state that the performance of services in the field of performing arts includes only the services of actors, actresses, singers, entertainers, and similar artists in their capacities and does not include the services of managers or promoters of those artists nor does it include the services of broadcasters or radio station employees who disseminate those artists' performances to the public.[79]

Footnote 46 in the Joint Statement concerning §199A makes the point that the performance of services in the field of consulting includes only the services of "advice and counsel" and does not include economically similar services.[80] A taxpayer in the business of providing economic analyses and forecasts and giving advice to clients based on those forecasts and analyses is considered to be engaged in the field of consulting.[81] A business of determining a client's electronic data processing needs is considered a consulting business.[82]

The Tax Court has ruled that a bookkeeping and tax return preparation business was engaged in the performance of accounting services for purposes of §448(d)(2) despite the fact that it employed no certified public accountants.[83] In Temp. Reg. §1.448-1T(e)(5)(vii) *Ex.* 1, a C corporation that prepared tax returns and financial statements was not only considered to be performing services in the field of accounting, but administrative and support services that were incidental to those activities were considered part of that trade or business. On the other hand, services of that corporation in leasing and maintaining a leased portion of an office building that it owned, as well as administrative and support services performed with respect to those leasing activities, were services in a field that was not accounting.[84]

Perhaps the hardest test in determining whether a business is a specified service trade or business will be deciding if the principal asset of that trade or business is the reputation or skill of one or more of its employees or owners. PLR 201717010 said that a company with expertise in certain laboratory testing that had employees who, other than the laboratory director, were not considered healthcare professionals was not engaged in a trade or business where the principal asset is the reputation or skill of one or more of its employees.[85] It was pointed out in a recent issue of *Daily Tax Report*[86] that the Tax Court ruled in a 2012 case[87] that even though the success of an insurance business that sold prepaid legal service policies was due to the efforts of its two owners, the principal asset of that trade or business was its training and organizational structure and not the reputation or skill of its owners because most of the policies were sold by independent contractors, including the two owners in their capacities as commission salesmen. In PLR 201436001, the IRS ruled that a company engaged in research, development, manufacture, and commercialization of experimental drugs that used manufacturing and intellectual property assets to create value for customers did not perform services in the health industry within the meaning of §1202(e)(3) nor was it "in the business of offering service in the form of individual expertise."[88]

Depending on how the IRS decides to apply this "principal asset" standard, this could be the hardest standard for even a non-specified service trade or business to meet. For instance, could a business with a reputation for providing unique landscaping or lawn services based on the skills of its highly trained employees or owners be considered a specified service trade or business using this standard?[89] If so, then many non-specified service trades or businesses could be trapped by the specified service business net.

Further Guidance Needed: One of the major questions raised is how the IRS will determine whether a service business is a specified service trade or business. The definition of a specified service trade or business in §199A(d)(2)(A) refers to §1202(e)(3)(A). That section states that a non-qualified business for purposes of §1202 is "any trade or business involving the performance of services" in the prohibited fields. If the IRS chooses to interpret those words literally, then a trade or business that performs any prohibited services could be a specified service trade or business.[90] On the other hand, if the IRS adopts the substantial activity standard of Temp. Reg. §1.448-1T(e)(4)(i), then the performance of services in a prohibited field would be substantial "only if 95 percent or more of the time spent by employees of the" trade or business were spent providing services in that prohibited field. Time spent by employees in providing incidental services to a prohibited business (typing,

[79] Joint Statement, 31, n.45, referring to §1.448-1T(e)(4)(iii).

[80] Joint Statement, 31, n.46, referring to §1.448-1T(e)(4)(iv).

[81] Temp. Reg. §1.448-1T(e)(4)(B) *Ex.* 1.

[82] Temp. Reg. §1.448-1T(e)(4)(B) *Ex.* 2.

[83] *Rainbow Tax Services, Inc. v. Commissioner*, 128 T.C. 42 (2007).

[84] Temp. Reg. §1.448-1T(e)(5)(vii) *Ex.* 1(ii).

[85] PLR 201717010.

[86] Ruth M. Wimer, *Tax Reform: Form W-2 Significance for Pass-through 20% Section 199A Deduction*, 10 Daily Tax Rep. J-1 (Jan. 16, 2018).

[87] *Owen v. Commissioner*, T.C. Memo 2012-21.

[88] PLR 201436001.

[89] This thought was expressed in Avi-Yonah et al., "The Games They Will Play: An Update on the Conference Committee Tax Bill."

[90] *Id.*

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administrative tasks, etc.) would be counted as part of time spent in the prohibited field. Future guidance in this area is necessary.

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

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

Exception for Specified Service Businesses Based on Taxable Income

If a taxpayer's taxable income before the QBI deduction is less than a threshold amount, then the exclusion of a specified service trade or business from the definition of a qualified trade or business does not apply.[91] The threshold amount is $157,500 in the case of a single individual or $315,000 (200% of $157,500) in the case of a joint return.[92] These threshold amounts will be increased for taxable years beginning after 2018 for an inflation adjustment.[93]

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

There is also a rule whereby a specified service trade or business can be a partially qualified trade or business based on a taxpayer's taxable income before the QBI deduction. Under that rule, a taxpayer's share of a specified service trade or business's qualified items of income, gain, deduction, or loss and the taxpayer's share of that business's W-2 wages and unadjusted basis immediately after acquisition of qualified property are taken into account in computing that business's deductible QBI amount only to the extent of the ''applicable percentage'' of those amounts.[94] The applicable percentage for a taxpayer's taxable year is 100% reduced (but not below zero) by a percentage equal to the ratio of the amount of the taxpayer's taxable income before the QBI deduction that exceeds the threshold amount bears to $50,000 ($100,000 in the case of a joint return).[95]

Example

Henry is a married doctor who has the following items applicable to his medical practice: $100,000 of qualified business income, $200,000 of W-2 wages, and $60,000 of unadjusted basis immediately after acquisition of qualified property. The joint tax return of Henry and his wife indicate a taxable income before the QBI deduction of $365,000. The amount of this taxable income before the QBI deduction of $365,000 exceeds the threshold amount of $315,000 by $50,000. This excess amount bears a ratio of .5 to 1 to $100,000, the phase-out amount for a joint return. The percentage equal to this ratio is 50%. Thus only 50% (100% minus 50%) of Henry's qualified business income, W-2 wages, and unadjusted basis immediately after acquisition of qualified property are taken into account in computing Henry's QBI deduction with respect to his medical practice.[96]

QUALIFIED BUSINESS INCOME

After it is determined that a taxpayer has one or more qualified trades or businesses or partially qualified trades or businesses, the QBI for each qualified trade or business of the taxpayer must be determined. In general, a taxpayer's QBI is the net amount of

[91] §199A(d)(3)(A)(i).
[92] §199A(e)(2)(A).
[93] §199A(e)(2)(B).
[94] §199A(d)(3)(A)(i)–§199A(d)(3)(A)(ii).
[95] §199A(d)(3)(B).
[96] This example is based on the one found in the Joint Statement, 36, Ex. 1.

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qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.[97] All qualified items of income, gain, deduction, and loss must either be included in or allowed as deductions in computing a taxpayer's taxable income for the year.[98] This provision reaffirms the rule that QBI for a trade or business is computed after application of: 1) the basis limitation rules for partnerships and S corporations; 2) the §465 at-risk rules; and 3) the passive activity loss rules of §469. Furthermore, items of income, gain, deduction, and loss are characterized as qualified items only to the extent those items are effectively connected with the conduct of a trade or business within the United States as determined under the rules of §864(c).[99] If a taxpayer has QBI from sources within Puerto Rico that is taxable under §1, that income shall be considered as effectively connected with the conduct of a trade or business within the United States if it would be treated as such under the rules of §864(c).[100] For purposes of determining alternative minimum taxable income, no adjustments to regular taxable income specified in §56–§59 are made to QBI.[101]

QBI does not include any reasonable compensation paid to the taxpayer by a qualified trade or business for services rendered to that business.[102] The IRS is authorized by §1366(e) to increase the compensation of shareholders of a family-owned S corporation to amounts that are considered reasonable compensation for services rendered if those shareholders did not receive compensation for the value of their services. The IRS may also reclassify any loans from an S corporation to shareholders as wages if those loans represent reasonable compensation to the employee-shareholder.[103] If S corporation distributions or loans to shareholders are considered reasonable compensation to shareholders, then QBI of the S corporation's trade or business would be reduced.

QBI also does not include any guaranteed payments to a partner described in §707(c) that are paid to a partner for services rendered to a qualified trade or business.[104] Some advisors might suggest that partners who receive guaranteed payments from a partnership that generates QBI may increase their distributive share of QBI from that partnership by foregoing their guaranteed payments in exchange for a priority allocation of partnership profits in the form of a preferred return. Because this priority allocation of partnership profits is a distributive share of partnership profits, it should be QBI. This seems like a reasonable strategy. However, anyone adopting this strategy should consider that, in the case of a family partnership, any portion of a partner's distributive share of partnership income that is determined to be reasonable compensation for services under §704(e) could be considered a §707(c) guaranteed payment that would reduce QBI. A partner that currently receives a guaranteed payment who is considering this strategy may wish to consider that he or she may be giving up a payment that is certain in exchange for an uncertain amount of profits that will only increase a 20% deduction — i.e., he or she may be exchanging a dollar for 20 cents.

A partner may also receive partnership distributions that are considered payments to that partner for services rendered to a partnership under §707(a). These amounts are not, to the extent to be provided in future regulations, QBI.[105] This provision could result in a partner's QBI being reduced if the partner is determined to have engaged in a disguised sale with a partnership that was not reported as a sale for income tax purposes.

QBI does not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income.[106] A qualified REIT dividend is a dividend received from a real estate investment trust that is neither a capital gain dividend (as defined in §857(b)(3)) nor qualified dividend income (as defined in §1(h)(11)).[107] Because capital gain dividends and qualified dividend income are subject to preferential rates of 0%, 15%, or 20%,[108] including capital gain distributions or qualified REIT dividends in QBI would result in giving a taxpayer a double tax benefit. Similarly, including qualified cooperative dividends as part of QBI would also result in double counting these amounts because Component Two of the QBI deduction consists of 20% of qualified cooperative dividends.

For purposes of §199A, qualified publicly traded partnership income of a taxpayer includes the sum of: 1) the net amount of the taxpayer's allocable share of each item of QBI of a publicly traded partnership that is not a corporation, plus 2) any gain recognized by the taxpayer from a sale or disposition of the taxpayer's interest in the publicly traded partnership that is

[97] §199A(c)(1).
[98] §199A(c)(3)(A)(ii).
[99] §199A(c)(3)(A)(i).
[100] §199A(f)(1)(C)(i).
[101] §199A(f)(2).
[102] §199A(c)(4)(A).
[103] *Joly v. Commissioner*, T.C. Memo 1998-361, 211 F.3d 1269 (6th Cir. 2000).
[104] §199A(c)(4)(B).
[105] §199A(c)(4)(C).
[106] §199A(c)(1).
[107] §199A(e)(3)(A), §199A(e)(3)(B).
[108] §1.

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treated as ordinary income under §751(a).[109] The QBI of a publicly traded partnership is determined after applying the rules of §199A(c)(4) for partnership guaranteed payments and payments to partners for services rendered to the partnership.[110]

As noted in the first paragraph under the caption in this article titled ''Combined Business Income Amount,'' the second amount in the Combined Qualified Business Amount is 20% of a taxpayer's aggregate amount of qualified REIT dividends and qualified publicly traded partnership income. Tax professionals have suggested that individuals owning interests in specified service trades or businesses that own and lease buildings to those businesses may increase their §199A deduction by forming a REIT. Those professionals would then become beneficial owners of that REIT after transferring their buildings to the REIT in exchange for shares or certificates of beneficial interest in the REIT. The businesses would then lease the buildings from that REIT for a large amount of rent.[111] This strategy may have limited application because a REIT may be very expensive to form and is subject to requirements that it not be closely held[112] and that it have beneficial ownership of at least 100 persons.[113]

QBI and Investment Income

Because QBI is intended to consist of business income, the following items of investment income are excluded from QBI.

- Short-term capital gains and losses and long-term capital gains and losses.[114] It should be noted that any income under §1245, §1250, §1252, §1253, §1254, and other sections that is treated as ordinary income and that is attributable to a qualified trade or business should be included in QBI as a qualified item of gain. On the other hand, any loss treated as an ordinary loss under §1231 is probably an item of loss that reduces QBI if that loss is attributable to a qualified trade or business. A §1231 gain that is ultimately taxed as a long-term capital gain would seem to be excluded from QBI. Based on §199A(e)(5)(B), gain from the sale or exchange of a partnership interest that is treated as ordinary income under §751(a) should also be QBI because it would seem to be attributable to ordinary income assets of a qualified trade or business.

- Any dividends, including any payments in lieu of dividends that are made pursuant to an agreement to which §1058 applies;[115]

- Interest income that is not properly allocable to a trade or business.[116] An example of interest income properly allocable to a trade or business would be interest on accounts receivable from the sale of property in the ordinary course of a trade or business that customarily extends credit to customers and charges interest on past-due accounts receivable.

- Excess of gains over losses from transactions in commodities. This exclusion from QBI does not apply to gains or losses arising out of commodity hedging transactions that are active business gains or losses from the sale of commodities, but only if substantially all of the commodities of the qualified trade or business are: 1) supplies described in §1221(a)(8) that are regularly used or consumed in the ordinary course of the qualified trade or business; 2) inventory or property held primarily for sale described in §1221(a)(1); or 3) real property or depreciable property used in the qualified trade or business that is described in §1221(a)(2).[117]

- Excess of foreign currency gains over foreign currency losses (as defined in §988(b) that are attributable to §988 transactions unless those transactions are directly related to the business needs of the qualified trade or business.[118]

- Any item of income, gain, deduction, or loss from notional principal contracts taken into account under §954(c)(1)(F) (determined without regard to clause (ii) thereof) and other than items attributable to notional principal contracts entered into as clearly identified hedging transactions that are treated as ordinary income assets rather than capital assets under §1221(a)(7).[119]

- Any amounts received from annuities that are not used in connection with the qualified trade or business.[120]

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[109] §199A(e)(5).

[110] §199A(e)(5)(A).

[111] Avi-Yonah et al., ''The Games They Will Play: An Update on the Conference Committee Tax Bill.''

[112] §856(a)(6).

[113] §856(a)(5).

[114] §199A(c)(3)(B)(i).

[115] §199A(c)(3)(B)(ii).

[116] §199A(c)(3)(B)(iii).

[117] §199A(c)(3)(B)(iv).

[118] *Id.*

[119] §199A(c)(3)(B)(v).

[120] §199A(c)(3)(B)(vi).

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- Any item of deduction or loss that is properly allocable to any of the amounts described in any of the preceding seven items.[121]

The QBI concept is different from the Excess Business Loss concept of §461(l). A taxpayer's Excess Business Loss is calculated by offsetting the aggregate deductions of all of a taxpayer's trades or businesses against the aggregate gross income or gain attributable to those trades or businesses.[122] QBI excludes capital gains that are attributable to a qualified trade or business. For purposes of §461(l), capital gain attributable to a trade or business is "gain" that reduces a taxpayer's Excess Business Loss.

Other Rules for QBI

A taxpayer may have more than one qualified trade or business and one of those qualified trades or businesses may have a loss for the taxable year. If so, that loss is to be multiplied by 20% and offset against the §199A(b)(2) deductible amount of the profitable qualified trades or businesses. This treatment is indicated by one of the examples in the in the Joint Statement concerning §199A.[123] It is also indicated by the definition of QBI, which states that QBI is the *net* amount of the qualified items of income, gain, deduction, or loss for *any* qualified trade or business of the taxpayer.[124] Following the rules of §199A(b)(2)(A), the qualified trade or business's loss is to be multiplied by 20%. Because this loss will be a negative number, it will be less than the greater of the W-2 Wages Limit or the W-2 Wages/Property Limit, which will either be zero or a positive number. Because the deductible QBI amount for any trade or business is the *lesser* of 1) 20% of QBI for that qualified trade or business or 2) the greater of a) 50% of the qualified trade or business's W-2 wages or b) 25% of that business's W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of qualified property, the negative 20% of QBI will necessarily be the lower than zero or any positive amount.

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

There is a rule for carryover of losses. That rule states that if the *net* amount of qualified items of income, gain, deduction, and loss of qualified trades or businesses of a taxpayer for a taxable year is less than zero, that *net* amount is to be treated as a loss from a qualified trade or business in the following year.[125]

Example

A taxpayer with two qualified trades or businesses has QBI of $10,000 from one of those businesses and a qualified business loss of ($20,000) from the other qualified trade or business. This taxpayer has taxable income before the QBI deduction of $100,000 for the taxable year. No limitations apply in determining the taxpayer's deductible amount for each trade or business. The net amount of QBI from all of the taxpayer's qualified trades or businesses ($10,000) is less than zero. The taxpayer is not allowed a QBI deduction.[126] The taxpayer has a carryover of a qualified business loss of ($10,000), which is calculated by offsetting the qualified business loss ($20,000) from one business with the QBI of $10,000 for the other business. In the following year, one business has QBI of $20,000 and the other business has QBI of $30,000. The taxpayer's taxable income before the §199A deduction is $125,000. There are no limitations that apply in determining the taxpayer's deductible amount for each trade or business. To calculate the QBI deduction for the following year, 20% of the QBI of $50,000 for both businesses is offset by 20% of the $10,000 carryover of a qualified business loss.[127]

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

[121] §199A(c)(3)(B)(VI).

[122] §461(l)(3)(A).

[123] Joint Statement, 29.

[124] §199A(c)(1).

[125] §199A(c)(2).

[126] This example is based on one in Joint Statement, 29.

[127] *Id.*

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W-2 WAGES LIMIT AND W-2 WAGES/ PROPERTY LIMIT

The §199A deductible amount for each trade or business is limited to the greater of two amounts that the author has named the W-2 Wages Limit and the W-2 Wages/Property Limit. The W-2 Wages Limit is 50% of the W-2 wages with respect to the qualified trade or business.[128] The W-2 Wages/Property Limit is the total of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property of that qualified trade or business.[129] Neither of these limits apply to a taxpayer with taxable income before the QBI deduction that does not exceed a threshold amount of $157,500 in the case of a single individual or $315,000 (200% of $157,500) in the case of a joint return.[130]

W-2 Wages

The W-2 wages taken into consideration include only W-2 wages that are properly allocable to the QBI of the qualified trade or business for which the deductible amount under §199A(b)(2) is being determined.[131] This rule will be fairly easy to follow in the case of a sole proprietorship that is reported on a separate tax return schedule. Partnerships and S corporations that engage in multiple activities that they have not elected to treat as one activity are required to furnish each partner with a schedule of activities with their Form 1065 or Form 1120S Schedule K-1. Each partner or shareholder is considered as having W-2 wages equal to that person's ''allocable share of the W-2 wages'' of the partnership or S Corporation.[132] A partner's or a shareholder's allocable share of W-2 wages is to be determined in the same manner as that owner's allocable share of the entity's wage expenses.[133]

An S corporation shareholder's allocable share of an S corporation's wage expenses would be that shareholder's pro rata share of those expenses, which is calculated under the provisions of §1377(a)(1). Under these provisions, each shareholder's share of the S corporation's wage expense would be calculated by: 1) assigning an equal portion of the wage expense to each day in the taxable year; 2) dividing that portion pro rata among the S corporation's shares of stock outstanding on that particular day; and 3) then totaling those daily amounts for each shareholder.[134]

A partner's allocable share of a partnership's wage expense is normally determined by the partnership agreement.[135] As a result, a partner's allocable share of a partnership's wage expense may be determined by special profit and loss allocation provisions contained in the partnership agreement. However, a partner's share of a partnership's allocable wage expense could be determined in accordance with a partner's interest in the partnership, taking into account facts and circumstances, if the partnership agreement either does not provide for the partner's share of partnership wage expense or the allocation of wage expense under the provisions in the partnership agreement does not have substantial economic effect as described in the §704(b) regulations.[136] The parenthetical phrase ''(as determined under regulations prescribed by the Secretary)'' that is contained in §199A(f)(1)(A)(iii) may indicate that the IRS will prescribe regulations in this area.

The term ''W-2 wages'' is defined by §199A(b)(4)(A) and includes amounts described in §6051(a)(3) and §6051(a)(8) paid by a taxpayer or pass-through entity with respect to the employment of employees by that person or entity during the calendar year that ends during the taxpayer's taxable year.[137] The wages described in §6051(a)(3) are wages defined by §3401(a), which basically include all amounts paid by employers to employees for services rendered by those employees in their employee capacities. There are a number of exclusions from the term ''wages'' contained in §3401(a).[138] If a taxpayer has QBI from Puerto Rico sources that is taxable under §1 for a taxable year and is considered effectively connected with a U.S. trade or business, the taxpayer's W-2 wages with respect to any qualified trade or business conducted in Puerto Rico are to be calculated without regard to any exclusion under §3401(a)(8) for remuneration paid for those services in Puerto Rico.[139] The wages described in §6051(a)(8) include amounts that are elective deferrals under §402(g)(3) (these deferrals include §401(k) cash or deferred arrangements, a §403(b) salary reduction arrangement, and other salary reduction plans described in §402(g)(3)), §457 deferred compensation arrangements, and designated contributions to a qualified

[128] §199A(b)(2)(B)(i).
[129] §199A(b)(2)(B)(ii).
[130] §199A(b)(3)(A); §199A(e)(2)(A).
[131] §199A(b)(4)(B).
[132] §199A(f)(1)(A)(iii).
[133] §199A(f)(1)(A).
[134] §1377(a)(1).
[135] §704(a).
[136] §704(b)(1)–§704(b)(2).
[137] §199A(b)(4)(A).
[138] This description may also be found in Kehl, *Practical Guide to the Sec. 199 Deduction*, p. 45.
[139] §199A(f)(1)(C)(ii).

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Roth contribution program described in §402A.[140] The term ''W-2 wages'' is not to include any amounts that are not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date, including extensions, for that return.[141]

In general, the IRS is supposed to issue regulations concerning how to apply §199A(b) for short taxable years as well as for acquisitions or dispositions by a taxpayer of either a major portion of a trade or business or a major portion of a separate unit of a trade or business.[142] However, Joint Statement concerning §199A did express its intentions as to how certain amounts contained in the definition of W-2 wages are to be treated for a short taxable year.[143] Generally, the intention expressed in that Joint Statement is that only those wages actually paid to employees of the qualified trade or business during the short taxable year are to be treated as W-2 wages.[144] In addition, only §402(g)(3) elective deferrals actually made by the qualified trade or business's employees during the short taxable year are to be considered W-2 wages.[145] Similarly, W-2 wages should only include compensation that is actually deferred under §457 during the short taxable year concerning employees of the qualified trade or business.[146] Finally, the Joint Statement's intention is that any amounts considered W-2 wages for a short taxable year are not to be considered W-2 wages for any other taxable year.[147]

These rules are very similar to the rules contained in the recently repealed §199(b)(2) concerning the former Domestic Production Activities Deduction.[148] There are similarities between former §199(b)(2) and §199A(b)(4).[149] The definition of the term ''W-2 wages'' found in §199A(b)(4)(A) is basically the same as the definition of that term found in §199(b)(2)(A). W-2 wages for purposes of the former Domestic Production Activities Deduction had to be allocable to Domestic Production Gross Receipts.[150] W-2 wages for purposes of the §199A deduction must be allocable to QBI.[151] Finally, W-2 wages for purposes of both deductions had to be properly includable on a return filed with the Social Security Administration.

One area that could also generate some controversy concerns the requirement of §199A(b)(4)(A) that W-2 wages be ''paid'' by the taxpayer for the employment of employees. For purposes of former §199, employees of the taxpayer were those described in §3121(d)(1), which are corporate officers, and §3121(d)(1), which are individuals that have the status of employees under the common law rules that apply in determining employer-employee relationships.[152] Under the former §199 regulations, a taxpayer was permitted to determine W-2 wages by taking ''into account any wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer.''[153] If the taxpayer was treated as the employer merely because the taxpayer controlled the payment of wages and was not the common law employer, the taxpayer could not consider the wages as §199(b)(2) W-2 wages.[154] Similarly, if the taxpayer paid W-2 wages as the agent of some other entity to persons who were not the taxpayer's employees, those wages were not W-2 wages.[155] Hopefully, similar rules will be enacted for purposes of §199A. These rules could enable taxpayers that use a common paymaster for payment of wages but who are the common law employers of those employees to still have W-2 wages for purposes of §199A.

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

One can surmise that payment of W-2 wages to individuals is preferred for purposes of the QBI deduction over paying individuals as independent contractors. Many of these independent contractors may ac-

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140 §6051(a)(8).

141 §199A(b)(4)(C).

142 §199A(b)(5).

143 Joint Statement, 32, n.51.

144 *Id.*

145 *Id.*

146 *Id.*

147 *Id.*

148 This was pointed out in Wimer, *Tax Reform: Form W-2 Significance for Pass-through 20% Section 199A Deduction.*

149 *Id.* The rules under former §199(b)(2) and accompanying regulations were also discussed by Kehl, *Practical Guide to the Sec. 199 Deduction*, Chapter 3.

150 §199(b)(2)(B).

151 §199A(b)(4)(B).

152 Reg. §1.199-2(a)(1).

153 Reg. §1.199-2(a)(2).

154 *Id.*

155 *Id.*

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tually be employees under the control tests previously mentioned, so reclassification of these individuals as employees may result in a more accurate designation of their status.

Guaranteed payments to partners for services rendered are not W-2 wages. However, as mentioned in a recent article in the *Daily Tax Report*,[156] an S Corporation may pay wages to its shareholder-employees and have those amounts paid considered W-2 wages. In addition, those S Corporations can also create W-2 wages by paying salaries to the spouses of owners and to other relatives. This was a technique employed to create wages under the now repealed §199.[157] Because incorporation of a sole proprietorship as an S Corporation has historically been a ''plain vanilla'' standard transaction, it is difficult to see any forthcoming regulations that would prevent this technique from being utilized in the future.

There have been discussions concerning the use of holding partnerships and operating partnerships in order to generate W-2 wages for partners instead of guaranteed payments for services rendered. In a simplified version of this scenario, the working partners who received §707(c) guaranteed payments for services would contribute their interests in the operating partnership (operating partnership) to a new partnership (holding partnership). Holding partnership would then become the partner in operating partnership. Because the working partners who formerly received guaranteed payments for services rendered would no longer be partners in operating partnership, the amounts paid to those individuals would be amounts paid to employees that would theoretically qualify as W-2 wages for purposes of §199A(b)(2)(B)(i). Would this scenario work? At this point, no one knows for sure. The statute states that the IRS is to prescribe regulations necessary to carry out the purposes of §199A, including regulations for the application of §199A in cases involving tiered entities.[158] This is in addition to the statutory mandate that the IRS is to issue regulations necessary to carry out the purposes of §199A that are to include regulations that restrict the allocation of wages. Anyone contemplating plans of this nature should take into consideration the possibility of future regulations that may restrict or limit the desired tax benefits.

Unadjusted Basis Immediately After Acquisition of Qualified Property

This definition is also being widely discussed by tax professionals. It was apparently enacted at the last minute so that owners of pass-through entities that are qualified trades or businesses that pay no W-2 wages, but own a large amount of fixed assets, may receive a §199A deduction. The example in the Conference Agreement seemed to indicate this.[159] Real estate entities that are qualified trades or businesses that pay management fees rather than W-2 wages may fit this description.

For purposes of §199A, qualified property is tangible property that is also depreciable property.[160] Qualified property must satisfy the following conditions: 1) the property must be held by and available for use in the qualified trade or business at the close of the taxable year;[161] 2) the property must be used at any point during the taxable year in the production of QBI;[162] and 3) the property's depreciable period, as defined by §199A(b)(6)(B), must not have ended before the close of the taxable year.[163] Apparently, the second requirement is satisfied if the property is used in the production of QBI for only the final days of a taxable year. Congress was also apparently concerned that businesses with a substantial amount of fixed assets with short MACRS recovery periods would not be able to include those assets in qualified property if the definition of a property's depreciable period was that property's MACRS recovery period. For that reason, §199A(b)(6)(B) defines the depreciable period for qualified property as the period that begins on the date the property was first placed in service by the taxpayer and ends on the date that is either 1) 10 years after the placed-in-service date or 2) the last day of the last full year in the applicable recovery period for the property under §168, whichever date is later.[164] The last full day in the qualified property's applicable recovery period is to be determined without regard to any recovery periods that are part of the Alternative Depreciation System described in §168(g).[165] Taxpayers using the MACRS recovery period as the depreciable period for qualified property because the MACRS recovery period ends after the tenth anniversary of the property's placed in service date should note that this period ends with ''the last full year in the applicable recovery period.''[166]

Similar to W-2 wages, each partner and S corporation shareholder is treated as having an amount of unadjusted basis immediately after acquisition of qualified property for the taxable year equal to that per-

[156] Wimer, *Tax Reform: Form W-2 Significance for Pass-through 20% Section 199A Deduction*.

[157] Kehl, *Practical Guide to the Sec. 199 Deduction*, p. 47.

[158] §199A(f)(4)(B).

[159] Joint Statement, 38.

[160] §199A(b)(6)(A).

[161] §199A(b)(6)(A)(i).

[162] §199A(b)(6)(A)(ii).

[163] §199A(b)(6)(A)(iii).

[164] §199A(b)(6)(B)(i)–§199A(b)(6)(B)(ii).

[165] §199A(b)(6)(B)(ii).

[166] *Id.*

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son's allocable share of the partnership's or S corporation's unadjusted basis immediately after acquisition of qualified property for the taxable year.[167] This amount is to be determined under future regulations.[168] However, the statute does contain one guideline for determining a partner's or an S corporation shareholder's allocable share of the partnership's or S corporation's unadjusted basis immediately after acquisition of qualified property for the taxable year. For an S corporation shareholder, this allocable share is to be determined in the same manner as the shareholder's allocable share of the S corporation's depreciation expense for the year.[169] Because an S corporation shareholder's allocable share of the S corporation's depreciation expense is that shareholder's pro rata share of that item as determined under the rules of §1377(a)(1),[170] a shareholder's allocable share of the S corporation's unadjusted basis immediately after acquisition of qualified property is also that shareholder's pro rata share of that item as determined under the rules of §1377(a)(1).[171] Those rules were briefly described above under the caption titled "W-2 wages."

A partner's allocable share of the partnership's unadjusted basis immediately after acquisition of qualified property for the taxable year is also that partner's allocable share of the partnership's depreciation expense.[172] A partner's distributive share of a partnership's depreciation expense is also determined by provisions, including special allocation provisions, in the partnership agreement.[173] However, a partner's allocable share of a partnership's depreciation expense could also be determined in accordance with the partner's interest in the partnership if the partnership agreement either is silent concerning the allocation of depreciation expense or if the allocation of depreciation expense in the partnership agreement does not have the substantial economic effect required by §704(b) and its regulations. However, if any property contributed to the partnership by a partner has a tax basis to the partnership that is different than the contributed property's fair market value on the date of the partner's contribution, then a partner's share of the partnership's depreciation expense for a taxable year must be determined in accordance with the rules of §704(c) and Reg. §1.704-3. These include the rules for making §704(c) allocations contained in Reg. §1.704-3(b), §1.704-3(c), and §1.704-3(d), depending upon whether the traditional method, the traditional method with curative allocations, or the remedial allocation method for allocating depreciation expense among its partners has been elected by the partnership. If built-in loss property has been contributed by a partner to a partnership, then a partner's share of depreciation expense with respect to that built-in loss property may have to take the provisions of §704(c)(1)(C) into consideration.[174] All of the partnership rules that affect the determination of a partner's allocable share of a partnership's depreciation expense could affect the determination of a partner's allocable share of a partnership's unadjusted basis immediately after acquisition of qualified property.

There have been discussions about shifting property among entities in order to cope with the limit on a qualified trade or business's QBI deduction enunciated by §199A(b)(2)(B)(ii). There are anti-abuse rules contained in §199A that direct the IRS to apply rules that are similar to the provisions of §179(d)(2) for the purpose of preventing the manipulation of the depreciable period of qualified property by engaging in related party transactions.[175] The provisions of §179(d)(2) define a purchase of property for purposes of the §179 election to expense certain qualified property acquired for use in the active conduct of a trade or business. That paragraph excludes from the definition of purchase any acquisition of property from a related person that would result in a disallowance of losses under either §267 or §707(b).[176] In speculating on a similar regulation for §199A, it is not too hard to imagine that acquisitions of property from a related party described in §267(b) or §707(b) would be excluded from a taxpayer's unadjusted basis immediately after acquisition of qualified property for the taxable year. These regulations could also enact a rule similar to the rule of §179(d)(2)(C), which states that a purchase for purposes of §179 does not include the acquisition of property if the basis for that property is determined in whole or in part by the adjusted basis of that property in the hands of the person from whom it is acquired,[177] or if the basis of the property in the hands of the person acquiring the property is determined under the rules of §1014(a).[178]

The future §199A regulations may exclude property acquired under either of these situations from the unadjusted basis immediately after acquisition of qualified property for the taxable year. Any strategies that involve increasing the unadjusted basis immediately

[167] §199A(f)(1)(A)(iii).

[168] *Id.*

[169] §199A(f)(1)(A).

[170] *Id.*

[171] *Id.*

[172] *Id.*

[173] §704(a).

[174] Prop. Reg. §1.704-3, REG-144468-05, 79 Fed. Reg. 3042 (Jan. 16, 2014).

[175] §199A(h)(1).

[176] §179(d)(2)(A).

[177] §179(d)(2)(C)(i).

[178] §179(d)(2)(C)(ii).

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after acquisition of qualified property to its fair market value if that property is acquired from a decedent through inheritance should take into consideration the possibility of that increase in value being excluded from the unadjusted basis immediately after acquisition of qualified property by future IRS regulation. This caveat could also apply to any strategy involving a §754 election for an inherited interest in a partnership owning qualified property.

A concern has also arisen as to whether the unadjusted basis immediately after acquisition of qualified property may have to be reduced by the amount of that qualified property that the taxpayer has elected to expense under §179 and/or by the additional allowance for depreciation described in §168(k) taken on that property. This concern apparently arose from the definition of ''unadjusted basis'' contained in Prop. Reg. §1.168-2(d), which basically states that the unadjusted basis of an item of recovery property is its basis for determining gain under §1011–§1016 without regard to any adjustments for depreciation taken that are described in §1016(a)(2) and (3) minus any portion of the basis for which a taxpayer has elected to take §167(k) amortization or to expense under §179. The other source cited for the definition of the term ''unadjusted basis'' is the definition contained in IRS Publication 946, which is in the Glossary of terms section of that publication. That definition states that unadjusted basis is the basis of an item for purposes of figuring gain on sale that does not take into consideration depreciation taken in prior years but is adjusted for §179 depreciation and any special depreciation allowance, among other items.[179] This concern does not seem to take certain matters into consideration. First, the definition of ''unadjusted basis'' in Prop. Reg. §1.168-2(d) is a definition for computing MACRS recovery depreciation and is not necessarily relevant to the §199A concept of unadjusted basis immediately after acquisition of qualified property. Second, the definition of unadjusted basis in IRS Publication 946 is for the purpose of determining gain on sale. It also does not seem to be relevant to §199A. The third and perhaps most important consideration is that §199A(b)(2)(B)(ii) states that the Property Limit is a percentage of ''the unadjusted basis immediately after acquisition of all qualified property.'' The §179 election is an election that is made with the taxpayer's return. Similarly, §168(k) bonus depreciation is taken on a taxpayer's return for the year qualified property is placed in service. However, §199A(b)(2)(B)(ii) states that qualified property's unadjusted basis is ''immediately after acquisition.'' Neither the §179 election nor the special allowance for depreciation has been taken with respect to an item of qualified property ''immediately after acquisition.'' For that reason, it seems that the phrase ''immediately after acquisition'' should prevent a qualified property's unadjusted basis from being reduced by any §179 depreciation or bonus depreciation.

Section 199A(b)(2)(B)(ii) definitely provides an incentive to qualified businesses to acquire and own depreciable property rather than lease it. As has been pointed out elsewhere, the 20% deduction for QBI will not be limited for a business that pays no W-2 wages as long as it owns qualified depreciable assets with an unadjusted basis immediately after acquisition in an amount that is sufficient to not limit the deduction.[180]

The anti-abuse rules of §199A(h) also contain a mandate to the IRS to set down rules for determining the unadjusted basis immediately after acquisition for any qualified property that is acquired in involuntary conversions or like-kind exchanges.[181] There could also be future regulations that restrict the transfer of property between related parties in order to avoid the limitation of a qualified business's 20% of QBI amount.

W-2 Wages Limit Amount and W-2 Wages/Property Limit Amount in Sample Problem

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

The deductible amount for LLC No. 2's qualified trade or business is limited to that business's W-2 Wages Limit Amount because the W-2 Wages Limit Amount of $10,000 is less than the 20% of QBI

[179] IRS Publication 946, *How to Depreciate Property*, p. 111.

[180] Wimer, *Tax Reform: Form W-2 Significance for Pass-through 20% Section 199A Deduction*.

[181] §199A(h)(2).

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Amount for that trade or business of $14,200. Therefore, the deductible amount for the trade or business of LLC No. 2 is $10,000.

The deductible amount for LLC No. 3's qualified trade or business results in a reduction of the taxpayer's Combined Qualified Business Income Amount. This reduction by 20% of the amount of a loss is an application of the mechanics for computing the §199A deduction and is appropriate because, in the case of a taxpayer subject to either the W-2 Wages Limit Amount or the W-2 Wages/Property Limit Amount, a negative number will always be less than zero or a positive number. If the qualified trade or business of LLC No. 3 had been the only business of the taxpayers, there would have been no QBI deduction for the taxpayers for the current year and that loss would have been carried over to subsequent years until 20% of that negative amount was used to reduce the taxpayer's Combined Qualified Business Income Amount for a future year.

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

Phase-In Limit for Certain Taxpayers

Taxpayers with taxable income before the QBI deduction in excess of a threshold amount of $157,500 ($315,000 for a joint return) plus $50,000 ($100,000 in the case of a joint return) are always subject to the W-2 Wages Limit or the W-2 Wages/Property Limit. Taxpayers with taxable income before the QBI deduction below the threshold amount will never be subject to those limits. There is a phase-in of the W-2 Wages Limit or W-2 Wages/Property Limit for taxpayers with taxable income before the QBI deduction that exceeds the threshold amount but is less than the threshold amount plus $50,000 ($100,000 in the case of a joint return).[182] This phase-in limit applies if the W-2 Wages Limit or W-2 Wages/Property Limit for a qualified trade or business is less than the 20% of QBI amount for a qualified trade or business.[183] If the W-2 Wages Limit Amount or W-2 Wages/Property Limit Amount for a qualified trade or business is equal to or greater than the 20% of QBI amount for that qualified trade or business, there is no limit that has to be phased in.

Taxpayers with taxable incomes within the applicable ranges ($157,501–$207,499 for single taxpayers, $315,001–$414,499 for joint returns) are subject to the phase-in of the W-2 Wages Limit and/or W-2 Wages/Property Limit.[184]

The limit that is phased in is termed the "Excess Amount" and is the amount by which 20% of a qualified trade or business's QBI exceeds the greater of 1) the W-2 Wages Limit Amount or 2) W-2 Wages/Property Limit Amount.[185] The 20% of QBI amount is reduced by an amount that bears the same ratio to the Excess Amount as the amount by which the taxpayer's taxable income before the QBI deduction for the taxable year in excess of the threshold amount bears to $50,000 for a single taxpayer or $100,000 for a joint return.

> *Example*
>
> Bob and Barbara file a joint return for 2018 and have taxable income before the QBI deduction of $355,000. Included in their taxable income is $100,000 of QBI. Bob and Barbara's share of W-2 wages with respect to this qualified trade or business is $30,000 and their share of this business's unadjusted basis immediately after acquisition of qualified property applicable to this qualified trade or business is $60,000. The 20% of QBI amount for this qualified trade or business is $20,000 (20% × $100,000). The W-2 Wages Limit Amount is $15,000 (50% × $30,000) and the W-2 Wages/Property Limit Amount is $9,000 (25% of W-2 wages of $30,000 equals $7,500 plus 2.5% of the $60,000 of the unadjusted basis immediately after acquisition of qualified property equals $1,500). The limit on the deductible amount for this qualified trade or business is the W-2 Wages Limit Amount of $15,000 because this amount is greater than the W-2 Wages/Property Limit Amount of $9,000. The Excess Amount is $5,000 ($20,000 [20% of

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182 §199A(b)(3)(B).

183 §199A(b)(3)(B)(ii).

184 §199A(b)(3)(B).

185 §199A(b)(3)(B)(iii).

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QBI amount] minus the W-2 Wages Limit Amount of $15,000). Bob's and Barbara's taxable income before their QBI deduction of $355,000 exceeds the threshold amount of $315,000 by $40,000. The ratio of this excess to $100,000 is .4 to 1. The amount that bears this .4 to 1 ratio to the $5,000 Excess Amount is $2,000 (.4 × $5,000 equals $2,000). Bob's and Barbara's 20% of QBI deductible amount for this trade or business must be reduced by $2,000. Bob's and Barbara's deductible amount for this trade or business is $18,000 (20% of QBI amount of $20,000 minus the reduction for the Excess Amount of $2,000).[186]

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

Example

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

The 20% of QBI amount for this specified service trade or business is $8,000, which is 20% of QBI of $40,000. The W-2 Wages Limit Amount is $4,000 (50% × $8,000) and the W-2 Wages/Property Limit Amount is $2,600 (25% of W-2 wages of $8,000 equals $2,000 plus 2.5% of the $24,000 of the unadjusted basis immediately after acquisition of qualified property equals $600). The W-2 Wages Limit Amount on the deductible 20% of QBI amount for this qualified trade or business is $4,000. The Excess Amount is $4,000 (20% of QBI amount of $8,000 minus the W-2 Wage Limit Amount of $4,000). Henry and his spouse's taxable income before their Combined QBI deduction of $375,000 exceeds the threshold amount of $315,000 by $60,000. The ratio of this excess to $100,000 is .6 to 1. The amount that bears this .6 to 1 ratio to the $4,000 Excess Amount is $2,400 (.6 × $4,000 equals $2,400). Henry and his spouse's 20% of QBI deductible amount for this trade or business must be reduced by $2,400. Henry and his spouse's deductible amount for this trade or business is $5,600, which is the 20% of QBI amount of $8,000 minus the phase-in W-2 Wages Limit Amount of $2,400.

ESTATES AND TRUSTS

As noted at the beginning of this article, estates and trusts are taxpayers that will qualify for the §199A deduction. Except as otherwise provided in Subchapter J, Part I of the Code, §641(b) states that "the taxable income of an estate or trust shall be computed in the same manner as in the case of an individual." Based on that provision, many tax advisors have concluded that a trust or estate has a threshold amount of taxable income before the §199A deduction for a taxable year of $157,500, the same amount as an individual taxpayer.[187] An estate or trust that has taxable income before the deduction for QBI that is equal to or less than the threshold amount would not be subject to the W-2 Wages Limit and W-2 Wages/Property Limit described in §199A(b)(2)(B)(i) and (ii) in determining its 20% deductible amount for each of its qualified trades or businesses. Furthermore, an estate or trust that has taxable income before the deduction for QBI that is equal to or less than the threshold amount would not be subject to the rules for specified service trades or businesses discussed above. If an estate's or trust's taxable income before the deduction for QBI is between $157,501 and $207,499, that estate or trust will be subject to the phase-in limit rules of §199A(b)(3)(B) and the phase-out rules for specified service trades or businesses contained in §199A(d)(3).

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

[187] §199A(e)(2)(A).

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Rules similar to those contained in former §199(d)(1)(B)(i) as in effect on December 1, 2017, for the apportionment of W-2 wages are to be applied to the apportionment of a trust's or an estate's W-2 wages and unadjusted basis immediately after acquisition of qualified property.[188] The rules of former §199(d)(1)(B)(i) as in effect on December 1, 2017, stated that W-2 wages of a trust or estate for a taxable year were to be apportioned between the beneficiaries and the trust or estate under regulations prescribed by the IRS.[189] For purposes of former §199, an estate's or a trust's W-2 wages were to be allocated to each beneficiary of the estate or trust and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI) for a taxable year that is either distributed or required to be distributed to the estate's or the trust's beneficiaries or that is retained by the trust or estate.[190] For purposes of this rule, the trust's or estate's DNI was to be calculated by taking into consideration the separate share rule.[191] If a trust or an estate had no DNI for a taxable year, any W-2 wages were to be allocated entirely to the trust or estate.[192]

If future §199A regulations are to be based on the former §199 regulations with respect to estates or trusts, it is likely that QBI, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property will be allocated between a trust or estate and its beneficiaries based on the proportions of DNI that is either retained by the trust or estate or distributed or required to be distributed to the beneficiaries of the trust or estate. This seems like a reasonable approach.

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

The incentive to create trusts is also enhanced when one considers the increase in the basic exclusion amount for federal estate and gift tax purposes from $5 million to $10 million for gifts made and for the estates of decedents dying after December 31, 2017, and before January 1, 2026.[193] This amount is adjusted annually for inflation.[194] The basic exclusion amount for 2018 is $11.2 million for gifts made and for decedents dying in 2018. If proper estate planning is done, surviving spouses who die after December 31, 2017, and before January 1, 2026, may not only be able to utilize their own basic exclusion amount but also the deceased spousal unused exclusion amount.[195] Based on the 2018 amount for the basic exclusion amount, a married couple could transfer $22.4 million free of federal estate and gift transfer taxes with proper planning. Many individuals who had made gifts and had fully utilized their applicable exclusion amounts prior to 2018 now have an opportunity to use the increases in those amounts that were enacted by 2017 tax act to make future gifts during the years 2018 through 2025.

There are many valid reasons for creating trusts. A discussion of those reasons is far beyond the scope of this article. The potential of a trust to achieve income tax savings under §199A is one more reason for family planners and attorneys to utilize trusts in wealth management planning. However, potential income tax savings through §199A should not be the only consideration in the decision to utilize trusts in transferring family wealth among generations. The other tax and

[188] §199A(f)(1)(B).

[189] The apportionment of W-2 wages and other §199 items of an estate or trust is discussed in Kehl, *Practical Guide to the Sec. 199 Deduction*, pp. 310–318.

[190] Kehl, n.189, above, p. 312, and Reg. §1.199-9(e)(2)(i).

[191] Reg. §1.199-9(e)(2)(i).

[192] *Id.*

[193] §2010(c)(3)(C), as amended by the 2017 tax act, §11061(a).

[194] §2010(c)(3)(B).

[195] §2010(c)(2).

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non-tax reasons for employing trusts that were valid planning considerations before the passage of the 2017 tax act remain as matters to be taken into consideration today.

SPECIFIED AGRICULTURAL OR HORTICULTURAL COOPERATIVES

Cooperatives were briefly described under the caption in this article titled ''Qualified Cooperative Dividend Component.'' Even though a cooperative is a corporation and §199A is to apply to ''a taxpayer other than a corporation,''[196] §199A(g) allows certain specified agricultural or horticultural cooperatives a deduction, for taxable years of those specified cooperatives that begin after December 31, 2017, equal to 20% of the excess of the specified agricultural or horticultural cooperative's gross income over the qualified cooperative dividends paid during a taxable year for that taxable year.[197] Similar to the limitations on the §199A deductible amount for a qualified trade or business, this deduction is limited to the greater of a W-2 Wages Limit or a W-2 Wages/Property Limit. The W-2 Wages Limit is 50% of the cooperative's W-2 wages with respect to its trade or business.[198] The W-2 Wages/Property Limit is the sum of 25% of the cooperative's W-2 wages with respect to its trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property of the cooperative.[199] The amount of this 20% deduction for a specified agricultural or horticultural cooperative cannot exceed the specified agricultural or horticultural cooperative's taxable income for the taxable year.[200]

A specified agricultural or horticultural cooperative is an organization subject to the provisions of Part I of Subchapter T of the Code that is engaged in any of the following activities: a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product;[201] b) the marketing of the agricultural or horticultural products that the cooperative's patrons have manufactured, grown, produced or extracted;[202] or c) the provision of supplies, equipment or services to farmers or to organizations described in items a) or b) of this sentence.[203]

CONCLUSION

The §199A deduction is effective for taxable years that begin after December 31, 2017, and terminates for taxable years that begin after December 31, 2025.[204] There are many issues that have to be addressed and many questions that have to be answered with respect to this brand new deduction. Several of those issues and questions have been discussed in this article. Taxpayers should begin planning in these early days of 2018 to maximize this deduction. However, it may be prudent to wait for future income tax regulations and other guidance before finalizing those plans.

[196] §199A(a).
[197] §199A(g)(1)(A).
[198] §199A(g)(1)(B)(i).
[199] §199A(g)(1)(B)(ii).
[200] §199A(g)(2).
[201] §199A(g)(3)(A).
[202] §199A(g)(3)(B).
[203] §199A(g)(3)(C).
[204] §199A(i).

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WORKSHEET 1

Sample Taxpayer
Summary of Taxpayer Information

Tax Return Information:	
Wages and Salaries	**100,000**
Non-Qualifying Dividends	**5,000**
Qualified Cooperative Dividends	**2,000**
Qualified DividendsNet Long-Term Capital Gain In Excess of	**3,000**
Net Short-Term Capital Loss	**24,000**
Qualified Publicly Traded Partnership Income	**10,000**
Non-Business Interest Income	**1,000**
Income-LLC No. 1	**252,000**
Income-LLC No. 2	**71,000**
Loss-LLC No. 3	**(39,000)**
Qualified REIT Dividends	**25,000**
Gross Income and Adjusted Gross Income	**454,000**
Itemized Deductions	
Taxes	**10,000**
Mortgage Interest	**5,000**
Charitable Contributions	**10,000**
Total Itemized Deductions	**25,000**
Taxable Income Before QBI Deduction	**429,000**
QBI Deduction-See Schedule	**(60,000)**
Taxable Income	**369,000**

Other Data	**LLC No. 1**	**LLC No. 2**	**LLC No. 3**
Taxpayer's share of W-2 wages	**1,625,000**	**20,000**	**0**
Taxpayer's Share of Unadjusted Basis of Qualified Property	**325,000**	**19,000**	**420,000**

This taxpayer is a married couple filing a joint return.

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WORKSHEET 2

Sample Client

Determination of Deductible Amount For Each Qualified Trade or Business and Combined Qualified Business Income Amount

	LLC No. 1	LLC No. 2	LLC No. 3	Aggregate Deductible Amount
QBI Amount:				
Partnership Income	252,000	71,000	(39,000)	
Guaranteed Payment to Partner	0	0	0	
Qualified Business Income (Loss)	252,000	71,000	(39,000)	
Percentage For Deduction	20%	20%	20%	
20% of QBI amount	50,400	14,200	(7,800)	
W-2 Wages Limit:				
W-2 wages	1,625,000	20,000	0	
Wage Percentage	50%	50%	50%	
W-2 Wages Limit Amount	812,500	10,000	0	
W-2 Wages/Property Limit				
W-2 wages	1,625,000	20,000	0	
Wage Percentage	25%	25%	25%	
W-2 Wages for W-2 Wages/Property Limit Amount	406,250	5,000	0	
Unadjusted Basis Immediately After Acquisition of Qualified Property	325,000	19,000	420,000	
Percentage Limit	2.50%	2.50%	2.50%	
Property Amount	8,125	475	10,500	
Total W-2 Wages/Property Limit Amount	414,375	5,475	10,500	
Greater of W-2 Wages Limit Amount or W-2 Wages/Property Limit Amount	812,500	10,000	10,500	
Aggregate Deductible Amount for Each Trade or Business	50,400	10,000	(7,800)	52,600
Qualified REIT Divdends and Qualified Publicly Traded Partnership Income				
Qualified REIT Dividends			25,000	
Qualified Publicly Traded Partnership Income			10,000	
Total			35,000	
Percentage of Qualified REIT and Qualified Publicly Traded Partnership Income			20%	
REIT and Qualified Publicly Traded Partnership Income Portion				7,000
Combined Qualified Business Income Amount				59,600

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WORKSHEET 3

Sample Client
Deduction For Qualified Business Income

The QBI deduction is the sum of the Qualified Business Income component and the Qualified Cooperative Dividend component.

Qualified Business Income Component:

	20% Excess Taxable Income Limit	Combined QBI Amount & Limit	QBI Deduction Components
Combined Qualified Business Income Amount (See Schedule)		59,600	
20% Excess Taxable Income Limit:			
Taxable Income Before QBI Deduction	429,000		
Less: Qualified Cooperative Dividends	(2,000)		
Qualified Dividends	(3,000)		
Net long-term capital gain in excess of net short-term capital loss	(24,000)		
Taxable income in excess of net capital gain and qualified cooperative dividends	400,000		
Excess Percentage	20%		
Excess Taxable Income Amount		80,000	
Qualified Business Income Component-lesser of Combined Qualified Business Income Amount or Excess Taxable Income Amount			59,600

	Qualified Cooperative Dividend Amount	Qualified Cooperative Dividend Amount & Limit	
Qualified Cooperative Dividend Component -Lesser of the following two amounts:			
20% of Qualified Cooperative Dividends:			
Qualified Cooperative Dividends	2,000		
Percentage of Qualified Cooperative Dividends	20%		
Qualified Cooperative Dividend Amount		400	

	Taxable Income Limit		
Taxable Income In Excess of Net Capital Gain Limit			
Taxable Income Before QBI Deduction	429,000		
Less: Qualified Dividends	(3,000)		
Less: Net long-term capital gain in excess of net short-term capital loss	(24,000)		
Taxable Income In Excess of Net Capital Gain		402,000	
Qualified Cooperative Dividend Component-Lesser of 20% of Qualified Cooperative Dividends or Taxable Income minus Net Capital Gain			400
Qualified Business Income Deduction-Sum of Qualified Business Income Component and 20% of Qualified Cooperative Dividend Component			60,000

Limit On Amount of QBI Deduction:

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Taxable Income Before QBI Deduction	**429,000**	
Less: Qualified Dividends	**(3,000)**	
Less: Net Capital Gain	**(24,000)**	
Limitation of QBI Deduction		**402,000**
Qualified Business Income Deduction-Lesser of QBI Deduction Before Limitation or Limit on QBI Deduction		**60,000**

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