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by Gerald (Jerry) S. Janoff, Nick Hollinden, and Stanislava Tochenova

The 20 Percent Solution

Rules that qualify income for deduction under the new federal tax regime are carefully constructed to deter high-income taxpayers from converting nonqualifying compensation

The Tax Cuts and Jobs Act of 2017 (2017 Tax Act)¹ was enacted with the dual promises of reducing taxes and simplifying tax reporting. However, as many taxpayers have discovered, these promises have not always been met. The one area in which the 2017 Tax Act does appear to live up to its selling points is in its promise to reduce taxes on businesses. The initial focus of business tax reduction was on C corporations, with proponents of tax reform emphasizing that the United States' existing 35 percent federal corporate income tax rate (39.1 percent, taking into account average state and local tax rates) was the highest marginal corporate income tax rate of any nation in the Organization for Economic Cooperation and Development (OECD).² Citing the need for corporate competitiveness, President Donald Trump initially advocated reducing the federal corporate tax rate to 15 percent. The 2017 Tax Act ultimately provided for a 21 percent corporate rate applicable to all levels of income.

Nevertheless, most businesses are not conducted in C corporation form. Businesses, particularly if privately held, typically operate for income tax purposes as partnerships (including LLCs and other legal entities treated as partnerships for tax purposes), S corporations (collectively with partnerships, referred to as “pass-through

entities”), and sole proprietorships. Unlike C corporations, pass-through entities generally are not subject to entity-level income taxes.³ Instead, pass-through entities allocate (or pass-through) items of income, gain, loss, and deduction among their owners, who report their respective allocable shares on their income tax returns, regardless of whether they receive cash distributions from the entity.⁴

In order to reduce the federal income tax liability on most businesses, not just C corporations, the 2017 Tax Act introduced an entirely new—and perhaps even radical—concept: a federal income tax deduction of up to 20 percent of income from a qualified business. While this concept appears simple, the new statutory and regulatory provisions are complex to apply.

This 20 percent deduction is contained in new Internal Revenue Code (IRC) Section 199A. Introducing new jargon and terminology, Section 199A essentially provides a deduction of up to 20 percent of “qualified business income” (referred to herein as “qualified income”) from U.S. businesses operated as a sole proprietorship or through a pass-through entity, trust, or estate. It does not apply to businesses conducted by C corporations. Very generally, qualified income is the net amount of items of income, gain, loss, and deduction with respect to a “qualified trade or business.”⁵ Section

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199A also provides for a 20 percent deduction for qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income.

In January 2019, the U.S. Department of the Treasury issued final regulations under Section 199A accompanied by an explanatory preamble, collectively consisting of 274 pages.⁶ Additional proposed regulations and two revenue procedures were also released. The result is a complex regulatory framework, in which unanswered questions and ambiguities remain.

Before delving into the multitude of definitions, exceptions, and issues, it is helpful to provide a general overview of Section 199A. First, the 20 percent deduction only applies to income from businesses not held by a C corporation that otherwise qualify under Section 199A. Second, after identifying these businesses, the amount of qualified income for Section 199A purposes of each such business must be determined. Third, taxpayers with qualified income must determine whether their taxable incomes exceed certain thresholds (for 2019, \$160,700 for single filers and \$321,400 for those filing joint returns as married) (Threshold Amount).⁷ Those with taxable incomes under the Threshold Amount are entitled to the 20 percent deduction without having to satisfy requirements applicable to taxpayers with higher incomes.

Fourth, two additional requirements apply to taxpayers with taxable incomes that exceed the sum of the applicable Threshold Amount plus \$50,000 (or, in the case of joint returns, the applicable Threshold Amount plus \$100,000) (Phase-In Amount). For these taxpayers, the business income must not be derived from one of the categories of businesses that the statute treats as effectively compensation for services based on the provider's skill and reputation. For businesses that meet this requirement, the 20 percent deduction applies only to qualified income that exceeds the higher of two limits: one based on the amount of employee wages paid by the business and the other based on a combination of wages paid and the unadjusted tax basis of certain qualified depreciable property held by the business. Complicated phase-in rules apply to taxpayers with taxable income between the Threshold Amount and the Phase-In Amount.

The 20 percent deduction is a below-the-line deduction that reduces adjusted gross income after the standard deduction or itemized deductions are taken.⁸ Generally, taxpayers who take the standard deduction may not reduce their adjusted gross income by itemized deductions.

However, the 20 percent deduction is unique in that it may be used by taxpayers who take the standard deduction.⁹ In the case of pass-through entities, the deduction is taken at the partner or shareholder level.¹⁰ Trusts and estates may also qualify for the 20 percent deduction.¹¹

The 20 percent deduction applies only for income tax purposes.¹² It does not reduce net earnings for purposes of determining self-employment tax or the 3.8 percent net investment income tax.¹³ Unless extended by future legislation, the 20 percent deduction is available for taxable years beginning after December 31, 2017 and before January 1, 2026.¹⁴ California does not presently provide a similar deduction for state income tax purposes, although some other states do.

Qualified Businesses

The first step in determining whether the 20 percent deduction applies is to identify whether the taxpayer holds, directly (such as in a sole proprietorship) or indirectly (through a pass-through entity), one or more "qualified trades or businesses" for Section 199A purposes (i.e., a "Qualified Business"). In order to have a Qualified Business, there must be activity that rises to the level of a "business" for income tax purposes.

The Section 199A regulations define a Qualified Business by reference to the meaning of "trade or business" under IRC Section 162 (162(a) Business), excluding a business consisting of the performance of services as an employee.¹⁵ However, Section 162(a) and the related regulations do not clearly define this term. Instead, one must look to the large body of case law and regulatory guidance that interpret this concept.

The U.S. Supreme Court, in *Commissioner v. Groetzinger*,¹⁶ explained that for an activity to constitute a business 1) the taxpayer must be involved in the activity with continuity and regularity and 2) the taxpayer's primary purpose for engaging in the activity must be for income or profit. Sporadic activities and hobbies do not qualify.¹⁷ Moreover, investment activity generally does not rise to the level of a business.¹⁸ A taxpayer need not actively or materially participate in order for an activity to qualify as a business. The passive activity rules of IRC Section 469, which generally limit the ability to use deductions from a passive activity against income from other sources, are inapplicable for this purpose.

Many regularly conducted profit-seeking activities should have no problem qualifying as a business. The primary area of

uncertainty relates to rental real estate, as there is limited case law on when such activity constitutes a business or an investment. Due to this uncertainty, the IRS released Notice 2019-07,¹⁹ which sets forth a safe harbor that, if satisfied, treats a "rental real estate enterprise" as a Qualified Business, but solely for Section 199A purposes.

For purposes of the safe harbor, a "rental real estate enterprise" is an interest in one or more rental real properties consisting of commercial or residential properties. The safe harbor generally does not apply to properties used as a residence for more than 14 days per year²⁰ or rented under an arrangement whereby the tenant is responsible for taxes, insurance, and maintenance (triple net lease).

The safe harbor generally applies to a "real estate rental enterprise" if 1) the enterprise maintains separate books and records, 2) at least 250 hours of "rental services" per year are performed by owners, employees, or agents,²¹ and 3) detailed contemporaneous records and time logs are maintained. Rental services generally include maintenance, lease negotiation, supervising employees, and certain other daily operations. Traveling to properties and activities relating to long-term capital improvements, finances, and investment management do not constitute rental services.

Rental real estate enterprises failing to satisfy the safe harbor nevertheless may be treated as a Qualified Business if they qualify under an exception in the Section 199A regulations applicable to the rental of property to a "commonly controlled" Qualified Business or otherwise qualify as a 162(a) Business.²² Outside of the commonly controlled context, rental activities involving triple net leases or a small number of units may be insufficient activity to constitute a 162(a) Business, particularly when the owner and agents have little day-to-day involvement.

As employee-provided services are explicitly excluded from the definition of Qualified Business, employee compensation is ineligible for the 20 percent deduction. In an attempt to qualify for the 20 percent deduction, some taxpayers may restructure employment relationships into that of an independent contractor. The Section 199A regulations contain a rebuttable presumption applicable to an employee who becomes an independent contractor while providing substantially the same services to the former employer, including through an entity. These persons are presumed to retain their "employee" status for three years after ceasing "employment," absent

MCLE Test No. 290

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1. The Tax Cuts and Jobs Act of 2017* reduced the corporate tax rate to 21 percent only on income above \$200,000.
True.
False.
2. Who may take the 20 percent deduction with respect to qualified income earned by a partnership?
A. The partnership.
B. The partners of the partnership in all cases.
C. The partnership and the partners who are treated as individuals.
D. The partners who are treated as individuals.
3. The 20 percent deduction applies to which of the following:
A. The net investment income tax.
B. Self-employment tax, for the purposes of reducing earnings.
C. California income taxes.
D. None of the above.
4. The 20 percent deduction is available for taxable years beginning after December 31, 2017, and before January 1, 2022.
True.
False.
5. To what income does the 20 percent deduction apply?
A. Income from a regularly conducted activity primarily engaged in to make a profit.
B. Income from a regularly conducted business or investment activity.
C. Income satisfying A and B.
D. None of the above.
6. Rental real estate operations automatically constitute a qualified business under I.R.C. Section 199A.
True.
False.
7. At least 250 hours of "rental services" per year must be performed by owners, employees, or agents to satisfy the "real estate rental enterprise" safe harbor.
True.
False.
8. Maintenance of complete and separate books and records is required to have a trade or business if an entity or individual conducts more than one business.
True.
False.
9. Which of the following is included in determining qualified business income?
A. Dividends.
B. Interest earned on accounts receivable for services provided by a business.
C. Interest earned on the business' working capital.
D. None of the above.
10. Which of the following potentially may be included in determining qualified business income?
A. Guaranteed payments for the use of capital.
B. Guaranteed payments for the use of services.
C. Income attributable to a preferred distributions to a partner.
D. None of the above.
11. A partner of a partnership generally cannot be treated as the partnership's employee.
True.
False.
12. A partnership may never deduct a guaranteed payment to a partner from qualified business income.
True.
False.
13. Which of the following is true for taxpayers with income exceeding the Phase-In Amount?
A. The 20 percent deduction is unavailable.
B. The 20 percent deduction is generally fully available provided the income does not derive from a specified service trade or business (SSTB) and the business has employees.
C. The 20 percent deduction is generally available for income from an SSTB provided the amount of qualified business income exceeds 50 percent of the wages paid by the business.
D. None of the above.
14. Which of the following is true for taxpayers with income between the Threshold Amount and the Phase-In Amount?
A. Income from an SSTB may be included in qualified business income if less than 25 percent of the business's gross receipts relate to specified services.
B. Income from an SSTB may be included in a qualified business income to the extent allowable under certain phase-in rules.
C. Income from an SSTB may never be included in qualified business income.
D. Both A and B.
15. The field of architecture is an SSTB.
True.
False.
16. The income of a pharmacist who sells prescription drugs is considered to be compensation for services in the field of health.
True.
False.
17. Providing landscaping design advice is an SSTB.
True.
False.
18. The 20 percent deduction applies to endorsement income to those earning above the Phase-in Amount.
True.
False.
19. Which of the following industries generally benefits from the alternative test limiting the 20 percent deduction to 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of qualified property.
A. Service businesses.
B. Retail.
C. Real estate rental property businesses.
D. All of the above.
20. In order to aggregate two businesses, there must be identical direct or indirect ownership of each business.
True.
False.

* General note: The answer to each question assumes that all other requirements of I.R.C. §199A are satisfied.

MCLE Answer Sheet #290



THE 20 PERCENT SOLUTION

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1. True False
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5. A B C D
6. True False
7. True False
8. True False
9. A B C D
10. A B C D
11. True False
12. True False
13. A B C D
14. A B C D
15. True False
16. True False
17. True False
18. True False
19. A B C D
20. True False

a showing that the services are performed in a nonemployee capacity.²³ This presumption does not apply to former employees who enter into an independent contractor relationship with a new service recipient. Moreover, federal employment tax law and state law might not recognize a purported “independent contractor” classification.²⁴ Failing to properly classify a worker as an employee could result in back taxes, penalties, and fines for employers.

An individual or a pass-through entity may be engaged in more than one Qualified Business. Whether a single entity conducts multiple businesses is a factual determination to which court decisions defining a 162(a) Business provide guidance. The U.S. Treasury’s view is that multiple businesses cannot exist within a single entity unless each business maintains complete and separate books and records.²⁵ In addition, a business generally cannot be conducted across multiple entities for tax purposes.²⁶

As a general matter, each Qualified Business is considered separately for purposes of determining the 20 percent deduction. However, as discussed later, under certain circumstances individuals and pass-through entities may elect to aggregate multiple businesses into a single business for the purpose of applying Section 199A.

Qualified Business Income

After the taxpayer’s Qualified Businesses are identified, the amount of qualified income from each business must be separately determined on an annual basis. Qualified income generally is the net amount of qualified items of gross income, gain, loss, and deduction that are 1) “effectively connected” with a business conducted in the U.S. and 2) allowed in determining taxable income for the taxable year.²⁷ Persons who are not U.S. citizens are eligible for the 20 percent deduction, provided that the income is effectively connected with a U.S. business.

Certain investment-related items are excluded from qualified income, including 1) capital gains and losses, 2) dividends, 3) interest income that is not allocable to a business, and 4) items of deduction or loss allocable to any of the foregoing items.²⁸ For this purpose, capital gains and losses include any items treated as such under the IRC, even if they do not involve the disposition of a capital asset.²⁹ In addition, interest attributable to a business’s working capital and reserves is not included in qualified income, as it is considered income derived from investment assets.³⁰ By contrast, interest on accounts receivable

for goods or services provided by a business is considered income received on assets acquired in the business’s ordinary course and, as such, is included in qualified income.³¹

With respect to S corporation shareholders, amounts received that are treated as “reasonable compensation” are excluded from qualified income.³² If a shareholder performs services for an S corporation without drawing a reasonable salary from the corporation prior to the distribution of dividends, all or part of dividends may be recharacterized as “reasonable compensation” and, as such, excluded from qualified income.³³ This exclusion is in addition to the actual payment of wages to employee-shareholders.

For income tax purposes, a partner of a partnership cannot be treated as the partnership’s employee.³⁴ Thus, two categories of employment-like payments to partners are excluded in determining qualified income. These categories are: 1) “guaranteed payments” (i.e., amounts payable without regard to the partnership’s income) paid by a partnership to a partner for services rendered by the partner with respect to a Qualified Business and 2) payments from a partnership to a partner for services when the partner does not act in the capacity as partner of the partnership (Section 707(a) payments).³⁵ As a general matter, partners who receive these payments report ordinary income, subject to self-employment taxes, and the partnership deducts these amounts. These deductions generally will reduce the amount of the partnership’s income that would otherwise be eligible for the 20 percent deduction.³⁶ In the case of a tiered partnership structure (i.e., when an upper-tier partnership owns an interest in a lower-tier partnership), any Section 707(a) payment or guaranteed payment for services from a lower-tier partnership to an upper-tier partnership is excluded from qualified income, even if it is not accompanied by a similar payment made to a partner of the upper-tier partnership.³⁷

Guaranteed payments to a partner for the use of capital (in contrast to guaranteed payments for the use of services), payable without regard to the partnership’s income, also are excluded from qualified income. A limited exception applies to the extent the guaranteed payment is allocable to a business of the partner, although the preamble to the Section 199A regulations explains that this fact pattern is unlikely to occur.³⁸ Partners of partnerships paying guaranteed payments may consider restructuring these arrangements as preferred cash flow distributions matched with priority allocations of net profit. In order to have

preferred cash distributions and matching allocations that are respected as such, partners should not have an absolute right to receive preferred distributions regardless of whether the business generates sufficient cash flow or produces a profit. Instead, these distributions should be limited to the partnership’s available cash flow after expenses are paid and amounts are set aside for reasonable reserves.

Similar to guaranteed payments, net profit allocations generally constitute ordinary income (assuming that the income is ordinary in the hands of the partnership), subject to self-employment taxes for service partners, and reduce the amount of net income allocated to the other partners. Unlike guaranteed payments, allocations of net profit may constitute qualified income. This alternative may not precisely mirror the guaranteed payment approach, as priority distributions are not unconditionally payable. In many cases, however, they should achieve a similar economic result.

High-Income Taxpayers

Taxpayers with taxable income (before taking into account the 20 percent deduction) not exceeding the Threshold Amount (for 2019, \$160,700 for single filers and \$321,400 for those filing joint returns) need not satisfy any additional requirements for the 20 percent deduction. These taxpayers generally are entitled to a deduction in an amount equal to 20 percent of the lesser of 1) the “total qualified income amount”³⁹ and 2) the amount by which the individual’s taxable income (before the 20 percent deduction) exceeds the sum of the individual’s net capital gain and qualified dividends taxed at the capital gains rates.⁴⁰ The “total qualified income amount” is determined by netting the amount of qualified income from each Qualified Business in which the taxpayer has an interest, including the taxpayer’s share of qualified income from Qualified Businesses held by a pass-through entity.⁴¹ If the taxpayer’s “total qualified income amount” is negative, then the taxpayer will not have qualified income for the taxable year. Instead, this negative amount will carry forward to the succeeding taxable year and will be treated as negative qualified income from a separate business in that year.⁴² Taxpayers with ordinary income in a taxable year that is less than the “total qualified income amount” may consider accelerating income to that year in order to take advantage of the 20 percent deduction.

Taxpayers whose taxable income (before the 20 percent deduction) exceeds

the Phase-In Amount (for 2019, \$210,700 for single filers and \$421,400 for joint returns) are subject to two additional limitations on the 20 percent deduction. These limitations aim to deter high-income taxpayers from converting compensation income into qualified income, including by using a pass-through business to provide services that the taxpayer otherwise would perform as an employee.⁴³ First, these taxpayers generally may not treat income from a “specified service trade or business” (SSTB) as qualified income. Second, with respect to each Qualified Business, the amount of qualified income is limited based on the amount of W-2 wages paid by the business and the unadjusted cost basis of “qualified property” held by the business. Complicated phased-in provisions apply to taxpayers with taxable income between the Threshold Amount and the Phase-In Amount.⁴⁴

Generally, an SSTB is a business that provides certain categories of services (specified services). Section 199A defines “SSTB” as any business either:

- Involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services;
- When the principal asset is “the reputation or skill of 1 or more of its employees or owners”; or
- Involving the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.⁴⁵

The fields of architecture and engineering are explicitly excluded from the definition of SSTB.⁴⁶

The Section 199A regulations elaborate on the various specified services enumerated in the definition of “SSTB” and do not follow state licensing laws.⁴⁷ For example, the term “services performed in the field of law” is not limited to services performed by attorneys. It also includes services by mediators, legal arbitrators, and paralegals. However, services not requiring skills unique to the field of law (such as stenography services) are not included in this field.⁴⁸

“Performing services in the field of health” means the direct provision of medical services to a patient by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other health care professionals. This category does not include providing health-related services not directly related to a medical services field, such as operating health clubs or the research, manufacture, and sales of pharmaceuticals.⁴⁹

The determination of whether a professional performs services in the field of health is not always cut and dry. For example, the sale of prescription drugs by a retail pharmacy does not by itself constitute the performance of services in the “field of health.”⁵⁰ However, a pharmacist who is engaged by physicians to make recommendations on dosing, performing inoculations, and checking for drug interactions is engaged in the performance of services in the field of health.⁵¹

“Services performed in the field of consulting” means providing professional advice and counsel to assist clients in achieving goals and solving problems, including landscaping design advice⁵² and regarding advocacy with the intent to influence government. “Consulting” does not include services other than advice and counsel. Sales and providing training and educational courses does not constitute “consulting.” This field also does not include performing consulting services ancillary to the sale of goods if there is no separate payment for the consulting services.⁵³ For example, a computer seller may provide customers with services relating to the setup, operation, and repair of computers without being an SSTB.⁵⁴

Before the release of the proposed regulations under Section 199A, there was uncertainty as to what constitutes a business when the principal asset is “the reputation or skill of 1 or more of its employees or owners.” Many tax practitioners were concerned that this category could cause most businesses with skilled employees to be deemed an SSTB. The Section 199A regulations take a more narrow view.⁵⁵

The Section 199A regulations limit the “reputation or skill” category to situations in which one is engaged in the business of receiving income from 1) endorsements; 2) the use of an individual’s image, likeness, name, or symbol associated with the individual’s identity; or 3) appearing at an event or on radio, television, or another media format.⁵⁶ To illustrate the scope of this category, assume that H, a famous chef, owns multiple restaurants. H receives a \$500,000 endorsement fee for the use of H’s name on a cookware line. H’s business of being a chef and owning restaurants does not constitute an SSTB. However, H’s business of receiving income for the use of H’s name is an SSTB.⁵⁷

The Section 199A regulations provide a *de minimis* exception to the rule that the performance of any specified services will cause a business to constitute an SSTB. Businesses with gross receipts of \$25 million or less in the taxable year will not

constitute an SSTB if less than 10 percent of the gross receipts are attributable to the performance of specified services. If gross receipts exceed \$25 million in the taxable year, the business will not constitute an SSTB if less than 5 percent of gross receipts are attributable to performing specified services.⁵⁸

The Section 199A regulations contain an anti-abuse rule aimed at structures attempting to separate parts of what otherwise would be an integrated SSTB into separate SSTB and non-SSTB businesses. If a business provides property or services to an SSTB with at least 50 percent direct or indirect common ownership, then the income attributable to providing property or services to the SSTB will be treated as income from an SSTB.⁵⁹

To illustrate this rule, assume that A and B each owns 50 percent of Partnership 1, a law firm; Partnership 2, which manages an office building; and Partnership 3. Partnership 2 leases 70 percent of its building to Partnership 1 and the remaining 30 percent to unrelated tenants. Partnership 3 employs administrative staff, all of whom provide administrative services to Partnership 1 in exchange for fees paid by Partnership 1 to Partnership 3. Partnership 3 would be an SSTB because it provides all of its services to a commonly controlled SSTB. Partnership 2’s lease with Partnership 1 would be treated as an SSTB. Partnership 2’s remaining leasing activity would not be considered an SSTB.⁶⁰

The second set of limitations applicable to high-income taxpayers is based on the amount of W-2 wages paid by the business and the unadjusted cost basis of qualified property held by the business. These limitations are applied annually and separately with respect to each Qualified Business.

More specifically, with respect to each Qualified Business, the deductible amount for a taxpayer with taxable income over the Phase-In Amount is limited to the greater of 1) 50 percent of the “W-2 wages” paid with respect to the business that is allocable to qualified income or 2) the sum of (x) 25 percent of the W-2 wages paid with respect to the business that is allocable to qualified income plus (y) 2.5 percent of the “unadjusted basis” determined immediately after acquisition (UBIA) of all “qualified property” of the business. Neither W-2 wages nor UBIA of an SSTB may be taken into account by any individual earning above the Phase-In Amount, even if derived from a non-specified service activity.⁶¹ Phase-in rules apply to taxpayers with income between the Threshold Amount and the Phase-In Amount.

When the Qualified Business is held by a pass-through entity, the taxpayer only takes into account the taxpayer's allocable share of the entity's W-2 wages and UBIA.⁶² The Section 199A regulations provide rules as to how to allocate an entity's W-2 wages and UBIA among its owners.⁶³

For purposes of the wage limitation, the term "W-2 wages" generally means wages for income tax withholding purposes and certain elective deferrals, such as Section 401(k) contributions.⁶⁴ Payments to independent contractors do not constitute W-2 wages. The Section 199A regulations contain extensive rules for identifying which W-2 wages are paid with respect to a Qualified Business and are allocable to qualified income.⁶⁵ Special rules apply in the case of short taxable years, acquisitions and dispositions, and wages paid by persons other than a common law employer (e.g., a professional employer organization).⁶⁶

Wages paid to S corporation shareholder-employees qualify as W-2 wages. By contrast, guaranteed payments to partners for services performed for the payor-partnership do not. Accordingly, a partnership with high income partners and few nonpartner employees may consider converting to an S corporation. After a conversion, the owners would receive W-2 wages from the S corporation, instead of excluded guaranteed payments from a partnership.

The Section 199A regulations contain extensive rules defining "qualified property." As a general matter, "qualified property" is tangible property subject to depreciation that 1) is held by the business at the end of the taxable year, 2) is used in the production of qualified income during the year, and 3) has a "depreciable period" not ending during the taxable year.⁶⁷ For this purpose, the depreciable period generally begins when the property is first placed in service and ends on the later of ten years thereafter or the last day of the last full year of the recovery period that would apply if the property were depreciated under the modified accelerated cost recovery system.⁶⁸ Inventory and unimproved land are not qualified property because they are not depreciable. Real estate improvements (which have a depreciable life in excess of 10 years) that are fully depreciated for income tax purposes also are not qualified property.

The nominal purpose of the qualified property-based limitation is to allow capital-intensive Qualified Businesses that do not pay substantial W-2 wages to qualify for the 20 percent deduction. The legislative history, however, suggests more limited

policy considerations. The Senate bill originally limited the 20 percent deduction of high-income taxpayers with respect to non-SSTBs solely based on W-2 wages.⁶⁹ Real estate rental property businesses often do not pay significant salaries. Instead, they typically pay compensation to independent contractors or "management fees" to related entities. Thus, had the Senate bill become law, owners of non-wage paying real estate companies would not qualify for the 20 percent deduction. During the reconciliation process, the alternative UBIA limitation was introduced for the first time, thereby creating a new tax break for high-income real estate business owners.⁷⁰ As a result, large landlords can take into account the fully nondepreciated cost of buildings over their 39-year depreciation period in computing the 20 percent deduction, regardless of whether they have employees.

Aggregation of Businesses

While Section 199A generally is applied on a business-by-business basis, the Section 199A regulations contain an aggregation regime that allows individual taxpayers and pass-through entities to combine businesses so long as certain requirements are met. The aggregate is treated as a single business for purposes of applying the Section 199A rules.⁷¹ Aggregation provides a powerful tax planning tool when a taxpayer has interests in multiple businesses and combining the businesses would produce a more favorable mix of qualified income, W-2 wages, or UBIA. In order to aggregate businesses, the following requirements must be satisfied:

- Each business rises to level of a Qualified Business,⁷² has the same taxable year, and is not an SSTB.
- The same person or group of persons, directly or indirectly through attribution rules, own at least 50 percent of each business to be aggregated for the majority of the taxable year and at the end of the taxable year.
- Two of the following three factors are satisfied: 1) the businesses provide products, property, or services that are the same (such as a restaurant and a food truck) or customarily offered together (such as a gas station and a car wash); 2) the businesses share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or 3) the businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (e.g., supply chain interdependencies).⁷³

Both individuals and pass-through entities may elect to aggregate. Taxpayers may decide to aggregate some activities while keeping others separate. A pass-through entity may aggregate businesses operated directly or through a lower-tier pass-through entity. It may aggregate additional businesses with the businesses aggregated by a lower-tier entity. However, the entity may not exclude a business that is aggregated by the lower-tier entity. If a pass-through entity does not aggregate, its owners may elect to aggregate and need not aggregate in the same manner.⁷⁴

Individuals may elect to aggregate businesses operated directly or through a pass-through entity to the extent it is not inconsistent with the pass-through entity's aggregation of its businesses. An individual may elect to aggregate additional businesses with the pass-through entity's aggregated business but may not disaggregate any of the businesses aggregated by the pass-through entity.⁷⁵

Reporting Requirements

Taxpayers who hold interests in a Qualified Business through a pass-through entity generally should receive the information required to calculate their 20 percent deduction on a Schedule K-1 issued by the entity. The Section 199A regulations obligate pass-through entities to compute each owner's allocable share of qualified income, W-2 wages, and UBIA of qualified property and provide relevant disclosures for each Qualified Business.⁷⁶ If the amounts of qualified income, W-2 wages, and UBIA are not so disclosed, they are presumed to be zero,⁷⁷ and amended tax returns may be required to subsequently provide complete and accurate information.

A pass-through entity is also obligated to determine and disclose whether any of its businesses constitute an SSTB.⁷⁸ While a pass-through entity may not have the information to determine whether the taxable income of any of its owners is above the Threshold Amount, the entity is best positioned to determine whether its business constitutes an SSTB.

Careful consideration should be given to businesses potentially subject to the aggregation rules since aggregated businesses must be consistently reported in subsequent taxable years unless circumstances materially change. These rules increase compliance costs of those electing to aggregate because they must calculate their deduction for both disaggregated and aggregated businesses to make the aggregation decision.

With respect to individuals and pass-through entities electing to aggregate, the

Section 199A regulations provide annual disclosure requirements, which contain identifying information about each business constituting a part of the aggregated business.⁷⁹ Aggregation need not be reported on the initial tax return; the taxpayer can elect to aggregate the businesses in subsequent years.⁸⁰ However, a failure to aggregate may not be corrected on an amended tax return, subject to an exception for the 2018 tax year.⁸¹

Those operating rental real estate enterprises who are relying on the safe harbor of Notice 2019-07 must attach a statement to their tax return certifying that the safe harbor has been satisfied.

The Section 199A regulations still leave a lot of unanswered questions, and additional reporting disclosures might be required in certain specific situations. ■

¹ Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2054 (2017). The actual name of the act is “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.”

² The emphasis on marginal statutory tax rates is misplaced, as they do not reflect the actual tax burden on U.S. corporations. Due to deductions, credits, and the deferral of certain categories of non-U.S. source income, the pre-2018 average U.S. tax rate on pre-tax corporate profits was not significantly different from the average effective foreign tax rate.

³ I.R.C. §701 (partnerships); §1363 (S corporations). Under certain circumstances, S corporations are subject to federal corporate income tax. Moreover, California subjects an S corporation’s California-source income to corporate tax at a 1.5 percent rate. REV. & TAX. CODE §23802(b)(1).

⁴ I.R.C. §702(a) (partnerships); §1366 (S corporations).

⁵ I.R.C. §199A(c)(1).

⁶ The Section 199A regulations were reissued in corrected form in February 2019.

⁷ I.R.C. §199A(e)(2); Rev. Proc. 2018-57, 2018-49 I.R.B. 827, §3.27. The Threshold Amount is increased for cost-of-living adjustments in subsequent taxable years.

⁸ “Above-the-line” deductions (e.g., certain business deductions, employer deductions, and losses) reduce “gross income” (defined in I.R.C. §61), resulting in “adjusted gross income.” See I.R.C. §62. By contrast, “below-the-line” deductions reduce “adjusted gross income,” resulting in “taxable income.” See I.R.C. §63.

⁹ I.R.C. §63(b)(3).

¹⁰ I.R.C. §199A(f)(1)(A)(i).

¹¹ Trusts and estates generally are treated as pass-through entities to the extent qualified income is allocated to beneficiaries. To the extent qualified income is treated as retained, trusts and estates generally are treated as individuals. See Treas. Reg. §1.199A-6(d)(1).

¹² I.R.C. §199A(f)(3).

¹³ Treas. Reg. §1.199A-1(e)(3). See I.R.C. §1402, 1411.

¹⁴ I.R.C. §199A(i).

¹⁵ Treas. Reg. §1.199A-1(b)(14).

¹⁶ Commissioner v. Groetzinger, 480 U.S. 23 (1987).

¹⁷ *Id.* at 35.

¹⁸ See Higgins v. Commissioner, 312 U.S. 212 (1941).

¹⁹ 2019-9 I.R.B. 740.

²⁰ The safe harbor excludes real estate used as a residence for any part of the year under I.R.C. §280A.

²¹ For taxable years ending after December 31, 2022,

at least 250 hours of rental services must be performed in any three of the five consecutive years.

²² Treas. Reg. §1.199A-1(b)(14) provides that the rental or licensing of property to “commonly controlled” Qualified Business will be treated as a Qualified Business. Treas. Reg. §1.199A-1(b)(14).

²³ Treas. Reg. §1.199A-5(d)(3)(i). This rule only treats the purported “independent contractor” as an employee for Section 199A purposes. It does not necessary apply for other tax purposes.

²⁴ See, e.g., *Dynamex Operations W., Inc. v. Superior Ct.*, 4 Cal. 5th 903 (2018).

²⁵ Section II(A)(3)(d) of the Preamble to the Section 199A regulations [hereinafter Preamble] states that multiple businesses generally will not exist within an entity unless different methods of accounting can be used for each business under Treas. Reg. §1.446-1(d), one requirement of which is that complete and separate books and records be maintained for each business.

²⁶ See Preamble, §V(A).

²⁷ I.R.C. §199A(c)(3)(A); Treas. Reg. §1.199A-3(b)(2)(i) “Effectively connected” with a U.S. business is determined under I.R.C. §864(c), applied by substituting “qualified trade or business” for “nonresident alien individual or a foreign corporation” or for “foreign corporation.”

²⁸ I.R.C. §199A(c)(3)(B)(i)-(vii); Treas. Reg. §1.199A-3(b)(2)(ii). Other excluded investment items include amounts from certain annuities, foreign currency gains and losses, and items from notional principal contracts. *Id.*

²⁹ Treas. Reg. §1.199A-3(b)(2)(ii)(A). An example of items treated as capital gain under the I.R.C. when there may not be a sale of a capital asset is I.R.C. §1231 gains. I.R.C. §1231(a) provides that certain gains and losses from business property and involuntary conversions are treated as either long-term capital gain or loss or as items with ordinary character. Section 1231 gains and losses are excluded from qualified income. By contrast, if I.R.C. §1231 treats gains and losses as ordinary, these items must be included in the calculation of qualified income, even they derive from the disposition of a capital asset. See Preamble, *supra* note 25, at Summary §IV(A)(10).

³⁰ Treas. Reg. §1.199A-3(b)(2)(ii)(C).

³¹ See Preamble to the Proposed Regulations, Explanation of Provisions, §III(A)(vii)(b) [hereinafter Preamble to Proposed Regs.].

³² Treas. Reg. §1.199A-3(b)(2)(ii)(H). The S corporation’s deduction for reasonable compensation will reduce qualified income if the deduction is allocable to the Qualified Business. *Id.*

³³ See Rev. Rul. 74-44, 1974-1 C.B. 287. An S corporation shareholder generally would prefer dividends rather than wages because wages are subject to employment taxes.

³⁴ See Treas. Reg. §1.707-1(c); Rev. Rul. 69-184, 1969-1 C.B. 256. Instead, the partner is generally treated as an independent contractor who receives a “guaranteed payment” from the partnership, which is reported on Schedule K-1.

³⁵ I.R.C. §199A(c)(4)(B), (C); Treas. Reg. §1.199A-3(b)(2)(ii)(I), (J).

³⁶ Treas. Reg. §1.199A-3(b)(2)(ii)(I), (J).

³⁷ See Preamble to Proposed Regs., *supra* note 31, at §III(A)(vii)(d), (e).

³⁸ Treas. Reg. §1.199A-3(b)(1)(ii). See Preamble, *supra* note 25, at §IV(A)(6).

³⁹ Treas. Reg. §1.199A-1(c)(1) actually uses the term “total QBI amount.”

⁴⁰ Treas. Reg. §1.199A-1(c)(1). Treas. Reg. §1.199A-1(b)(3) defines “net capital gain” as the sum of net capital gain and qualified dividend income (as defined in I.R.C. §1(h)(1)(B)).

⁴¹ Treas. Reg. §1.199A-1(b)(13).

⁴² I.R.C. §199A(c)(2); Treas. Reg. §1.199A-1(c)(2)(i).

⁴³ See 1 H.R. Conf. Rep. 115-466, at 222 (2017).

⁴⁴ See I.R.C. §199A(d)(3); Treas. Reg. §1.199A-1(d)(2).

⁴⁵ I.R.C. §199A(d)(2) (incorporating I.R.C. §1202(e)(3)(A)).

⁴⁶ I.R.C. §199A(d)(2)(A).

⁴⁷ See Preamble to Proposed Regs., *supra* note 31, at §V(A)(2)(a)(i).

⁴⁸ Treas. Reg. §1.199A-5(b)(2)(iii).

⁴⁹ Treas. Reg. §1.199A-5(b)(2)(ii).

⁵⁰ Preamble, *supra* note 25, at §VI(A)(2).

⁵¹ Treas. Reg. §1.199A-5(b)(3)(i).

⁵² See Treas. Reg. §199A-5(c)(1)(iii)(A).

⁵³ Treas. Reg. §1.199A-5(b)(2)(vii).

⁵⁴ Preamble to Proposed Regs., *supra* note 31, at §V(A)(2)(a)(i)(f).

⁵⁵ The Treasury Department expressed concern that a broad definition of “reputation or skill” would result in substantial uncertainty for taxpayers and potentially excluding all service business income of high-income taxpayers from the 20 percent deduction would be inconsistent with Congressional intent. Preamble, *supra* note 25, at §VI(A)(13).

⁵⁶ Treas. Reg. §1.199A-5(b)(2)(xiv)(A)-(C). The regulations clarify that income includes the receipt “of equity in a pass-through entity and any income attributable to that equity. Treas. Reg. §1.199A-5(b)(2)(xiv)(D).

⁵⁷ See Treas. Reg. §1.199A-5(b)(3)(xv).

⁵⁸ Treas. Reg. §1.199A-5(c)(1)(i), (ii).

⁵⁹ Treas. Reg. §1.199A-5(c)(2)(i), (ii).

⁶⁰ See Treas. Reg. §1.199A-5(c)(2)(iii)(A)-(B).

⁶¹ Treas. Reg. §1.199A-5(a)(2).

⁶² I.R.C. §199A(f)(1)(A).

⁶³ See Treas. Reg. §1.199A-2(a)(3)(ii), (iii). When qualified property is held by a partnership, the partners’ shares of UBIA are determined based on how the partnership would allocate depreciation for book purposes on the last day of the taxable year under the capital account maintenance rules in the Treasury Regulations. Treas. Reg. §1.199A-2(a)(3)(ii). See Treas. Reg. §1.704-1(b)(2)(iv)(g).

⁶⁴ I.R.C. §§199A(b)(4)(A), 6051(a)(3), (8). Treas. Reg. §1.199A-2(b)(2)(i). Amounts are excluded as W-2 wages if they 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 such return. I.R.C. §199A(b)(4)(C).

⁶⁵ See Treas. Reg. §1.199A-2(b).

⁶⁶ See Treas. Reg. §§1.199A-2(b)(2)(ii), (iv)(B), (iv)(C).

⁶⁷ I.R.C. §199A(b)(6)(A). Treas. Reg. §1.199A-2(c)(1)(i).

⁶⁸ I.R.C. §199A(b)(6)(B). See I.R.C. §168. If qualified property that has been placed in service is subsequently added to or improved, then the addition or improvement is treated as “separate” qualified property first placed in service on the date the addition or improvement is placed in service. Treas. Reg. §1.199A-2(c)(1)(ii).

⁶⁹ See 1 H.R. Conf. Rep. 115-466, at 217 (2017).

⁷⁰ See Josh Keefe, *Last-Minute Real Estate Tax Break In GOP Bill Will Benefit Trump*, INT’L BUS. TIMES (Dec. 16, 2017), <http://www.ibtimes.com/political-capital/last-minute-real-estate-tax-break-gop-bill-will-benefit-trump-2629381>.

⁷¹ Treas. Reg. §1.199A-4(a).

⁷² See Treas. Reg. §1.199A-4(d)(13) (explaining that a business cannot be aggregated with a nonbusiness activity).

⁷³ Treas. Reg. §1.199A-4(b)(1).

⁷⁴ Treas. Reg. §1.199A-4(b)(2)(ii).

⁷⁵ Treas. Reg. §1.199A-4(b)(2)(i).

⁷⁶ Treas. Reg. §1.199A-6(b)(3)(i), (ii).

⁷⁷ Treas. Reg. §1.199A-6(b)(3)(iii).

⁷⁸ Treas. Reg. §1.199A-6(b)(3)(i)(B).

⁷⁹ See Treas. Reg. §§1.199A-4(c)(2)(i), -4(c)(4)(i).

⁸⁰ Preamble, *supra* note 26, at §V(D).

⁸¹ Treas. Reg. §§1.199A-4(c)(1), (3).

