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Do the §199A Proposed Regulations Provide Clarity for Business Owners?

By James M. Kehl, CPA[*]

INTRODUCTION

The Internal Revenue Service has recently released proposed regulations with respect to §199A.[1] Tax professionals have eagerly awaited these regulations with the expectation that this guidance would address many of the issues and questions concerning §199A.[2] A public hearing on these proposed regulations has been scheduled for October 16, 2018. It is thus imperative for tax practitioners to understand these new regulations so they can submit comments on these new rules prior to that date. However, Prop. Reg. §1.199A-1 through §1.199A-6 do not apply to the calculation of the §199A(g) deduction for specified agricultural and horticultural cooperatives.[3]

The author embarked on the journey to understand §199A and its benefits for taxpayers in two previous articles.[4] This article is a continuation of that quest for clarity. The §199A proposed regulations address many questions and comments the IRS received from tax practitioners, including: the definition and methods of calculating W-2 wages;[5] specified service trades or businesses (SSTB) and the definitions of those types of businesses; and, rules for trusts and estates and publicly traded partnerships (PTPs). In addition, new terms and definitions were added to the §199A glossary. The §199A proposed regulations cover a lot of ground.

This article will not undertake the Herculean task of discussing every definition and every explanation contained in the §199A proposed regulations. Instead, this article will restrict itself to discussing the trade or business concept and the new aggregation rules that may benefit the owners of certain trades or businesses. This article also discusses clarifications to the rules concerning the trade or business of performing services as an employee and for determining the unadjusted basis immediately after acquisition (UBIA) of qualified property. The new rules for carrying forward a negative combined amount of qualified REIT dividends and qualified PTP income are also mentioned. The rule for offsetting the losses from trades or businesses with negative qualified business income (QBI) against the QBI of businesses with positive QBI in situations where the total QBI amount is positive is noted. This article concludes with an example that compares a taxpayer's computation of the §199A deduction without an aggregation election for that taxpayer's commonly controlled trades or businesses with a computation of the §199A deduction of the same taxpayer that reflects an election to aggregate those commonly controlled trades or businesses.

The new §199A proposed regulations for trades or businesses do not contain a concise and specific definition of the term ''trade or business.'' However, they

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[1] REG-107892-18, 83 Fed. Reg. 40,004 (Aug. 16, 2018). All section references in this article are to the Internal revenue code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.

[2] Laura Davison, *Pass-through Guidance Said to be Delayed Until End of July*, 135 Daily Tax Rep. 4, (July 13, 2018).

[3] Prop. Reg. §1.199A-1(a)(1).

[4] James M. Kehl, *The Most Important Deduction in the 2017 Tax Act: 199A* 34 Tax Mgmt. Real Estate J., 48 (March 7, 2018). *See also* James M. Kehl, *§199A Gets an Update Three Months After Its Enactment*, 59 Tax Mgmt. Memo. 115 (April 16, 2018).

[5] These methods were discussed in more detail by IRS Notice 2018-64.

do permit certain commonly controlled entities that conduct operations through several pass-through entities to elect to aggregate the QBI, W-2 wages, and UBIA of qualified property of these controlled businesses if certain conditions are satisfied. In that respect, the §199A proposed regulations offer a choice to certain taxpayers.

DEFINITIONS

Prop. Reg. §1.199A-1 discusses the operational rules of §199A and defines several §199A terms. Many of these operational rules and definitions were discussed in the prior articles alluded to in the introduction to this article. However, the §199A proposed regulations contain some new definitions and explanations of some definitions discussed in the prior articles.

RELEVANT PASS-THROUGH ENTITY (RPE)

This is a new term used to describe either a partnership that is not a PTP or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust.[6] A trust or estate is treated as an RPE to the extent that fiduciary entity passes through QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income.[7] It is apparently termed a ''relevant'' pass-through entity because §199A items may be passed through by this entity to its owners. This definition does not seem to address an upper-tier/lower-tier partnership arrangement. In that type of arrangement, the upper-tier partnership has partners who are individuals (when the term ''individual'' is used in the §199A proposed regulations, it refers not only to individuals but also to non-grantor trusts and estates to the extent the §199A deduction for those trusts or estates is determined under Prop. Reg. §1.199A-6)[8] and owns interests in lower-tier partnerships that conduct trades or businesses. However, an upper-tier partnership may be an RPE and each lower-tier partnership it owns an interest in could also be an RPE.

Generally, an RPE must determine and report information to its owners or beneficiaries concerning its trades or businesses that enables those persons to compute their §199A deduction.[9] There are six steps an RPE must normally take to ascertain this information. First, the RPE must determine if it is engaged in at least one trade or business. If a pass-through entity is not engaged in any trade or business, then the rest of the steps are unnecessary. For instance, a partnership that invests solely in bonds or other securities is not engaged in a trade or business. That partnership is not an RPE and would not have any §199A information to furnish to its partners. It is possible that a partnership not engaged in a trade or business directly may indirectly be engaged in a trade or business through investments in other partnerships that are RPEs (lower-tier partnerships). If that is the case, then the lower-tier partnerships would have passed through this partnership's distributive share of §199A items generated by those lower-tier partnerships. Second, after an RPE determines it is engaged in one or more trades or businesses, it must determine whether any of those trades or businesses is an SSTB. Third, the QBI for each trade or business that the RPE engages in directly must be computed. Fourth, the RPE must determine the W-2 wages and UBIA of qualified property for each trade or business it engages in directly. Fifth, the RPE must determine whether it has any qualified REIT dividends that it either earned directly or through another RPE. Sixth, the RPE must determine the net amount of qualified PTP income it has either earned directly or earned indirectly because of its investments in PTPs.[10]

After the RPE makes these calculations, it must report the results on an attachment to the Form 1065 Schedule K-1 it furnishes to each of its partners. The items to be reported on that attachment are the QBI, W-2 wages, and UBIA of qualified property attributable to each of its trades or businesses. The RPE must also inform its owners of any trade or business it conducts directly that is an SSTB.[11] Furthermore, an RPE must inform its owners of any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations reported to it by any RPE in which it owns a direct or indirect interest.[12] The RPE must also report to each of its owners on each owner's Form 1065 Schedule K-1 attachment that owner's share of any qualified REIT dividends or qualified PTP income or loss it has received directly or that it is treated as having received as a result of its investments in other RPEs.[13] As it stands right now, each RPE must report this information ''regardless of whether a taxpayer is below the threshold.''[14]

The burden for any failure of an RPE to comply with these reporting obligations falls squarely on the shoulders of the RPE's owners. The reason for this effect is because if an RPE fails to either separately

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[6] Prop. Reg. §1.199A-1(b)(9).

[7] *Id.*

[8] Prop. Reg. §1.199A-1(a)(2).

[9] Prop. Reg. §1.199A-6(b)(1).

[10] Prop. Reg. §1.199A-6(b)(2).

[11] Prop. Reg. §1.199A-6(b)(3)(i).

[12] Prop. Reg. §1.199A-6(b)(3)(ii).

[13] *Id.*

[14] REG-107892-18, Preamble, Explanation of Provisions, §VI.

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identify or separately report an owner's share of any of the items described in the above paragraph, that owner's share of positive QBI, W-2 wages, and UBIA of qualified property attributable to any trades or businesses of the reporting RPE is presumed to be zero.[15]

The IRS requested comments as to whether it is administratively feasible to provide a special rule that exempts RPEs with no owners that have taxable incomes above the threshold amount ($157,500 for a single taxpayer and $315,000 for a joint return) from the above reporting requirements. To be eligible for this special rule, the RPE would need to know each of its owners' taxable incomes.[16] A family-owned or other closely held RPE may possess this knowledge and a special rule that exempts those RPEs from these reporting requirements may relieve those entities of an unnecessary reporting burden.

TRADE OR BUSINESS

The first two articles in this §199A trilogy discussed the meaning of a trade or business and attempted to convey that this is the most important concept that underlies §199A.[17] Some practitioners were hoping the §199A proposed regulations would provide a clear, bright-line definition of the term ''trade or business.'' That did not happen. However, the rules permitting certain commonly controlled trades or businesses to be treated as a single aggregated trade or business should benefit many taxpayers. The treatment of the activity of renting or licensing property to a commonly controlled trade or business as a trade or business for purposes of §199A may result in many taxpayers in that situation obtaining a §199A deduction. For this reason, the trade or business definition and the aggregation rules contained in the §199A proposed regulations merit scrutiny and analysis.

The preamble to the §199A proposed regulations correctly states that ''neither the statutory text of §199A nor the legislative history provides a definition of trade or business for purposes of §199A.''[18] Another sentence in the preamble begins with the phrase ''although the term trade or business is defined in more than one provision of the Code.''[19] This is not literally correct. While numerous sections of the Code and its related regulations use the term ''trade or business,'' none of those sections or income tax regulations define that term. The reason for this lack of a definition was stated by the Supreme Court in *Higgins v. Commissioner*, where the Court explained that whether a group of activities is ''carrying on a trade or business requires an examination of the facts in each case.''[20] That statement is the reason it is not possible to come up with a standard definition of the term ''trade or business'' that applies in every case. The classification of an activity or group of activities as a trade or business is too dependent upon facts and circumstances for anyone to provide a concise, all-encompassing definition that applies in every situation.

The preamble to the §199A proposed regulations states that the IRS and Treasury Department agree with commenters that the ''§162(a) definition provides the most appropriate definition of a trade or business.''[21] Persons that read this statement literally will discern that there is no definition of the term ''trade or business'' contained in §162(a). However, the next sentences may indicate that this statement is not to be read literally. Those sentences note that the §162 ''trade or business'' definition ''is derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries.''[22] This statement indicates that the case law and other guidance discussed in the first two articles of this trilogy is applicable in defining a §162 trade or business. The definition of a trade or business as an activity or group of activities conducted on a regular, continuous, and substantial basis for the purpose of making a profit still seems to be an appropriate definition of a trade or business.[23]

RENTAL ACTIVITY

A ''trade or business'' is defined by the §199A proposed regulations as ''a §162 trade or business other than the trade or business of performing services as an employee.''[24] The next sentence begins with the phrase ''in addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a §162 trade or business.''[25] This is an indication that the IRS continues to believe that not every rental activity is a trade or business. As noted in the prior articles, a rental activity may be a §212 activity with a purpose of producing income. The question some tax practitioners may have is how one knows if a rental activity is a §162 trade or business or is a §212 activity. The §199A proposed regulations do not answer that question.

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[15] Prop. Reg. §1.199A-6(b)(3)(iii).

[16] REG-107892-18. Preamble, Explanation of Provisions, §VI.

[17] See n.4, above.

[18] REG-107892-18, Preamble, Explanation of Provisions, §I.

[19] *Id.*

[20] 312 U.S. 212 (1941).

[21] REG-107892-18, Preamble, Explanation of Provisions, §I.

[22] *Id.*

[23] See n.4, above.

[24] Prop. Reg. §1.199A-1(b)(13).

[25] *Id.*

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Many cases, regulations, and other published guidance have addressed whether net rental income is trade or business income or some other type of income. In addition to the guidance cited in the prior articles of this trilogy, there is the definition of ''rents derived in the active trade or business of renting property'' for purposes of determining whether rent income is passive investment income.[26] After defining rents as ''amounts received for the use of, or right to use, property (whether real or personal) of the corporation,'' Reg. §1.1362-2(c)(5)(ii)(B)(2) states that the term rents, for purposes of passive investment income, does not include ''any rents derived from the active trade or business of renting property.'' Rents ''are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered, and substantial costs are not incurred in connection with net leases. Whether significant services are performed, or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).''[27] What constitutes ''significant services'' and ''substantial costs'' may vary depending upon the facts and circumstances, the location of a property, and other situational factors. Making repairs, providing janitorial and cleaning services, and incurring significant expenses in providing those services on an active and continuous basis would seem to constitute significant services. Perhaps published guidance that references this regulation would help taxpayers and their advisors decide whether any net rental income generated by those rental activities is derived from a trade or business.

TRADE OR BUSINESS OF BEING AN EMPLOYEE

Prop. Reg. §1.199A-5(a)(3) clarifies that the trade or business of performing services as an employee is not a §199A trade or business and that no §199A deduction may be claimed with respect to a taxpayer's wage income regardless of the amount of that person's taxable income. To prevent individuals who are employees from subsequently treating themselves as independent contractors and claiming a §199A deduction based on income that was formerly employee wages, the IRS and the Treasury Department felt it was necessary to elaborate on the definition of services as an employee and to include a presumption about former employees who perform the same services as independent contractors that those persons performed as employees.

A person may be an employee of another person if the common law relationship of an employer and employee exists. This relationship generally exists if ''the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.''[28] In an employer-employee common law relationship, an employee is subject to the employer's direction and control as to the tasks to be performed as well as to how those tasks are to be done. It is not necessary for the employer to actually direct or control the way these tasks are performed; it is sufficient if the employer has the right to do so.[29] An officer of a corporation, including an S Corporation, is generally an employee.[30] However, for purposes of §199A, an officer who performs either no services or only minor services as an officer and is neither entitled to nor receives compensation may not be considered an employee of that corporation.[31] An individual who is considered an employee under the common law rules for determining an employer-employee relationship is also an employee.[32]

Income derived from the trade or business of being an employee includes all wages described in §3401(a) as well as W-2 payments described in Reg. §1.6041-2(a)(1).[33] The term does not include: (1) payments under life insurance contracts described in §72(m)(3); or (2) amounts distributed or made available to a beneficiary to which the rules of §402 or §403 apply.[34] Income derived from the trade or business of being an employee does not include payments received by persons who are not corporate officers or common law employees but who are individuals described in §3121(d)(3) (certain life insurance salespersons, agent or commission drivers, home workers, or traveling salespersons).[35]

If a worker is properly classified as an employee for purposes of §199A under these rules, the employer's classification of that employee for federal employ-

[26] Reg. §1.1362-2(c)(5)(ii)(B).

[27] Reg. §1.1362-2(c)(5)(ii)(B)(2).

[28] REG-107892-18, Preamble, Explanation of Provisions, §V.B.1.

[29] *Id.*

[30] §3121(d)(1).

[31] REG-107892-18, Preamble, Explanation of Provisions, §V.B.1. *See also* Rev. Rul. 74390.

[32] §3121(d)(2).

[33] Prop. Reg. §1.199A-5(d)(1).

[34] *Id.* referring to payments described in Reg. §1.6041-2(b)(1).

[35] §3121(d)(1).

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ment tax purposes is immaterial.[36] To prevent individuals who are employees from subsequently treating themselves as independent contractors and claiming a §199A deduction with respect to income that is, in substance, employee compensation for services, Prop. Reg. §1.199A-5(d)(3) contains a rebuttable presumption that an individual who was properly treated as an employee by an employer for federal employment tax purposes and who is subsequently treated as an independent contractor or other than an employee by that employer with respect to the rendering of ''substantially the same services directly or indirectly'' to that employer or to a person related to that employer is ''presumed to be in the trade or business of performing services as an employee with regard to such services.''[37]

Example 1

Nancy is a CPA who was employed as an accountant by WABC (a CPA firm partnership) and was properly treated as an employee by WABC for federal employment tax purposes. Nancy and some other accountants formerly employed by WABC have taxable incomes below the $157,500/$315,000 thresholds. Nancy and those accountants terminate their employment relationship with WABC and form their own CPA firm partnership, which contracts with WABC to perform accounting services for WABC. Nancy, who is now a partner in this new CPA firm partnership, continues to provide the same services to WABC and its clients that she rendered during her term of employment with WABC. The compensation for Nancy's services is now business income of Nancy's firm. Because Nancy was previously classified as an employee and now is no longer treated as such with respect to the services she currently provides to WABC, Nancy is presumed to be, solely for purposes of §199A(d)(1)(B), to be in the trade or business of performing services as employee with respect to the services she renders to WABC indirectly through her CPA firm partnership. Unless this presumption is rebutted, Nancy's distributive share of income from her CPA firm partnership that is attributable to her services for WABC is not QBI. The results would be the same if Nancy's CPA firm partnership were admitted as a partner in WABC.[38]

This rebuttable presumption would also apply to a full-time employee who quits that person's current job and then enters into a contract with that person's former employer to provide ''substantially the same services'' that were provided by that person to that former employer in an employee capacity.[39] This presumption can be rebutted if the individual can demonstrate that, under the federal income tax regulations and principles, the person is performing these subsequent services in a non-employee capacity.[40]

Example 2

Nicole is an architect that has been employed by AIA LLC, an architectural firm that is treated as a partnership for federal income tax purposes. AIA LLC's policy is that persons can become partners after a period of seven years if they attain certain performance goals. After 13 years, Nicole attains those goals and is admitted as a partner in charge of AIA LLC's Sarasota, Florida office. Nicole makes a capital contribution to AIA LLC, shares in its profits, and does other things necessary to be respected as a partner. For purposes of §199A(d)(1)(B), Nicole is still presumed to be in the trade or business of performing services as an employee of AIA LLC with respect to her services to AIA LLC. However, Nicole rebuts this presumption by clearly showing that she became a partner because of achieving certain performance objectives, becoming in charge of AIA LLC's Sarasota office, making a capital contribution, and satisfying the other requirements of federal income tax law and regulations for being treated as a partner.[41]

RENTAL OF PROPERTY TO COMMONLY CONTROLLED BUSINESS

The prior articles in this trilogy questioned whether the net rental income derived by an owner of a building from leasing that building to that owner's family-owned business could be QBI. As also noted in those articles, many of these leasing arrangements may not have qualified as §162 trades or businesses. Some tax practitioners were wondering whether there would have to be regulations that would permit the grouping of these rental activities with other qualified trades or businesses for purposes of §199A. Even the IRS observed that ''it is not uncommon that for legal or other non-tax reasons taxpayers may segregate rental property from operating businesses.''[42] Fortunately, the definition of a trade or business in Prop. Reg. §1.199A-1(b)(13) seems to have provided guidance in this area.

It is interesting to note that the Preamble to the §199A proposed regulations states that these ''regula-

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[36] Prop. Reg. §1.199A-5(d)(2).

[37] Prop. Reg. §1.199A-5(d)(3)(i).

[38] This example is based on Prop. Reg. §1.199A-5(d)(3)(ii) *Ex.* 2.

[39] *See* Prop. Reg. §1.199A-5(d)(3)(ii) *Ex.* 1.

[40] REG-107892-18, Preamble, Explanation of Provisions, §V.B.1.

[41] This example is based on Prop. Reg. §1.199A-5(d)(3)(ii) *Ex.* 3.

[42] REG-107892-18, Preamble, Explanation of Provisions, §I.A.

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tions extend the definition of trade or business for purposes of §199A beyond §162 in one circumstance.''[43] That circumstance is the second sentence of the definition of ''trade or business'' in Prop. Reg. §1.199A-1(b)(13), which states that, in addition to a §162 trade or business that is other than the trade of business of performing services as an employee, the ''rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under §1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under §1.199A-4(b)(1)).'' If a rental activity satisfies this definition of a trade or business, then one must look to the definition of a ''qualified trade or business'' for purposes of §199A, which is contained in §199A(d)(1). A ''qualified trade or business'' under §199A(d)(1) is any trade or business that is neither a specified service trade or business (SSTB) nor a trade or business of performing services as an employee. Therefore, if the commonly controlled test of Prop. Reg. §1.199A-4(b)(1)(i) is satisfied, the rental of buildings and other property by an owner to that owner's trade or business should be a qualified trade or business that generates QBI. The IRS hopes that allowing this exception ''may prevent taxpayers from improperly allocating losses or deductions away from trades or businesses that generate income that is eligible for a §199A deduction.''[44]

One of the questions some tax practitioners had was whether the rental income derived by a professional from a building leased to a medical practice or other SSTB could be QBI. This question was addressed by Prop. Reg. §1.199A-5(c)(2). Prop. Reg. §1.199A-5(c)(2)(i) states that any trade or business that provides 80% or more of its property or services to an SSTB is an SSTB if there is 50% or more common ownership of the SSTB and that trade or business. If a trade or business provides less than 80% of its property or services to an SSTB, but there is 50% or more common ownership of that SSTB and the trade or business providing the property or services, then the portion of the trade or business that provides property or services to the 50% or more commonly owned SSTB is treated as part of the SSTB.[45] For purposes of these rules, direct or indirect ownership by related parties, within the meaning of either §267(b) or §707(b), is included in the 50% or more common ownership test.[46]

Example 3

Dr. Albert is a dentist who owns a dental practice and an office building. If Dr. Albert leases 80% or more of that building to his dental practice, the rental of the building is treated as part of an SSTB and the rental income derived from that activity is not derived from a §199A(d)(1) qualified trade or business. If Dr. Albert leases less than 80% of his building to his dental practice, then only the portion of the building rented to the dental practice will be treated as part of the SSTB.[47]

COMMON CONTROL

The common control test of Prop. Reg. §1.199A-4(b)(1)(i) states that either the same person or the same group of persons must, directly or indirectly, own 50% or more of each trade or business, which means ''in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership.'' In determining whether this ownership test is satisfied, an individual is treated as owning the interest in each trade or business that is owned, directly or indirectly, by or for: (1) that individual's spouse, provided that individual is not separated from the spouse under a divorce or separate maintenance decree; and (2) the individual's parents, children, and grandchildren.[48]

Example 4

Mort owns 100% of the stock of Gold, Inc., which is a C corporation that engages in the business of mining gold and other minerals. Mort also owns a building that he leases to Gold, Inc as a warehouse and administrative office. The rental of a building may or may not be a §162 trade or business, depending on the facts and circumstances. Gold, Inc. and Mort's rental property cannot be aggregated because Gold, Inc. is a C Corporation that is not eligible for the §199A deduction.[49] However, the mining activity of Gold, Inc. is a §162 trade or business. Mort also satisfies the definition of common control because he owns 100% of the building and 100% of the trade or business of Gold, Inc. through his stock ownership in that corpo-

[43] *Id.*

[44] *Id.*

[45] Prop. Reg. §1.199A-5(c)(2)(ii).

[46] Prop. Reg. §1.199A-5(c)(2)(iii).

[47] This example is based on an example contained in REG-107892-18, Preamble, Explanation of Provisions, §V.A.3.

[48] Prop. Reg. §1.199A-4(b)(3).

[49] §199(a)(1); Prop. Reg. §1.199A-4(d) *Ex.* 11.

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ration. Once the rental of Mort's building is considered a trade or business for purposes of §199A, it should be a qualified trade or business based on §199A(d)(1). The question about this conclusion is because the common control definition in Prop. Reg. §1.199A-4(b)(1)(i) only talks about businesses owned by S Corporations and partnerships. That portion of the definition could lead to the belief that the common control definition is only meant to apply to ownership interests in partnerships and S Corporations. A clarification of this example when the §199A proposed regulations are finalized would help business owners who rent property to their C Corporations.

The result is much clearer if the trade or business that leases the property as a tenant is a pass-through entity.

Example 5

Howard and Mary are a married couple who together own 100% of a partnership that leases its building to an S Corporation. The S Corporation conducts a §162 trade or business of providing transportation. The stock of the S Corporation is owned 20% by Howard, 20% by Mary, 30% by their son Mark, and 30% by their daughter Rachael. The common control test is met because the stock owned by Mark and Rachael is attributed to Howard and Mary. A business that provides transportation services is not an SSTB. Therefore, the building is not part of an SSTB. Thus, the commonly controlled definition is satisfied and the rental of the building to the S Corporation is treated as a trade or business for purposes of §199A. The rental of the building to the S Corporation is a qualified trade or business described in §199A(d)(1) because the trade or business of renting the building is neither a SSTB nor a trade or business of performing services as an employee. The net rental income derived from renting the building should be QBI.

AGGREGATED TRADE OR BUSINESS

This concept was created in response to requests received by the IRS that taxpayers be allowed to group their trades or businesses for purposes of §199A.[50] The IRS rejected the idea of allowing this grouping to be done using the grouping rules contained in Reg. §1.469-4 because it deemed those rules to be ''not appropriate for determining a trade or business for §199A purposes.''[51] However, the IRS recognized that aggregation rules were necessary in order to prevent taxpayers from having to restructure their business operations for tax purposes.[52] In response to this need, the aggregated trade or business concept was devised.

An aggregated trade or business is two or more trades or businesses that have been aggregated pursuant to Prop. Reg. §1.199A-4. This aggregated trade or business is treated as a single trade or business for purposes of determining the QBI component of the §199A deduction.[53] This aggregation is allowed but is not required; trades or businesses can only be aggregated to the extent provided in Prop. Reg. §1.199A-4.

First Requirement: An individual can aggregate trades or businesses only if that individual can demonstrate that the requirements of Prop. Reg. §1.199A-4(b)(1) are fulfilled. The first requirement is that each trade or business to be aggregated must be a trade or business as defined by Prop. Reg. §1.199A-1(b)(13).[54]

Example 6

Donna owns a golf course through a single member LLC. The golf course is open seven days per week and allows golfers to play golf on the golf course in exchange for fees. The golf course has a shop that sells golf clubs, golf balls, tees, and other golf paraphernalia. This golf course is a profit-making venture. Donna also owns a 100% interest in a golf team that plays in amateur golf tournaments and is a hobby. The golf course is a §162 trade or business defined in Prop. Reg. §1.199A-1(b)(13). The golf team is not. Donna cannot aggregate the golf course and her ownership interest in the golf team.[55]

Second Requirement: The second requirement is that either the same persons or group of persons must, directly or indirectly, own 50% or more of each trade or business that is being aggregated.[56] This is the common control requirement that was discussed above. The family attribution rules of Prop. Reg. §1.199A-4(b)(3) apply for purposes of this ownership test. The IRS noted that ''because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate.''[57]

Third Requirement: The third requirement is that the majority ownership in each business that is part of

[50] REG-107892-18, Preamble, Explanation of Provisions, §IV.A.

[51] *Id.*

[52] *Id.*

[53] Prop. Reg. §1.199A-1(b)(1); Prop. Reg. §1.199A-4(a).

[54] REG-107892-18, Preamble, Explanation of Provisions, §IV.A.

[55] This example is based on Prop. Reg. §1.199A-4(d) *Ex.* 13, which is an example of a marina and a sailboat racing team not qualifying for aggregation under Prop. Reg. §1.199A-4(b)(1) because the racing team is not a §162 trade or business.

[56] Prop. Reg. §1.199A-4(b)(1)(i). See Prop. Reg. §1.199A-4(d) *Exs.* 2 and 11, which are examples of a group of individuals owning a majority interest in several entities.

[57] REG-107892-18, Preamble, Explanation of Provisions,

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the aggregation must exist most of the taxable year in which the items attributable to each trade or business being aggregated are included in income.[58]

Fourth Requirement: The fourth requirement is that all items attributable to each trade or business being aggregated must be reported on income tax returns with the same taxable year.[59] This requirement means that RPEs with calendar tax years cannot be aggregated with RPEs that use fiscal years.

Fifth Requirement: The fifth requirement is that none of the trades or businesses being aggregated is an SSTB.[60]

Sixth Requirement: The purpose of the sixth requirement is to make individuals show that the trades or businesses being aggregated ''are in fact part of a larger, integrated trade or business.''[61] To accomplish this, Prop. Reg. §1.199A-4(b)(1)(v) requires that the trades or businesses being aggregated must meet two of three factors.[62] The first factor is that the trades or businesses must provide products and services that are either the same or that are ''customarily offered together.''[63] Services that are the same under Prop. Reg. §1.199A-4(b)(1)(v)(A) include the following: (1) a restaurant and a food truck;[64] (2) a catering business and a restaurant; (3) four hardware stores; (4) three grocery stores; and (5) five restaurants.[65] An example of two businesses that provide products or services that are customarily offered together is a gas station business and a car wash business.[66] Examples of two businesses that provide products or goods that are neither the same nor customarily offered together is a business that manufactures clothing and a business that is a retail pet store, or a business that sells non-food items to grocery stores and a business that is a trucking business.[67] The second factor is that the businesses share either facilities or significant centralized business elements, which could be common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.[68] The third factor, which is apparently referring to ''supply chain interdependencies,'' is that the aggregated trades or businesses must be operated in either coordination with or reliance on other businesses in the aggregated group.[69]

Example 7

Taylor owns two buildings in single member LLCs that she leases to two businesses that are operated in partnerships owned by Taylor's parents and herself. One of these partnerships is a manufacturer of auto parts. The other partnership is a retail store that sells those auto parts. Taylor does the accounting for her buildings and both partnerships using a computerized bookkeeping program. Taylor and her parents manage the buildings and both businesses. Employees of both partnerships perform services for each business and for both buildings. Because Taylor and her parents as a group or individually own 50% or more of the capital and profits interest of each partnership, the common control test of Prop. Reg. §1.199A-4(b)(1)(i) is met. Taylor's buildings and both partnerships share significant centralized business elements in terms of the same personnel, accounting, management, and information technology resources. Taylor's buildings and both partnerships are also operated in coordination with and in reliance upon one or more of the businesses in the aggregated group. Because two of three factors are satisfied, Taylor can treat the business operations of both partnerships as a single trade or business. Taylor's two LLC's are also eligible to be included in the aggregated group because both entities lease real property to trades or businesses that are commonly controlled and meet the aggregation requirements of Prop. Reg. §1.199A-4(b)(1).[70]

A partnership that owns a business that sells non-food items to grocery stores and another partnership that owns a trucking business that predominantly transports goods for the non-food items partnership are two partnerships that are considered operated in reliance on each other.[71] An example of businesses operated in coordination are three partnerships where one partnership engages in the business of construction, another partnership has a business that is a lumber yard that supplies the construction partnership with building materials, and a third partnership operates a trucking business that delivers the lumber and

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§IV.A. *See also* Prop. Reg. §1.199A-4(d) *Exs.* 5 and 10.

[58] Prop. Reg. §1.199A-4(b)(1)(ii).

[59] Prop. Reg. §1.199A-4(b)(1)(iii).

[60] Prop. Reg. §1.199A-4(b)(1)(iv).

[61] REG-107892-18, Preamble, Explanation of Provisions, §IV.A.

[62] See Prop. Reg. §1.199-4(d) *Ex.* 12, for an example of two businesses that could not be aggregated because only one of three factors was satisfied.

[63] Prop. Reg. §1.199A-4(b)(1)(v)(A).

[64] REG-107892-18, Preamble, Explanation of Provisions, §IV.B.

[65] *See* Prop. Reg. §1.199A-4(d) *Exs.* 1, 4, 6, 10.

[66] REG-107892-18, Preamble, Explanation of Provisions, §IV.B.

[67] *See* Prop. Reg. §1.199A-4(d) *Exs.* 3, 12.

[68] Prop. Reg. §1.199A-4(b)(1)(v)(B). See Prop. Reg. §1.199A-4(d) *Exs.* 1–4, 5–6, 8–10, 14, for examples of businesses that share facilities or centralized business elements.

[69] Prop. Reg. §1.199A-4(b)(1)(v)(C).

[70] This example is based on Prop. Reg. §1.199A-4(d) *Exs.* 8, 9.

[71] *See* Prop. Reg. §1.199A-4(d) *Ex.* 12.

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other building supplies sold by the second partnership.[72]

OPERATING RULES FOR AGGREGATING BUSINESSES

An individual may aggregate all trades or businesses that satisfy the aggregation requirements that the individual operates directly and that individual's share of QBI, UBIA of qualified property, and W-2 wages generated by trades or businesses that are operated through RPEs.[73] The individual must carefully evaluate whether the trades or businesses of the RPEs meet the qualifications to be aggregated with the trades or businesses the individual operates directly. If an individual chooses to aggregate trades or businesses under these rules, the individual must first compute QBI, W-2 wages, and UBIA of qualified property for each trade or business operated directly by the individual before applying the aggregation rules.[74] That rule seems logical because each RPE owned by an individual would have already computed that individual's share of QBI, W-2 wages, and UBIA of qualified property for each of that RPE's trade or businesses and furnished those amounts to that individual. Under the general computational rule of Prop. Reg. §1.199A-1(d)(2)(iv), the individual must combine the QBI, W-2 wages, and UBIA of qualified property for all trades or businesses that are part of the aggregated trade or business before applying the §199A(b)(2)(B) limitations.

The basic premise of the rules for aggregating trades or businesses is that each of the individual trades or businesses being aggregated are part of one business. Once a taxpayer makes an election to aggregate trades or businesses, the taxpayer must continue to report the aggregated trades or businesses as one aggregated business in all future years.[75] Any new trades or businesses that are created or acquired in subsequent years can be added to the existing aggregated business if the conditions for aggregation of Prop. Reg. §1.199A-4(b)(1) are fulfilled.[76] If there is a change in facts and circumstances and a taxpayer's prior aggregation of trades or businesses no longer qualifies for aggregation under the aggregation rules, then the trades or businesses will no longer be aggregated, and the taxpayer must reapply the aggregation rules to determine if there is a new permissible aggregation.[77]

For each taxable year that there is an aggregation, the taxpayer doing the aggregation must attach a statement to that individual's tax return that identifies each trade or business being aggregated and contains the information for each aggregated trade or business that is required by Prop. Reg. §1.199A-4(c)(2)(i). If the individual fails to attach this required statement, the IRS may disaggregate the individual's trades or businesses.[78]

TO AGGREGATE OR NOT TO AGGREGATE

This will be one of the major decisions confronting taxpayers and their advisors for 2018. The fact that this is in essence an irrevocable election heightens the importance of this decision.

Example 8

A married couple, both of whom are U. S. citizens, own interests in two RPEs that are limited liability companies (LLCs) treated as partnerships for federal income tax purposes. The married couple owns an 80% interest in partnership capital and profits in each of these RPEs. Both RPEs own and operate hotels. The married couple owns a third hotel through a disregarded entity. The married couple has held these majority ownership interests throughout the entire taxable year. The married couple and each of the RPEs use a calendar year for income tax reporting purposes. The married couple actively manages these three hotels and makes all personnel decisions. The accounting and payroll records are maintained by a bookkeeper at one of the hotels using a software program designed for hotels that is operated on a computer. All hotels generate income that is effectively connected to a trade or business within the United States. The hotels are §162 trades or businesses.

The fictional married couple satisfies the control requirement of Prop. Reg. §1.199A-4(b)(1)(i) because the couple owns 50% or more of each trade or business to be aggregated. This ownership was present for the entire taxable year. All taxable items of each trade or business that is being aggregated are reported on returns that have the same taxable year. The requirement that none of these trades or businesses be an SSTB is also met. Finally, the hotels to be aggregated satisfy two of the three factors contained in Prop. Reg. §1.199A-4(b)(1)(v). All hotels provide lodging for transients and thereby satisfy the requirement that the

[72] *See* Prop. Reg. §1.199A-4(d) *Ex.* 14.
[73] Prop. Reg. §1.199A-4(b)(2).
[74] *Id.*
[75] Prop. Reg. §1.199A-4(c)(1).
[76] *Id.*
[77] *Id.*
[78] Prop. Reg. §1.199A-4(c)(2)(ii).

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trades or businesses to be aggregated provide the same services. The factor specified by Prop. Reg. §1.199A-4(b)(1)(v)(B) that the businesses to be aggregated share centralized elements or facilities is satisfied because all businesses share the same management, accounting, information technology resources, and human resources functions. The married couple may thus aggregate its hotel operated directly with its share of QBI, W-2 wages, and UBIA of qualified property from the hotels operated through RPEs. The married couple is unsure about making the aggregation election. The couple decides to make a calculation of its §199A deduction without aggregating its trades or businesses and compare that calculation to a calculation of its §199A deduction with aggregation of its trades or businesses.

Example: Calculation of the §199A Deduction without Aggregation

Worksheet 1, Worksheet 2, and Worksheet 3 contain the calculation of the fictional couple's §199A deduction. The §199A proposed regulations have added some new definitions to the glossary of §199A terms and have added a netting rule when some of a taxpayer's qualified trades or businesses have positive QBI, some have negative QBI, but the total QBI amount is positive. The combined qualified business income amount has been described by the §199A proposed regulations as consisting of a QBI component and a component that is a taxpayer's combined qualified REIT dividends and qualified PTP income. The QBI component is the amount computed in accordance with the rules prescribed by Prop. Reg. §1.199A(d)(2).[79] A taxpayer's total QBI amount is the net total QBI from all trades or businesses and includes an individual's share of QBI from businesses that are conducted by RPEs.[80]

UNADJUSTED BASIS IMMEDIATELY AFTER ACQUISITION (UBIA) OF QUALIFIED PROPERTY

The §199A proposed regulations have also clarified the definition of unadjusted basis immediately after acquisition (UBIA) of qualified property. This amount is part of the §199A(b)(2)(B)(ii) alternative deduction limitation of the §199A(b)(2) deductible amount for each trade or business.[81] After restating the definition of qualified property contained in §199A(b)(6)(A), Prop. Reg. §1.199A-2(c)(1)(ii) clarifies that any addition or improvement to qualified property that has already been placed in service is treated as separate qualified property that is first placed in service on the date this addition or improvement is placed in service. For instance, a taxpayer may place qualified property in service during 2018 and then make capitalized improvements to that property in 2020. In this case, the taxpayer has two separate qualified properties that consist of the original item of qualified property and the improvements to that qualified property that were placed in service in 2020.[82]

Contrary to some speculation, Prop. Reg. §1.199A-2(c)(1)(iii) clarifies that qualified property does not include any partnership special basis adjustments under §743(b) or §734(b). This rule was enacted because the IRS felt that ''treating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property (if, for example, the fair market value of the property has not increased, and its depreciable period has not ended).''[83]

There is also an ''anti-stuffing'' rule contained in the §199A proposed regulations. The reason for this rule is to prevent taxpayers from acquiring qualified property for the principal purpose of increasing the §199A deduction through manipulation of UBIA of qualified property attributable to a trade or business.[84] This rule applies to property acquired shortly before the end of a taxable year and disposed of by a taxpayer within a short period of time afterwards. This rule states that acquired property is not qualified property if that property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition.[85] This rule will not apply if the taxpayer can show that the principal purpose of the acquisition and related disposition of the property was a purpose other than increasing the §199A deduction.[86]

The proposed regulations also address the depreciable period and placed-in-service date of qualified property. Prop. Reg. §1.199A-2(c)(2)(i) restates the statutory definition of depreciable period found in §199A(b)(6)(B). Prop. Reg. §1.199A-2(c)(2)(ii) then states that the applicable recovery period for qualified property is not affected by any additional first-year depreciation deductions that are allowable under §168

[79] Prop. Reg. §1.199A-1(b)(5).

[80] Prop. Reg. §1.199A-1(b)(12).

[81] Prop. Reg. §1.199A-1(b)(14).

[82] REG-107892-18, Preamble, Explanation of Provisions, §II.B.7.

[83] REG-107892-18, Preamble, Explanation of Provisions, §II.B.2.

[84] REG-107892-18, Preamble, Explanation of Provisions, §II.B.3.

[85] Prop. Reg. §1.199A-2(c)(1)(iv).

[86] *Id.*

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(for instance, the bonus depreciation deduction of §168(k)). This provision seems reasonable in that the §168 bonus depreciation allowances deal with the timing of the depreciation deductions and do not affect the recovery periods. This rule also negates the speculation by some people that the UBIA of qualified property was to be reduced by bonus depreciation.

The Preamble to the §199A proposed regulations explains the meaning of the term ''immediately after acquisition.'' This term means ''as of the date the property is placed in service.''[87] The IRS felt this was the appropriate meaning of this statutory term because §199A requires qualified property ''be used in the production of QBI. In order to be used in the production of QBI, the qualified property necessarily must be placed in service.''[88] Using the placed-in-service date as the meaning of the phrase ''immediately after acquisition'' also ''ensures consistency between purchased and produced qualified property.''[89]

Unless an exception applies, qualified property acquired in a §1031 like-kind exchange or §1033 involuntary conversion will have two placed-in-service dates for purposes of two different determinations.[90] For purposes of determining the UBIA of MACRS property acquired in a like-kind exchange or due to an involuntary conversion, the placed-in-service date is the date the replacement MACRS property (MACRS property in the hands of the acquiring taxpayer that is acquired for other MACRS property in a like-kind exchange or in an involuntary conversion) is actually placed in service.[91] In determining the depreciable period of that property, the placed in service date is generally the date the relinquished MACRS property (MACRS property transferred by the taxpayer in a like-kind exchange or in an involuntary conversion) is first placed in service.[92] The tax basis of property acquired in a §1031 exchange or a §1033 exchange may consist of an ''exchanged basis,'' which is generally the basis in the MACRS property that is being relinquished in the like-kind exchange or involuntary conversion, and an ''excess basis,'' which is the amount of the basis in the replacement MACRS property (as determined under either the basis rules of §1031(d) or §1033(b)) that exceeds the exchanged basis.[93] For property acquired through a like-kind exchange or involuntary conversion, the depreciable period of the exchanged basis that is part of the basis of the replacement MACRS qualified property begins on the date on which the relinquished MACRS property was first placed in service by the individual or RPE; the depreciable period of the excess basis begins on the date on which the replacement MACRS property was first placed in service by the individual or RPE.[94]

The effect of this rule is that the depreciable period for the exchanged basis portion of the replacement qualified property will expire before the depreciable period for the excess basis portion of the replacement qualified property terminates.[95] There is an exception to this rule for an individual or an RPE that makes an election under Reg. §1.168(i)-6(i)(1) not to apply the rules of Reg. §1.168(i)-6. If an individual or an RPE makes this election, then the date the exchanged basis and excess basis in the replacement qualified property are first placed in service is the date on which the replacement qualified property is first placed in service by the individual or RPE.[96] The effect of the Reg. §1.168(i)-6(i)(1) election is that the depreciable periods for the exchanged basis and the excess basis of the replacement qualified property will expire on the same date.[97] The UBIA of the replacement qualified property for an individual or RPE that makes a Reg. §1.168(i)-6(i)(1) election is also determined as of the date on which the replacement qualified property is first placed in service by the individual or RPE.[98]

An individual or an RPE may acquire property in a §168(i)(7)(B) non-recognition transaction that is described in §332, §351, §361, §721 or §731. These transactions may be described as ''transferred basis transactions'' because, generally, a portion of the recipient's basis for property received in these transactions is determined by reference to the transferor's basis in the transferred property.[99] There are different placed-in service dates for purposes of determining the depreciable period for portions of qualified property acquired in one of these non-recognition transactions. For the portion of the recipient's unadjusted basis in the qualified property that does not exceed the transferor's unadjusted basis in that property, the date

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[87] REG-107892-18, Preamble, Explanation of Provisions, §II.B.1.

[88] *Id.*

[89] *Id.*

[90] REG-107892-18, Preamble, Explanation of Provisions, §II.B.4.

[91] Reg. §1.168(i)-6(b)(1); REG-107892-18, Preamble, Explanation of Provisions, §II.B.4.

[92] Reg. §1.168(i)-6(b)(2); REG-107892-18, Preamble, Explanation of Provisions, §II.B.4.

[93] Reg. §1.168(i)-6(b)(7); §1.168(i)-6(b)(8).

[94] Prop. Reg. §1.199A-2(c)(2)(iii).

[95] REG-107892-18, Preamble, Explanation of Provisions, §II.B.4.

[96] Prop. Reg. §1.199A-2(c)(2)(iii)(C).

[97] REG-107892-18, Preamble, Explanation of Provisions, §II.B.4.

[98] *Id.*

[99] REG-107892-18, Preamble, Explanation of Provisions, §II.B.5.

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this portion is first placed in service by the recipient is the date the transferor first placed the qualified property in service.[100] For the portion of the transferee's unadjusted basis in the qualified property that exceeds the transferor's unadjusted basis in that property, that portion is treated as separate qualified property the recipient first placed in service on the date of the transfer.[101]

The major question that the §199A proposed regulations answered concerned the UBIA of qualified property. The general principles for defining UBIA can be found in the definition of ''unadjusted basis'' contained in Reg. §1.263(a)-3(h)(5) . The IRS believes that this definition provides a ''reasonable basis'' that is ''appropriate'' for purposes of §199A.[102] As a result, the UBIA for qualified property produced by the taxpayer or that the taxpayer acquired by purchase is that property's cost under §1012 as of the date the property is placed in service.[103] If qualified property is contributed to a partnership in a §721 transaction and is immediately placed in service by the partnership, its UBIA generally will be the property's basis as determined under §723.[104] Similarly, if qualified property is contributed to an S corporation in a transaction governed by §351 and is immediately placed in service, that property's UBIA generally will be its basis under §362.[105] The UBIA of qualified property could also be the basis as determined under other sections of the Code, ''including subchapter O (relating to gain or loss on dispositions of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses).''[106] The UBIA of property inherited from a decedent and immediately placed in service by the heir will generally be its fair market value at the time of the decedent's death under §1014.[107] One should note that this rule applies only to property. The §743 special basis adjustment that may be made to an inherited partnership interest is not part of UBIA.[108]

As noted in this trilogy's prior articles, UBIA of qualified property is not reduced by any adjustment for accumulated depreciation, depletion, amortization, or other adjustments described in §1016(a)(2) or §1016(a)(3).[109] UBIA of qualified property is also calculated without any adjustments for tax credits claimed by the taxpayer and without any adjustments for any portion of the basis of qualified property that the taxpayer has elected to expense. This means that UBIA of qualified property is not reduced for any expense claimed under §179, which was a question asked by some taxpayers. However, UBIA must reflect the reduction in basis for the percentage of the RPE's or individual's use of property for the taxable year that is not in the trade or business.[110]

Example 9

Whalen LLC is a partnership that purchases residential rental property on January 9, 2011, for $2.75 million. Whalen LLC operates this residential rental property as an apartment house that is a qualified trade or business as defined by §199A(d)(1). Whalen LLC's initial tax basis for the residential rental property under §1012 is its cost of $2.75 million. As of December 31, 2018, Whalen LLC's tax basis in the residential rental property, after adjustment under §1016(a)(2) for depreciation deductions claimed under §168(a), is approximately $1.954 million. Whalen LLC's UBIA for this residential rental property is its §1012 cost basis of $2.75 million.[111] On January 6, 2019, Whalen LLC executes a §1031 like-kind exchange and exchanges the residential rental property for other residential rental property. There is no cash or other boot property involved in the exchange. Whalen LLC's basis under §1031(d) for the residential rental property received in the exchange is approximately $1.95 million. Whalen LLC's UBIA for the residential rental property received in the exchange is also approximately $1.95 million. The date this residential rental property received in the exchange is placed in service is January 9, 2011, which is the date the residential rental property relinquished in the exchange was placed in service.[112]

COMBINED QUALIFIED REIT DIVIDENDS AND QUALIFIED PTP INCOME LESS THAN ZERO

The §199A proposed regulations clarified many of the statutory rules of §199A and proposed some additional rules. One additional proposed rule concerns negative combined qualified REIT dividends and qualified PTP income. The first two articles in this

[100] Prop. Reg. §1.199A-2(c)(2)(iv)(A).

[101] Prop. Reg. §1.199A-2(c)(2)(iv)(B).

[102] REG-107892-18, Preamble, Explanation of Provisions, §II.B.1.

[103] Prop. Reg. §1.199A-2(c)(3).

[104] *Id. See also* REG-107892-18, Preamble, Explanation of Provisions, §II.B.1.

[105] *Id.*

[106] Prop. Reg. §1.199A-2(c)(3).

[107] REG-107892-18, Preamble, Explanation of Provisions, §II.B.1.

[108] Prop. Reg. §1.199A-2(c)(1)(iii).

[109] Prop. Reg. §1.199A-2(c)(3).

[110] *Id.*

[111] This example is based on Example 1 of Prop. Reg. §1.199A-2(c)(4).

[112] *See* Prop. Reg. §1.199A-2(c)(4) *Ex.* 2.

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trilogy mentioned the rule of §199A(c)(2), which states that, for purposes of §199A, if the net QBI with respect to a taxpayer's qualified trades or businesses for any taxable year is less than zero, that negative amount is treated as a loss from a separate qualified trade or business in the following taxable year. The §199A proposed regulations added a separate carryover rule with respect to the component of the §199A deduction that consists of the combined total of qualified REIT dividends and qualified PTP income. It is clear from the statute that if the combined amount of a taxpayer's qualified REIT dividends and qualified PTP income is less than zero, the qualified REIT dividends and qualified PTP income component of the individual's §199A deduction is zero for the taxable year.[113] Prop. Reg. §1.199A(c)(2)(ii) adds a rule stating that this negative combined amount must be carried forward and used to offset the combined total of qualified REIT dividends and qualified PTP income in the individual's following taxable year for purposes of §199A. This rule for carryovers does not affect the deductibility of the loss for purposes of other provisions of the Code.[114]

It is hard to envision a taxpayer having negative qualified REIT dividends. However, it is very realistic that a taxpayer may have negative PTP income. A partner in a PTP may not use any losses and credits from a PTP against income from other PTPs or other taxable income until the partner's interest in that PTP is disposed of. Losses from a PTP are carried forward and can be offset against a taxpayer's future income from that specific PTP and deducted in full in the year the taxpayer's interest in that PTP is disposed of. Are an individual's losses from PTPs required to be deductible PTP losses before they become part of the calculation of the combined amount of qualified REIT dividends and qualified PTP income? Although far from being entirely clear, there could be two reasons for concluding that the losses from PTPs must be deductible losses. The first reason is the example of a negative combined amount of qualified REIT dividends and qualified PTP income being carried forward, which is Prop. Reg. §1.199A-1(d)(4) *Ex.* 4, consisting of a deductible qualified net loss from a PTP. The second reason is that the rules concerning losses of a taxpayer from qualified PTPs appear to indicate that these losses do not exist until they become deductible losses either because of future income generated by that PTP or because of a disposition of the taxpayer's interest in the PTP. This issue should be clarified by the IRS when the proposed regulations are finalized.

[113] Prop. Reg. §1.199A-1(c)(2)(ii).

[114] *Id. See also* Prop. Reg. §1.199A-1(d)(3).

'NETTING' OF LOSSES IF TOTAL QBI IS POSITIVE AND QBI FROM AT LEAST ONE TRADE OR BUSINESS IS LESS THAN ZERO

Another rule added by the §199A proposed regulations addresses a situation where an individual has total QBI from all trades or businesses that is positive but an individual's QBI from one or more trades or businesses is less than zero. The first two articles in this trilogy correctly pointed out that the statute required that negative QBI from qualified trades or businesses would have to offset positive QBI. It was not clear from the statute itself as to whether this netting should be done before the §199A(b)(2)(B) limits were applied or after those limitations were taken into consideration for each individual trade or business. The QBI component of the §199A deduction is affected depending upon when this netting is done.

Example 10

Arnold is a taxpayer with taxable income for 2018 that exceeds the threshold amount plus the phase-out range. Arnold owns two non-service trades or businesses that generate QBI. Business A generates positive net QBI of $100,000, has paid W-2 wages of $30,000 and has no UBIA of qualified property. Business B has negative net QBI of ($50,000), has paid $10,000 of W-2 wages, and has no UBIA of qualified property. If the negative QBI from business B offsets the positive QBI from business A after applying the W-2 wages limitation separately for each business, then business A generates a §199A deduction of $15,000. This is because the W-2 wages limitation for business A of $15,000 (50% × $30,000) is less than business A's $20,000 §199A(b)(2)(A) amount (20% × $100,000). Business B would generate a negative §199A(b)(2)(A) amount of ($10,000), which is 20% of ($50,000). Arnold's total QBI deduction would be $5,000 ($15,000 positive amount from Business A minus the negative amount of $10,000 from Business B). In this situation, Arnold would have an incentive to shift the $10,000 of wages paid by Business B to Business A. If Arnold does this, then the §199A deduction generated by Business A would be $18,000 ($100,000 of QBI minus $10,000 of additional W-2 wages equals $90,000. 20% of $90,000 equals $18,000). Business B would generate a negative §199A amount of ($8,000) [$50,000 of negative QBI reduced by $10,000 of W-2 wages shifted to Business A equals ($40,000). 20% of this amount is ($8,000)]. Arnold's total §199A deduction would be $10,000 ($18,000 positive amount from Business A minus the negative amount of $8,000 from Business B). On the other hand, if the negative QBI from Business B of ($50,000) offsets Business A's positive QBI of $100,000 before the §199A(b)(2)(B) limitation is ap-

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plied, then the combined QBI amount prior to applying the W-2 wages limitation is $50,000 and results in a §199A deduction of $10,000 (20% × $50,000) because this amount is less than the W-2 wages limitation of $15,000.[115]

To prevent taxpayers from having ''perverse incentives for shifting wages and capital assets across businesses''[116] and prevent ''inconsistent and counterintuitive results that Congress did not intend,''[117] Prop. Reg. §1.199A-1(d)(2)(iii)(A) states that if an individual's QBI from at least one trade or business is less than zero, that individual must offset the QBI of the trades or businesses that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net positive QBI in the trades or businesses with positive QBI. After this offset is accomplished, then the QBI component calculation that takes into consideration the §199A(a)(2)(B) limitations is performed. The W-2 wages and UBIA of qualified property from the trades or businesses that produced net negative QBI are neither considered in this calculation nor carried over to a subsequent taxable year.[118]

This rule is demonstrated in the attached computation of Hotel Operator's §199A deduction that is made without aggregating that taxpayer's trades or businesses. Worksheet 1 applies the rule of offsetting positive QBI from trades or businesses with negative QBI from trades or businesses by offsetting the negative QBI of ($60,000) generated by Vegas Hotel LLC against the positive QBI of Cal Hotel LLC and Reno Hotel LLC in proportion to the relative amounts of net positive QBI generated by Cal Hotel LLC and Reno Hotel LLC. Worksheet 2 completes the calculation of the QBI component of the §199A deduction. The UBIA of the qualified property of Vegas Hotel LLC is not considered in this calculation. The calculation of the component of the §199A deduction that consists of qualified REIT dividends and qualified PTP income is also contained in Worksheet 2. Worksheet 3 completes the calculation of the §199A deduction by comparing the Combined Qualified Business Income Amount to the 20% Excess Taxable Income Limit. The result of this calculation is a §199A deduction of $44,800.

AGGREGATION ELECTION

The basic premise of the aggregation rules is that the aggregated business is a single trade or business that is operated through multiple entities for various legal, economic, and other reasons. Based on this precept, the rule of Prop. Reg. §1.199A-1(d)(2)(ii) requires an individual who elects to aggregate trades or businesses to combine the QBI, W-2 wages, and UBIA of qualified property of each trade or business that is being aggregated prior to applying the W-2 wages and UBIA of qualified property limitations. The positive and negative QBI amounts of all qualified trades or businesses are combined prior to applying the §199A(b)(2)(B) limitation. The W-2 wages and UBIA of qualified property are also combined. The §199A(b)(2)(B) limitation is applied by comparing the total QBI amount for all aggregated businesses to the greater of 50% of the total W-2 wages for all aggregated trades or businesses or the sum of 25% of the total W-2 wages for all aggregated trades or businesses plus 2.5% of the total UBIA of qualified property for all aggregated trades or businesses.

Worksheet 4 contains the same summary data for the fictional hotel operator as Worksheet 1. Because the businesses are being aggregated, there is no need to make a calculation that offsets the negative QBI of Las Vegas Hotel LLC against the positive QBIs of Cal Hotel LLC and Reno Hotel LLC. Worksheet 5 combines the QBI, W-2 wages, and UBIA of qualified property of Cal Hotel LLC, Reno Hotel LLC, and Las Vegas Hotel LLC before making the QBI component calculation. The §199A QBI component and the §199A component for qualified REIT Dividends and qualified PTP Income are then calculated. Worksheet 6 completes the calculation of the hotel operator's §199A deduction by comparing the combined qualified business income amount to the 20% excess taxable income limit. The result is a §199A deduction of $50,800.

CONCLUSION

The §199A proposed regulations do not provide a simple definition of the term ''§162 trade or business.'' However, a simple definition of this term may not be possible. These proposed regulations also do not state that a rental property or a property that generates royalties is a §162 trade or business. In fact, the definition of a trade or business in Prop. Reg. §1.199A-1(b)(13) indicates that there are circumstances where a rental activity ''does not rise to the level of a trade or business.'' This is in accordance with case law and published guidance concerning a §162 trade or business.

The §199A proposed regulations did address the circumstances of a person who operates one trade or business through multiple entities by allowing that person to aggregate the §199A items of those entities. These aggregation rules do reflect the principle that

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[115] See REG-107892-18, Preamble, Special Analyses, §I.C.2.

[116] *Id.*

[117] REG-107892-18, Preamble, Explanation of Provisions, §I.C.

[118] Prop. Reg. §1.199A-1(d)(3)(iii)(A).

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different trades or businesses cannot be aggregated unless they are truly one business. Once a decision is made to aggregate trades or businesses that qualify for aggregation, the consistency rule requires an individual to live with that election. The aggregation election is a choice that will have to be considered carefully by persons able to make the election to aggregate.

The §199A proposed regulations also made clear that an individual's property that is leased to a trade or business commonly controlled by that individual qualifies as a trade or business solely for purposes of §199A. If this building is leased to a commonly controlled SSTB, the §199A proposed regulations delineated the circumstances where either the entire rental activity or the portion of the property leased to the commonly controlled SSTB would be part of the SSTB. In addition, the §199A proposed regulations amplify the definitions of many terms and address several issues not discussed in this article.

The §199A proposed regulations may not have provided the complete clarity that some people desired. However, they are a significant step in the ongoing quest to understand §199A and its ramifications. This article pointed out certain areas where further clarification would be helpful.

Taxpayers and their advisors have a chance to submit comments and suggestions concerning the §199A proposed regulations before these proposed regulations are finalized. Hopefully, many tax professionals will take advantage of that opportunity and make suggestions that will shed even more light on a complex subject.

Hotel Operator

Summary of Taxpayer Information **Worksheet 1**

Tax Return Information:	
Wages and Salaries	200,000
Non-Qualifying Dividends	10,000
Qualified Dividends	5,000
Net Long-Term Capital Gain In Excess of Net Short-Term Capital Loss	25,000
Qualified Publicly Traded Partnership Income	4,000
Non-Business Interest Income	6,000
QBI-Cal Hotel LLC	200,000
QBI-Reno Hotel LLC	100,000
Loss-Vegas Hotel LLC	(60,000)
Qualified REIT Dividends	10,000
Gross Income and Adjusted Gross Income	500,000
Itemized Deductions	
Taxes	10,000
Mortgage Interest	5,000
Charitable Contributions	10,000
Total Itemized Deductions	25,000
Taxable Income Before QBI Deduction	475,000
QBI Deduction-See Schedule	(44,800)
Taxable Income	430,200

This taxpayer is a married couple filing a joint return.

	Cal Hotel LLC	**Reno Hotel LLC**	**Vegas Hotel LLC**
Other Data			
Taxpayer's share of W-2 wages	900,000	20,000	0
Unadjusted Basis Immediately After Acquisition of Qualified Property	325,000	19,000	420,000
Guaranteed Payment to Partner	0	0	0

	Cal Hotel LLC	**Reno Hotel LLC**	**Total**
Allocation of Loss:			
Relative Amounts of Positive QBI	200,000	100,000	300,000
Percentage of Positive QBI	66.67%	33.33%	100.00%
Loss from Vegas Hotel LLC	(40,000)	(20,000)	(60,000)
QBI Adjusted for Net Loss	160,000	80,000	240,000

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Hotel Operator **Worksheet 2**

Determination of Deductible Amount For Each Qualified Trade or Business and Combined Qualified Business Income Amount Without Aggregation of Trades or Businesses

	Cal Hotel LLC	Reno Hotel LLC	Vegas Hotel LLC	Aggregate Deductible Amount
QBI Amount:				
Partnership Income	160,000	80,000	-	
Guaranteed Payment to Partner	-	-	-	
Qualified Business Income (Loss)	160,000	80,000	-	
Percentage For Deduction	20%	20%		
20% of QBI amount	32,000	16,000	-	
Greater of W-2 Wages Limit Amount or W-2 Wages/Property Limit Amount				
W-2 Wages Limit:				
W-2 wages	900,000	20,000	-	
Wage Percentage	50%	50%		
W-2 Wages Limit Amount	450,000	10,000	-	
W-2 Wages/Property Limit Amount				
W-2 Wages/Property Limit				
W-2 wages	900,000	20,000	-	
Wage Percentage	25%	25%		
W-2 Wages for W-2 Wages/Property Limit Amount	225,000	5,000	-	
Unadjusted Basis Immediately After Acquisition of Qualified Property	325,000	19,000		
Percentage Limit	2.5%	2.5%		
Property Amount	8,125	475	-	
Total W-2 Wages/Property Limit Amount	233,125	5,475	-	
Greater of W-2 Wages Limit Amount or W-2 Wages/Property Limit Amount	450,000	10,000	-	

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	Cal Hotel LLC	Reno Hotel LLC	Vegas Hotel LLC	Aggregate Deductible Amount
QBI Component	32,000	10,000	-	42,000
Qualified REIT Divdends and Qualified Publicly Traded Partnership Income				
Qualified REIT Dividends			10,000	
Qualified Publicly Traded Partnership Income			4,000	
Total			14,000	
Percentage of Qualified REIT and Qualified Publicly Traded Partnership Income			20%	
REIT and Qualified Publicly Traded Partnership Income Portion				2,800
Combined Qualified Business Income Amount				44,800

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Worksheet 3

Hotel Operator

Deduction For Qualified Business Income

	20% Excess Taxable Income Limit	Combined QBI Amount & Limit	§199A Deduction
Combined Qualified Business Income Amount (See Schedule)		44,800.00	
20% Excess Taxable Income Limit:			
Taxable Income Before §199A (a) Deduction	475,000.00		
Less: Qualified Dividends	(5,000.00)		
Net long-term capital gain in excess of net short-term capital loss	(25,000.00)		
Taxable income in excess of qualified dividends and net long-term capital gain in excess of short-term capital loss	445,000.00		
Excess Percentage	20.00%		
Total Excess Taxable Income Amount		89,000.00	
§199A deduction-lesser of Combined Qualified Business Income Amount or Excess Taxable Income Amount			44,800.00

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Hotel Operator

Summary of Taxpayer Information **Worksheet 4**

Tax Return Information:

Wages and Salaries	200,000
Non-Qualifying Dividends	10,000
Qualified Dividends	5,000
Net Long-Term Capital Gain In Excess of Net Short-Term Capital Loss	25,000
Qualified Publicly Traded Partnership Income	4,000
Non-Business Interest Income	6,000
QBI-Cal Hotel LLC	200,000
QBI-Reno Hotel LLC	100,000
Loss-Vegas Hotel LLC	(60,000)
Qualified REIT Dividends	10,000
Gross Income and Adjusted Gross Income	500,000
Itemized Deductions	
Taxes	10,000
Mortgage Interest	5,000
Charitable Contributions	10,000
Total Itemized Deductions	25,000
Taxable Income Before QBI Deduction	475,000
QBI Deduction-See Schedule	(50,800)
Taxable Income	424,200

This taxpayer is a married couple filing a joint return.

Other Data	**Cal Hotel LLC**	**Reno Hotel LLC**	**Vegas Hotel LLC**
Taxpayer's share of W-2 wages	900,000	20,000	0
Unadjusted Basis Immediately After Acquisition of Qualified Property	325,000	19,000	420,000
Guaranteed Payment to Partner	0	0	0

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Hotel Operator **Worksheet 5**

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

	Cal Hotel LLC	Reno Hotel LLC	Vegas Hotel LLC	Aggregated Amount
QBI Amount:				
Partnership Income	200,000	100,000	(60,000)	240,000
Guaranteed Payment to Partner	-	-	-	
Qualified Business Income (Loss)	200,000	100,000	(60,000)	240,000
Percentage For Deduction				20%
20% of QBI amount				48,000
Greater of W-2 Wages Limit Amount or W-2 Wages/Property Limit Amount				
W-2 Wages Limit:				
W-2 wages	900,000	20,000		920,000
Wage Percentage				50%
W-2 Wages Limit Amount				460,000
W-2 Wages/Property Limit Amount				
W-2 Wages/Property Limit				
W-2 wages	900,000	20,000		920,000
Wage Percentage				25%
W-2 Wages for W-2 Wages/Property Limit Amount				230,000
Unadjusted Basis Immediately After Acquisition of Qualified Property	325,000	19,000	420,000	764,000
Percentage Limit				2.5%
Property Amount				19,100
Total W-2 Wages/Property Limit Amount				249,100
Greater of W-2 Wages Limit Amount or W-2 Wages/Property Limit Amount				460,000
QBI Component				48,000
Qualified REIT Dividends and Qualified Publicly Traded Partnership Income				
Qualified REIT Dividends			10,000	
Qualified Publicly Traded Partnership Income			4,000	
Total			14,000	
Percentage of Qualified REIT and Qualified Publicly Traded Partnership Income			20%	
REIT and Qualified Publicly Traded Partnership Income Portion				2,800
Combined Qualified Business Income Amount				50,800

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Worksheet 6

Hotel Operator

Deduction For Qualified Business Income

	20% Excess Taxable Income Limit	Combined QBI Amount & Limit	§199A Deduction
Combined Qualified Business Income Amount (See Schedule)		50,800.00	
20% Excess Taxable Income Limit:			
Taxable Income Before §199A (a) Deduction	475,000.00		
Less: Qualified Dividends	(5,000.00)		
Net long-term capital gain in excess of net short-term capital loss	(25,000.00)		
Taxable income in excess of qualified dividends and net long-term capital gain in excess of short-term capital loss	445,000.00		
Excess Percentage	20.00%		
Total Excess Taxable Income Amount		89,000.00	
§199A deduction-lesser of Combined Qualified Business Income Amount or Excess Taxable Income Amount			50,800.00

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