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IRS Provides Guidance On 20% Pass-Through Deduction, But Questions Remain

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Taxes

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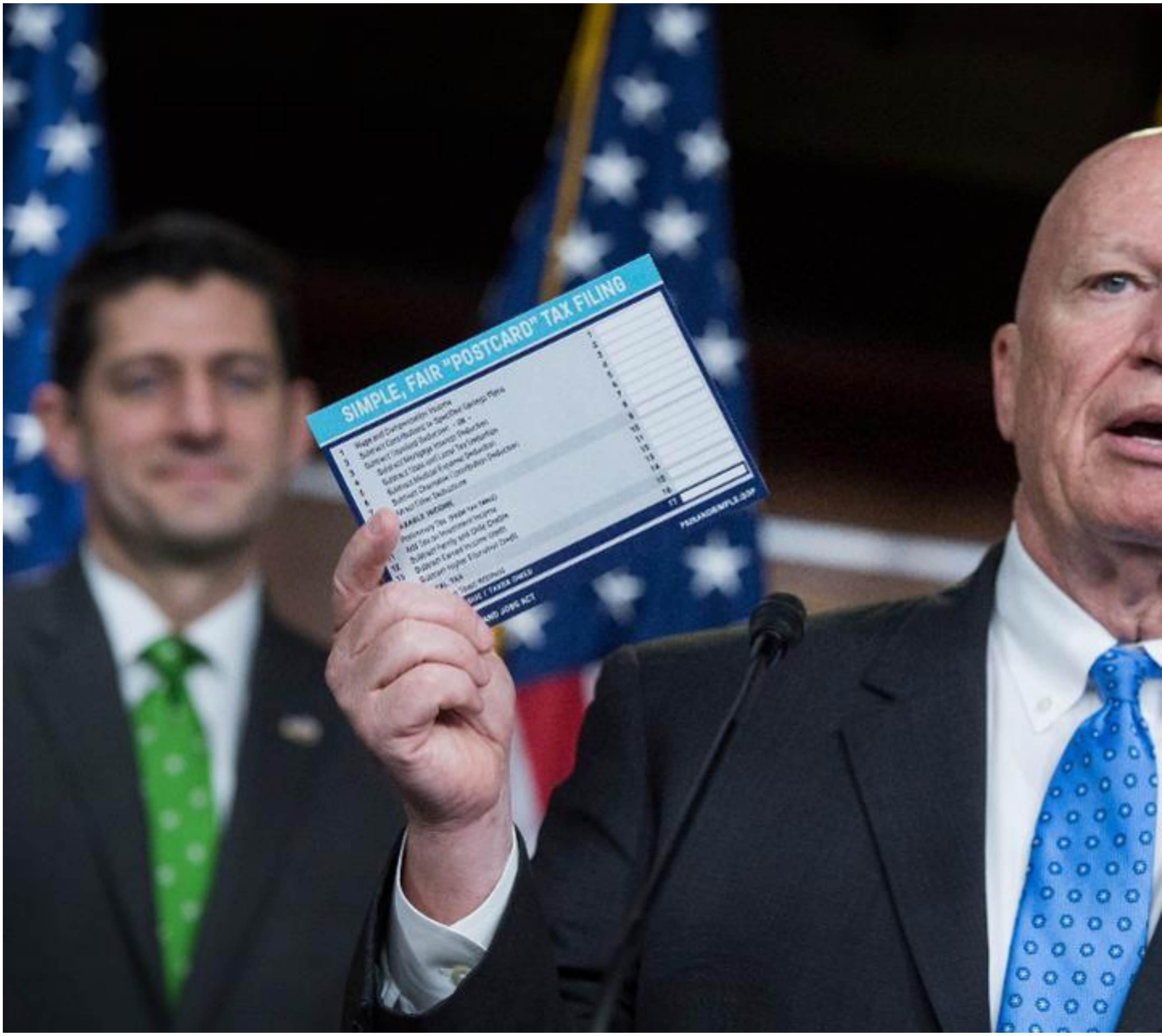
The Tax Cuts and Jobs Act -- signed into law on December 22, 2017 — gave birth to a brand new provision: Section 199A, which permits owners of sole proprietorships, S corporations, or partnerships to deduct up to 20% of the income earned by the business. While the provision has the potential to bestow a tremendous benefit upon owners of these pass-through businesses, since its enactment, no one has been able to, well... *figure out how the whole thing work*s. Quite truthfully, the statutory language of Section 199A created more questions than answers, with those queries ranging from the seemingly simple -- what do we do about a fiscal year business that crosses over January 1, 2018? -- to the much more complex -- what exactly is a "specified service business" for which a deduction is generally prohibited?



UNITED STATES - APRIL 17: Ways and Means chairman Rep. Kevin Brady, R-Texas, holds a sample of a postcard-style tax filing during a news conference in the House studio after a meeting of the GOP Conference on April 17, 2018. House Majority Leader Kevin McCarthy, R-

Calif., right, and Speaker Paul Ryan, R-Wis., also appear.(Photo By Tom Williams/CQ Roll Call)

I've spent more than my fair share of time writing and teaching about Section 199A since its enactment, and have grown weary of repeating the familiar refrain of WE DON'T KNOW YET each time someone asked a perfectly reasonable question. But that has been the reality.

Until now. Yesterday, the IRS issued 184 pages of highly-anticipated regulations that provide much-needed clarity on many -- but not all -- of the issues raised by the statute. Of course, as we'll see below, some of that clarity was not of the taxpayer-friendly variety, but that's how things go in the tax world. Let's take a look at the good and bad of the proposed regulations, but first, let's start with the basic structure of Section 199A. (And for those who want even more -- and with fewer grammatical errors -- I will be teaching a 2-hour webinar on the topic. You can register here.).

How Does it Work?

Effective for tax years beginning after December 31, 2017 and before January 1, 2026, a taxpayer other than a corporation is entitled to a deduction equal to 20% of the taxpayer's "qualified business income" earned in a "qualified trade or business." The deduction is limited for taxpayers with income in excess of a threshold, however, to the greater of:

- 50% of the W-2 wages with respect to the qualified trade or business, or
- The sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.

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The resulting deduction is then subject to a second limitation equal to 20% of the excess of:

- The taxable income for the year, over
- The sum of net capital gain (as defined in Section 1(h)).

The purpose of this overall limitation is to ensure that the 20% deduction is not taken against income that is taxed at preferential rates.

Ex. In 2018, A, a married taxpayer, has $100,000 of qualified business income, $100,000 of long-term capital gain, and $30,000 of deductions, resulting in taxable income of $170,000. A's Section 199A deduction is limited to the lesser of $20,000 (20% of $100,000) or $14,000 (20% of $70,000, the excess of taxable income of $170,000 over net capital gain of $100,000).

Who Can Claim the Deduction?

The Section 199A deduction is available to any taxpayer "other than a corporation." This includes:

- Individual owners of sole proprietorships, rental properties, S corporations, or partnerships, and
- An S corporation, partnership, or trust that owns an interest in a pass-through entity.

What is a Qualified Trade or Business?

In General

A taxpayer must be engaged in a "qualified trade or business" in order to claim the Section 199A deduction.

Section 199A defines a qualified trade or business by exclusion; every trade or business is a qualified business other than:

- The trade or business of performing services as an employee, and
- A specified service trade or business.

The first prohibition prevents an employee from claiming a 20% deduction against his or her wage income.

Ex. A is an employee, but not an owner, in a qualified business. A receives a salary of $100,000 in 2018. A is not permitted to a Section 199A deduction against the wage income, because A is not engaged in a qualified business.

Specified Service Business

This second category of disqualified businesses serves the same purpose as the first, to prevent the conversion of personal service income into qualified business income. This latter category, however, takes aim at business owners, rather than employees, prohibiting the owner of a "specified service business" from claiming a Section 199A deduction related to the business.

Section 199A(d)(2) defines a specified service business in reference to Section 1202(e)(3)(A), which includes among the businesses ineligible for the benefits of that section:

…any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

Section 199A modifies this definition in two ways: first, by removing engineering and architecture from the list of prohibited specified services businesses, before then amending the final sentence to reference the reputation or skill of one or more of its "employees or owners" rather than merely its "employees."

Section 199A(d)(2)(B) then adds to the list of specified service businesses any business which involves the performance of services that consist of investing and investing management, trading, or dealing in securities, partnership interests, or commodities.

Qualified Business Income

In General

Once a taxpayer has established that he or she is engaged in a qualified business, the taxpayer must determine the "qualified business income" for each separate qualified trade or business.

Qualified business income is defined as the net amount of qualified items of income, gain, deduction and loss with respect to a qualified trade or business that is effectively connected with the conduct of a business within the United States. Qualified business income does not include, however, certain investment-related income, including the following:

- Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss;
- Dividend income, income equivalent to a dividend, or payment in lieu of a dividend described in Section 954(c)(1)(G);
- Any interest income other than interest income properly allocable to a trade or business;
- Net gain from foreign currency transactions and commodities transactions;
- Income from notional principal contracts;
- Any amount received from an annuity which is not received in connection with the trade or business, and
- Any deduction or loss properly allocable to the items described in the bullets above.

Reasonable Compensation and Guaranteed Payments

In addition, qualified business income does not include:

- Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,
- Any guaranteed payments described in Section 707(c) paid to a partner for services rendered with respect to the trade or business, and
- To the extent provided in regulations, any payment described in Section 707(a) to a partner for services rendered with respect to the trade or business.

As discussed in this article, the decision by Congress to exclude wages paid to a shareholder or guaranteed payments to a partner from qualified business income will place those taxpayers at a disadvantage relative to sole proprietors at certain income levels.

Determining the Deductible Amount

Tentative Deduction

A taxpayer determines his or her deductible amount separately for each qualified trade or business. The taxpayer begins by computing a tentative deduction equal to 20% of qualified business income.

Ex. A owns 20% of X, an S corporation, and 30% of a Y, a partnership. Both X and Y are qualified businesses. X allocates to A $40,000 of qualified business income. Y allocates to A $20,000 of qualified business income. A's tentative deduction related to X is $8,000, and his tentative deduction related to Y is $4,000.

50% of W-2 Wages Limitation

For taxpayers with taxable income in excess of a threshold, the tentative deduction attributable to each separate qualified trade or business is limited to the greater of:

- 50% of the W-2 wages with respect to the qualified trade or business, or
- The sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.

"W-2 wages" are the total wages (as defined in Section 3401(a)) subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to its employees during the calendar year ending during the tax year of the taxpayer.

25% of W-2 Wages Plus 2.5% of Unadjusted Basis Limitation

The version of Section 199A that initially passed the Senate contained only the "50% of W-2 wages" limitation. During the subsequent conference committee meetings, however, an alternate limitation was added: 25% of W-2 wages plus 2.5% of the unadjusted basis of "qualified property."

The unstated motivation behind this late addition to the statute was to permit owners of rental property to qualify for the benefits of Section 199A. It is common that an entity that houses rental property – typically, a partnership – will not pay W-2 wages; rather, it will pay a management fee to a management company. Because a management fee is not considered W-2 wages for the purposes of Section 199A, without this last-minute change, many large landlords would have been shut out from claiming the deduction.

Ex. A owns a commercial rental property through an LLC. His share of the rental income earned by the LLC is $800,000. The LLC pays no W-2 wages, but A's share of the unadjusted basis of the building is $10,000,000. In the absence of the alternate limitation, A would be entitled to no deduction because the "50% of W-2 wages" limitation would be zero. Under the final version of Section 199A however, A is entitled to a deduction of $160,000, the lesser of 20% of qualified business income or the greater of:

- *50% of W-2 wages, or $0, or*
- *25% of W-2 wages plus 2.5% of $10,000,000, or $250,000.*

Only the unadjusted basis of "qualified property" is counted towards the limitation. Qualified property is tangible property subject to depreciation; as a result, the basis of raw land and inventory, for example, would not be taken into account.

The basis of property used to determine the limitation is unadjusted basis determined "immediately after acquisition." Thus, the basis is not reduced for any subsequent depreciation.

A taxpayer may take into consideration the unadjusted basis of property only for a year for which the "depreciable period" of the property has not ended *before the close of the tax year*. The depreciable period begins on the date the property is placed in service and ends on the later of:

- 10 years after the date placed in service, or
- The last day of the last full year in the applicable recovery period that would apply to the property under Section 168 (ignoring the alternative depreciation system).

Exception to W-2 and Qualified Property-Based Limitations Based on Taxable Income

The W-2 and qualified property-based limitations do not apply when the taxpayer claiming the deduction has taxable income for the year of less than $315,000 (if married filing jointly, $157,500 for all other taxpayers). Taxable income for these purposes is determined without regard to any Section 199A deduction.

Ex. A is a sole proprietor. The business generates $100,000 of qualified business income during 2018 but pays no W-2 wages and has no qualified property. A files jointly with his wife for 2018, and their combined taxable income for the year, including the qualified business income, is $250,000. Ordinarily, A's tentative deduction of $20,000 would be limited to $0, the greater of:

- *50% of W-2 wages, or $0, or*
- *25% of W-2 wages plus 2.5% of unadjusted basis of qualified property, or $0.*

Because A's taxable income for 2018 is less than $315,000, however, the W-2 limitations do not apply, and A is entitled to claim the full $20,000 deduction.

The W-2 limitations are phased in over the next $100,000 of taxable income (if married filing jointly; $50,000 for all other taxpayers). Thus, by the time taxable income reaches $415,000 for a married taxpayer filing jointly ($207,500 for all other taxpayers), the W-2 limitations apply in full.

Ex. A is a sole proprietor. During 2018, the business generates $400,000 of qualified business income, pays $120,000 of W-2 wages, and has $100,000 of qualified property. A files jointly with his spouse for 2018, and their combined taxable income for the year, including the qualified business income, is $600,000.

*A's tentative deduction is $80,000 ($400,000 * 20%). Because A's taxable income for 2018 is greater than $415,000, however, the W-2 limitations apply in full. As a result, A's deduction is limited to the greater of:*

- *50% of W-2 wages, or $60,000, or*
- *25% of W-2 wages ($30,000) plus 2.5% of unadjusted basis of qualified property ($2,500), or $32,500.*

Thus, A is entitled to a $60,000 deduction in 2018.

For guidance on what to do when the taxpayer's taxable income is within the phase-out range, read this post.

Exception to the Denial of Deductions for Specified Service Businesses Based on Taxable Income

Similarly, the prohibition on claiming the Section 199A deduction against income earned in a specified service business does not apply if the taxpayer claiming the deduction has taxable income of less than $315,000 (if married filing jointly; $157,500 for all other taxpayers). Because the two W-2-based limitations also do not apply when taxable income is below those same thresholds, a taxpayer in a specified service business with taxable income below the thresholds simply deducts 20% of any qualified business income (subject to the overall limitation).

Ex. A, a single taxpayer, is an attorney who operates his business as a partnership. The partnership pays no W-2 wages during the year. During 2018, A earns $100,000 from his law business and has total taxable income of $150,000. While A would normally be barred from claiming a deduction under Section 199A by virtue of being engaged in a specified service business, because A's taxable income is less than $157,500, the prohibition on specified service businesses does not apply. In addition, because taxable income is less than $157,500, the W-2 limitations do not apply. As a result, A's final deduction is $20,000 (20% of $100,000).

The ability to claim the deduction for owners of a specified service business is phased out over the next $100,000 of taxable income (if married filing jointly; $50,000 for all other taxpayers), so that by the time taxable income exceeds $415,000 (if married filing jointly; $207,500 for all other taxpayers) the deduction is lost completely.

Ex. Same facts as in the previous example, except A has taxable income of $230,000. Because taxable income exceeds $207,500, A is not entitled to any deduction under Section 199A.

For an example of how to determine the deduction attributable to a specified service business when a taxpayer has taxable income within the phase-out range, read this post.

PROPOSED REGULATIONS

At long last, we've got guidance under Section 199A. Let's break down the regulations by taking a look at the unanswered questions that emerged from the statutory language we just covered, and how the regulations address those questions. We'll go topic-by-topic, starting with the area of greatest interest:

Definition of Specified Service Trades or Businesses

1. What did we know? OK, we can all read. We know that Section 199A defined a specified service business -- for which no deduction is allowed once the owner's taxable income exceeds $415,000 (if married filing jointly, $207,500 for all other taxpayers) -- as follows:

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

2. What didn't we know? What any of that actually *means.* And this is largely attributable to the fact that this definition was largely stolen directly from Section 1202, and while that provision is a useful one, it has only recently become so. As a result, there are (almost) no court decisions or administrative rulings to help us make sense of what it means to perform services in one of these prohibited fields.

3. What do the Regulations say?

The regulations provide much needed clarity on the definition of a specified service trade or business (SSTB). Of course, the authors couldn't possibly anticipate every alternative, so there will surely be fact patterns that continue to create confusion. But here's what was addressed:

De Minimis Rule

The regulations provide a de minimis exception that will allow a business that both sells product and performs services to avoid being treated as a SSTB. Regulation Section 1.199A-5(c) states that if a trade or business has gross receipts of $25 million or less for the tax year, it will NOT be treated as a SSTB as long as less than 10% of the gross receipts of the business are attributable to the performance of services in one of the disqualified fields listed above. If a business has gross receipts in excess of $25 million, a similar de minimis rule exists, only 10% is replaced by 5%.

Ex. X Co. has annual revenue of $20 million. $18.5 million of the revenue is attributable to the sales of computers, and the remaining $1.5 million is attributable to consulting, installation, and training services. Because X Co.'s consulting services comprise less than 10% of X Co.'s total receipts, those services are ignored, and X Co. is not treated as a SSTB.

Definitions of Specific Disqualified Fields

The regulations attempt to leverage off existing regulations under Section 448 and provide further interpretation of the disqualified fields. Let's see who's disqualified and who isn't in each field:

- Health

  - Disqualified: doctors, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide services directly to a patient.
  - Not disqualified: people who provide services that may improve the health of the recipient, such as the operator of a health club or spa, or the research, testing, and sale of pharmaceuticals or medical devices.
- Law
  - Disqualified: Lawyers, paralegals, legal arbitrators, and mediators.
  - Not disqualified: Those that provide services not unique to law, like printing, stenography, or delivery services.
- Accounting
  - Disqualified: Accountants, enrolled agents, return preparers, financial auditors, bookkeepers, and similar. You don't need to be a licensed CPA to fall victim to this rule.
  - Not disqualified: No one, from what I can tell. We're all screwed.
- Actuarial Science:
  - Disqualified: actuaries and similar professionals.
  - Analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.
- Performing Arts:
  - Disqualified: Actors, singers, musicians, entertainers, directors, and similar professionals who provide services that lead to the creation of performing arts.
  - Not disqualified: Those who broadcast or disseminate video or audio to the public, and those who maintain or operate equipment or facilities used in the performing arts.
- Consulting:
  - Disqualified: those who provide professional advice and counsel to clients to assist in achieving goals and solving problems, including government lobbyists.
  - Not disqualified: Salespeople and those who provide training or educational courses. This category also does not include any services ancillary to the sale of goods in a business that is NOT a SSTB (such as a building contractor) as long as there is no separate fee for the consulting services.
- Athletics:
  - Disqualified: athletes, coaches, team managers.
  - Not disqualified: Broadcasters or those who maintain or operate equipment used in an athletic event.
- Financial Services:
  - Disqualified: Those who provide financial services to clients including managing wealth, developing retirement or transition plans, M&A advisory, valuation work. In other words, financial advisors, investment bankers, wealth planners, and retirement advisors.
  - Not disqualified: Banking!
- Brokerage Services
  - Disqualified: A broker who arranges transactions between a buyer and a seller with *respect to securities;* i.e., a stock broker.
  - Not disqualified: Owing to the italics above, a real estate broker is OK!

- Investment Management
  - Disqualified: Those who receive fees for providing investing, asset management, or investment management services.
  - Not disqualified: REAL ESTATE MANAGEMENT!
- Trading:
  - Disqualified: those who trade in securities, commodities or partnership interests.
  - Not disqualified: A farmer or manufacturer who engages in hedging transactions as part of their trade or business.

Application of the 'Catch-All"

The most concerning aspect of the Code's definition of a SSTB is the catch-all that includes "*any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees."*

The most obvious problem posed by the catch-all is that it threatened any taxpayer who was not engaged in one of the businesses that is specifically listed as a disqualified field. Consider the case of a "personal trainer to the stars:" using the definition of a SSTB found in Section 199A and the proposed regulations, the argument can be made that the trainer is not in the field of health or athletics.

Application of the catch-all, however, if interpreted broadly, would likely yield a different result. What is the principal asset of a celebrity personal trainer if not the reputation and expertise of that trainer?

Fortunately -- and to me, this is the BIGGEST news in the entirety of the proposed regulations -- the IRS chose to define the catch-all VERY narrowly. Only the following trades or businesses will fall victim to the catch all because their principal assets will be treated as the skill or reputation of its employees:

- A trade or business in which a person receives fees, compensation, or other income for endorsing products or services,
- A trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, or
- Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

The regulations provide a couple of illustrative examples, including this one:

Ex. H is a well known chef and the sole owner of multiple restaurants, each of which is owned in a disregarded entity. Due to H's skill and reputation as a chef, H receives an endorsement fee of $500,000 for the use of H's name on a line of cooking utensils and cookware. H is in the trade or business of being a chef and owning restaurants and such trades or businesses are NOT SSTBs. However, H is also in the trade or business of receiving endorsement income. H's trade or *business consisting of the receipt of the endorsement fee for H's skill and/or reputation is an SSTB.*

I love this example, because it makes clear that while H cannot take the 20% deduction against his endorsement income, he CAN against his restaurant, even though he is a famous chef. In other words, the fact that he's famous -- and that his reputation is likely the primary drawing card of the restaurant -- does not make that business a SSTB via the catch-all. Instead, his endorsement/licensing/appearance fee income is "carved out" and treated as an SSTB, preserving everything else. Prior to the regulations, the expectation was that the restaurants WOULD be SSTBs in this scenario given the chef's reputation, so this is a welcome interpretation. It basically means that:

1. If you ain't famous, as long as you don't provide services in one of the specific disqualified fields, you are not in an SSTB, even if your skill or reputation is the only thing you have to sell, such as a personal trainer or author.
2. Even if you ARE famous, it's only the income you earn from licensing your likeness, shilling products, or making appearances that will be treated as ineligible for the 20% deduction.

Services or Property Provided to a Specified Service Trade or Business

The moment the statute was finalized, tax lawyers and CPAs scrambled to find ways to strip income OUT of a specified service business and into a business that was eligible for the 20% deduction. The first of these strategies was coined "cracking," and involved removing a qualified business from an SSTB and having it charge a fee to the SSTB; for example, the owners of a law firm would purchase a building in a separate LLC and rent the building to the law firm. This would reduce the income in the law firm -- which isn't eligible for a 20% deduction anyway -- and move it to a rental activity, where -- the thought was -- it would be treated as qualified business income.

The proposed regulations put a big damper on cracking, however, by providing that an SSTB includes any trade or business that provides 80% or more of its property or services to an SSTB, as long as the two businesses share 50% or more common ownership.

Ex. A and B own law firm AB. A and B purchase a building in AB LLC, and rent the entire building to the law firm. The building is the only asset the LLC owns. Even though the rental of real property is generally not treated as an SSTB, because 1) more than 80% of the building is being rented to an SSTB (the law firm), and 2) the same owners own 50% or more of both the LLC and the law firm, the rental income is treated as being earned in an SSTB, and is not eligible for the 20% deduction.

If a trade or business provides LESS than 80% of its property or services to a commonly-controlled SSTB, while the entire business is not treated as an SSTB, any income earned from the rental of property or provision of services to the SSTB is treated as income earned in an SSTB and is ineligible for the 20% deduction.

Ex. Same facts as in the example above, except only 50% of the building is rented to the law firm, with the other 50% rented to an unrelated party. In this case, the entire rental business is not treated as an SSTB (because less than 80% of the rental is to a commonly-controlled SSTB), but the income attributable to the rental of the building to the law firm IS treated as income earned in an SSTB, and is not eligible for the 20% deduction.

This rule, while taking up only a few brief paragraphs in the proposed regulations, effectively kills the cracking idea. Now, a law firm that engages in a self-rental or a doctor group that sets up a separate administrative entity will find that those new businesses, while once thought to avoid classification as an SSTB, will in fact be treated as such, at least to the extent the property is rented or services provided to the related SSTB.

Of course, now owners of SSTBs will simply have to get more creative to beat the system, by finding a way to keep common ownership below the 50% tipping point. It won't be easy, however, because the attribution rules that govern the related party provisions of Section 267(b) and 707(b) apply for these purposes.

Ex. A and B own a law firm that generates $1,000,000 in revenue. C and D, unrelated to A and B, own an accounting firm that generates $2,000,000 in revenue. To strip earnings out of the two SSTBs, A, B, C and D team up with a fifth individual, E, and purchase a commercial building. A and B own a combined 49% of the building, D and E own another 49%, and E owns 2%. The building charges both the law firm and the accounting firm rent of $500,000 each. This strips earnings out of the law firm and accounting firm and moves it to the rental LLC.

In this case, the rental income allocated to A, B, C and D should not be reclassified as income from an SSTB, because neither the owners of the law firm (A and B) and accounting firm (C and D) do not own 50% or more of the rental LLC. Thus, A, B, C and D can claim a 20% deduction against the rental income.

4. Takeaway This is not the last we've heard about the definition of a specified service business. Many common businesses will slip through the cracks. Is a radiologist who reads films, but doesn't directly treat a patient, in the field of health? Is a DJ who performs live, but only plays other people's music an artist? As with all things in the tax law, we'll need to build up a pile of precedent in the form of court cases and administrative rulings in order to fill in the gaps.

Here's who's happy: real estate brokers, property managers, architects, engineers, and bankers. They will get the deduction regardless of income level, because they are not engaged in a SSTB. Oh, and anyone with a kick-ass reputation that helps them make their millions, provided none of those millions are from endorsements, likeness rights, or appearance fees. Courtesy of the extremely narrow interpretation of the catch-all, regardless of how integral their reputation may be to their business, that business will not be treated as a SSTB, unless it is engaged in one of the specifically delineated disqualified fields.

Here's who's *not* happy: any taxpayer that got a bit impatient after Section 199A came out, and jumped onto the cracking opportunity, spending time and money to establish a new rental or administrative entity that was likely just converted into a disqualified SSTB by the stroke of a pen.

Treatment of Employees-Turned-Independent Contractors

1. What did we know? An employee is not permitted to claim the Section 199A deduction against wage income because an employee is not treated as being in a qualified trade or business.

2. What didn't we know? How the IRS would prevent employees from running to their employer and asking to be treated as independent contractors so as to take advantage of the Section 199A deduction.

3. What do the Regulations say? They basically create a series of rules intended to prevent abuse. First, as we expected, the general employee versus independent contractor analysis will hold true. Thus, it is immaterial if an "employer" treats a service provider as an employee if the IRS finds that the service provider is truly an employee using the relevant factors.

Next, if a person WAS an employee of an employer, but suddenly becomes an independent contractor while providing substantially the same services directly or indirectly to the former employer, it is presumed that they are STILL an employee for purposes of Section 199A, and thus ineligible for the Section 199A deduction. This presumption may be overcome if the employee-turned-independent contractor can show that under Federal tax law, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than an employee. The regulations contain an example that effectively puts an end to what was once considered a popular planning idea:

Ex. C is an attorney employed as an associate with Law Firm 1. C and the other associates in Law Firm 1 have taxable income below the threshold amount. Law Firm 1 terminates its employment relationship with C and its other associates. C and the other former associates form a new partnership, Law Firm 2, which contracts to perform services to Law Firm 1. C continues to provide substantially the same services to Law Firm 1 and its clients through Law Firm 2. The goal, obviously, was for C to convert wage income into pass-through income from Law Firm 2 that is eligible for the 20% deduction (even though Law Firm 2 is a SSTB, C is below the taxable income threshold).

Because C was formerly an employee of Law Firm 1 and continues to provide substantially the same services to Law Firm 1, C is presumed to be in the trade or business of being an employee of Law Firm 1. Unless the presumption is rebutted, C's distributive share of income from Law Firm 2 will be treated as akin to wages, and will not be treated as qualified business income.

It's important to note, this recharacterization from independent contractor to employee is only for the purposes of Section 199A. It does not automatically convert the taxpayer to an employee for payroll tax purposes.

4. Takeaway The anti-abuse presumption may help stem the anticipated rush of employees to flee employment status. Of course, if an employee leaves his or her employment and takes an independent contractor role with a NEW company, the presumption doesn't apply. So as long as you're not too wedded to your current bosses, a 20% deduction is within reach!

Aggregation of Commonly Controlled Businesses

1. What did we know? Section 199A required that the deduction be determined on a business-by-business basis. This was going to send a lot of taxpayers scrambling in order to make sure the mix of qualified QBI, W-2 wages and property basis were such that it would maximize each, separate deduction.

2. What didn't we know? Would the IRS bail taxpayers out? Would it provide the ability to elect to aggregate businesses, perhaps by leveraging off the existing aggregation regime of Section 469?

3. What do the regulations say? Good news: The regulations gave us an aggregation regime! Bad news: They did not leverage off of the existing regime of Section 469, meaning that taxpayers and their advisors will have to understand the difference between the two sets of rules, and keep track of what are likely to be entirely different groupings for different purposes of the Code.

Aggregation under Section 199A can only be done when the following requirements are met:

- The same person or group of persons, directly or indirectly, own 50% or more of each business to be aggregated. For S corporations, the ownership is measured by reference to the outstanding stock; for partnerships, it is measured by reference to the interest in capital or profits in the partnership. There are obviously attribution rules for these purposes.
- The "control test" is met for the "majority" of the tax year.
- The businesses share the same tax year.
- None of the businesses may be SSTBs.
- The businesses to be aggregated much satisfy two of the following three factors:
    - They must provide products or services that are the same or customarily offered together;
    - They must share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or
    - The businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

Aggregation is done at the owner level; thus, one owner of a business may elect to aggregate that business with another business while a second owner may not choose to do so. By apparently allowing a taxpayer to group some activities while leaving others alone, this aggregation regime more closely resembles the "slice and dice" grouping rules of Section 1.469-4, as opposed to the "all or nothing" grouping regime for real estate professionals under Reg. Section 1.469-9(g).

Aggregation under Reg. Section 1.199A-4 is purely elective, and generally cannot be revoked once an election is made. If a new business comes into the fold, however, the taxpayer may add the new business to any previously aggregated businesses provided all of the requirements are met. If at any point, previously aggregated businesses no longer meet the requirements for aggregation, the aggregation will cease to exist. For EACH year, individuals must attach a statement to their returns identifying each aggregated business, and include additional information as required by the regulations. Failure to disclose the aggregation may result in the IRS disallowing the grouping.

If you elect to aggregate, you determine your share of QBI, W-2 wages, and property basis for the aggregated businesses before computing the deduction.

Ex. E owns a 60% interest in the capital and profits of each of four partnerships (PRS1, PRS2, PRS3, and PRS4). Each partnership operates a hardware store. A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the businesses as a whole. Human resources and accounting are centralized for the four businesses. E elects to aggregate PRS1, PRS3, and PRS4 for purposes of Section 199A, and leaves PRS2 alone. PRS2 is the only business that generates a loss.

Because E owns more than 50% of the capital of each of the four partnerships, and because the partnerships 1. sell the same product, and 2. have centralized management, they are eligible to be grouped together. Thus, A aggregates the QBI, W-2 wages, and property basis of PRS1, PRS3 and PRS4 together before reducing the QBI (with no impact on the W-2 wages, see discussion later in this article on netting of losses) for the loss generated by PRS2.

It is important to remember, the electing owner does not have to own more than 50% of each business directly; rather, he or she must simply establish that SOMEONE owns 50% or more of all of the entities the owner wishes to aggregate.

Ex. F owns a 75% interest in five partnerships. G owns a 5% interest in each of the five partnerships. H owns a 10% interest in only two of the partnerships. Each partner is a restaurant and shares centralized function and management. F may elect to aggregate all five partnerships. So may G, even though G owns only a 5% interest in each partnership, because G can show that F owned 50% or more of each of the partnerships, thus they are "commonly controlled." H may only aggregate the two partnerships in which H owns an interest.

In order to include a business within an aggregated group, as described more fully below, the activity must rise to the level of a Section 162 trade or business.

Ex. C owns 60% of a sailboat racing team and also owns an interest in PRS1, which operates a marina. Because the sailboat racing team does not rise to the level of a Section 162 trade or business, it cannot be aggregated with the marina. Furthermore, any income from the team is not qualified business income.

Through a special rule in the regulations, however, an activity WILL be treated as a trade or business if the activity rents or licenses tangible or intangible property to a commonly controlled trade or business of the taxpayer.

Ex. G owns 80% of the stock of S1, an S corporation that leases property to LLC1 and LLC2. The two LLCs manufacture and sell widgets. G also owns 80% of LLC1 and LLC2. While S1, as the owner of a rental property, generally might not be considered to rise to the level of a Section 162 trade or business, under Proposed Reg. Section 1.199A-1(b)(13), because S1 leases to a commonly controlled business, S1 is treated as a trade or business and may be aggregated with LLC1 and LLC2.

4. Takeaway Adding an aggregation rule will provide welcome relief to many taxpayers who had long ago established business structures that may not have yielded ideal results under Section 199A: for example, when one entity has a lot of income and low W-2 wages, while a different entity has high wages and low income. Aggregation solves that conundrum, but at the same time, adds further complexity to the Code by forcing taxpayers and their advisors to learn a new set of rules and make a new grouping election; one that may be dramatically different than the taxpayer's aggregated activities for purposes of Section 469.

What is a Qualified Trade or Business

1. What did we know? Before a business could generate QBI, it had to meet the definition of a qualified "trade or business."

2. ***What didn't we know?*** By using the term "trade or business," was Congress requiring that a business rise to the level of a Section 162 trade or business? Case law has determined that to reach the standard of a Section 162 trade or business, a taxpayer must be involved in the activity "with continuity and regularity" (and not "merely sporadically"); and the taxpayer's primary purpose for engaging in the activity must be for income or profit. As a result, whether an activity constitutes a Section 162 trade or business is generally a factual decision.

A Section 162 standard is particularly problematic in the context of rental properties. When determining whether a rental rises to the level of a trade or business, the courts have based their decisions on various factual elements, including the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).

In light of this uncertainty, we were very, very desperate for proposed regulations to take the Section 162 determination out of our hands, perhaps by providing a safe harbor hour requirement similar to the one found in the net investment income tax regulations of Section 1411. Alas, it was not to be.

3. What do the Regulations say? This ain't good. They are sticking it to us. The regulations require that every business be able to separately establish that it rises to the level of a Section 162 trade or business, and that means big problems for landlords. There's not even a carve-out for real estate professionals under Section 469(c)(7), meaning even those who truly ply their trade in the rental real estate world will have to establish that the rentals satisfy the nebulous Section 162 standard.

The regulations provide only one exception, found at Reg. Section 1.199A-1(b)(13), which provides that if a taxpayer rents or leases tangible or intangible property to a commonly controlled trade or business (a self-rental), the self-rental activity is treated as a Section 162 trade or business. A commonly controlled business is defined in the same manner as in the aggregation rules discussed above. The purpose of this rule is to allow the owners of the two activities to aggregate the businesses together under the rules described above, though the taxpayer is not REQUIRED to aggregate them.

4. Takeaway The only solace one can take from the Section 162 trade or business requirement found in the proposed regulations is that the same standard was demanded in the proposed regulations to Section 1411. By the time final regulations were published, however, the IRS had come to its senses and provided the aforementioned safe harbor. Perhaps a similar form of relief will be found in the final Section 199A regulations. But if not, it's time to learn your Section 162 case history, and perhaps prepare your clients for the need to redo leases to strengthen the case that their rental activity is a trade or business.

Determining W-2 Wages for Commonly Controlled Businesses and PEOs

1. What did we know? Under the statute, the Section 199A deduction is determined on a business by business basis, and the W-2 and property basis limits apply separately for each business.

2. What didn't we know? What we would do about a very common business structure, like this one:

A and B together own S corporations in ten states, all of which conduct the same business. All of the employees for the operating companies are housed in one management company. In addition, none of the operating companies hold significant qualified property.

Based solely on the statute, Section 199A did not allow for an allocation of the W-2 wages paid by the management company to each of the operating companies. As a result, assuming A and B have taxable income in excess of the threshold amounts, they would be precluded from claiming a deduction related to the operating companies courtesy of the W-2 limitations. Similar problems arise in the case of leased employees through a professional employer organization (PEO) or employee leasing firm.

3. What do the regulations say? We hoped the regulations would allow for an allocation of W-2 wages or an aggregation regime. We got both. Because we already discussed aggregation, let's take a look at the new allocation rules.

Proposed Reg. Section 1.199A-2 provides that an individual looking to claim a deduction related to a particular business can take into account any W-2 wages paid by another business, provided that the W-2 wages were paid to "common law employees or officers" of the business for which the taxpayer is claiming the deduction. Of course, in this case, the business who actually paid and reported the W-2 wages that are being allocated to the common law employer must reduce its W-2 wages for purposes of Section 199A by that amount. This treatment extends to professional employer organizations (PEOs), allowing a taxpayer who uses leased employees to allocate a portion of the PEO's W-2 wages to the taxpayer.

So how do we go about actually allocating W-2 wages to a common law employer? Well, apparently, 184 pages of regulations weren't enough to allow for such guidance, so in addition to the proposed regulations, we also got another 14 pages of Notice 2018-64 to lay down the law specific to the allocation of W-2 wages. This notice provides three possible methods for determining W-2 wages; I won't get into detail about them here, because there are FAR too many references to W-2 boxes for my liking. Perhaps it will warrant a separate post.

Once W-2 wages are allocated to common law employers, the work is not done. Those wages must then be allocated WITHIN the common law employer, if that employer happens to have more than one business. Then -- and this the part you won't like if you're preparing the partnership or S corporation return -- you'll have to report on the Form 1065 or 1120-S each partner or shareholder's allocable share of the W-2 wages.

4. Takeaway The allocation of W-2 wages will likely serve as a backup plan for businesses that aren't eligible to be aggregated under the regulations at Section 1.199A-4.

Treatment of a Fiscal Year Business with a Year Straddling January 1, 2018

1. What did we know? Section 199A is effective January 1, 2018.

2. What didn't we know? What do we do about an owner of a fiscal-year business, whose tax year straddled January 1, 2018? To illustrate, assume calendar year individual A owns an S corporation with a fiscal year-end of May 31, 2018. Is A permitted to claim a Section 199A deduction on his or her 2018 Form 1040 against only the income earned by the S corporation from January 1, 2018 through May 31, 2018? Or is A allowed a deduction against the income earned from June 1, 2017 through May 31, 2018, even though seven months of the income was earned *before* the effective date of Section 199A?

3. What do the Regulations Say? The regulations make clear that an owner of a fiscal year business that straddles January 1, 2018 may take the full amount of QBI, W-2 wages, and property basis into account despite the fact that, for example, some portion of the income and wages were earned and incurred prior to 2018. Effectively, the regulations treat all of the income and wages as being earned and incurred during 2018. Thus, in the example above, the shareholder would be entitled to claim the deduction against the full amount of income allocated to A on the K-1 from the S corporation, because that income is reported on A's 2018 tax return.

4. Takeaway Does this mean -- and I suspect it does -- that the owner of the right kind of business -- think architects or engineers -- could claim both a Section 199A deduction AND a

Section 199 deduction (this provision wasn't repealed until December 31, 2017) for the same income -- i.e., income earned by a fiscal year business before December 31, 2017?

Treatment of S Corporation Reasonable Compensation

1. What did we know? The statute provides that wages paid by an S corporation to a shareholder are included in the W-2 wage limitation. Furthermore, those same wages are NOT treated as QBI to the shareholder.

2. What didn't we know? If this made any sense, because it meant that sole proprietors and sole shareholders in an S corporation would wind up with different Section 199A deductions at different income levels. To illustrate, consider the following example:

Ex. A and B own identical businesses. Neither business has any employees or any qualified property. Each business generates $500,000 of qualified business income before any wages are paid. A operates his business as a sole proprietor; B as a wholly-owned S corporation. Because A's has no employees – and because as a sole proprietor, A cannot pay himself a wage – A has a W-2 wage limitation of $0. Thus, A is entitled to no deduction.

As opposed to a sole proprietor, a shareholder who provides significant services to an S corporation is required to receive "reasonable compensation." This requires a shareholder to be paid W-2 wages from the corporation; wages that Section 199A appears to include in the total wages paid by the business for the purposes of the W-2 limitation. This will place sole shareholders in an S corporation in an advantageous position relative to sole proprietors at income levels where the W-2 limitations apply in full.

*Ex. Continuing the previous example, B, as a shareholder in an S corporation, must comply with the reasonable compensation requirement. As a result, assume B pays himself $80,000 in 2018. Because the $80,000 of reasonable compensation B receives from the corporation is not included in qualified business income, B's tentative deduction is $84,000 (20% * $420,000). This reasonable compensation creates $80,000 of W-2 wages, however, and a corresponding W-2 limit of $40,000. This leaves B with a deduction of $40,000.*

In summary, A, who operates a business as a sole proprietorship, gets no deduction, while B, who operates an identical business as a wholly-owned S corporation, is entitled to a deduction of $40,000 by virtue of being required to pay himself wages. This result makes little sense given the objectives of Section 199A.

Making matters worse, contrary to the preceding example, a shareholder of an S corporation is disadvantaged relative to a sole proprietor when the owner's taxable income is *below* the threshold at which the W-2 limitations apply. This is because Section 199A provides that qualified business income *does not include* reasonable compensation paid to a shareholder in an S corporation or guaranteed payments paid to a partner in a partnership. Consider the following example:

Ex. Same facts as in the previous examples, except the income earned in each business is $150,000 rather than $500,000. Assume further that both A and B have taxable income below the $315,000/$157,500 thresholds.

A, the sole proprietor, is entitled to a deduction of $30,000 (20% of $150,000). B, the sole shareholder of the S corporation, remains required to pay himself reasonable compensation. Assume he is paid W-2 wages of $70,000. This reduces the qualified business income B receives from the S corporation to $80,000, and in turn reduces B's Section 199A deduction to $16,000.

Thus, when income is below the threshold, the reasonable compensation requirement works against the shareholder in the S corporation, reducing both his qualified business income and Section 199A deduction. A, the sole proprietor, has no such requirement, and thus preserves the full amount of his qualified business income, giving him a deduction of $30,000 when his S corporation shareholder counterpart receives a deduction of only $16,000.

These inequities could be resolved fairly simply, by:

1. Providing that the W-2 wage limitations do not include any amounts paid to an S corporation shareholder, and
2. Providing that any reasonable compensation or guaranteed payments received by an owner of a qualified business are included in the determination of qualified business income.

3. *What do the Regulations say?* Nothing. W-2 wages continue to include amounts paid to an S corporation shareholder, and QBI continues to not include wages received by a shareholder. As a result, these inequities continue.

4. Takeaway Similarly situated taxpayers should generally enjoy similar federal income tax consequences. But by virtue of two pieces of Section 199A – the inclusion of wages paid to an owner in the W-2 limitation and the exclusion from qualified business income of reasonable compensation and guaranteed payments paid to an owner – inequities arise at all income levels. If I'm a sole proprietor with income above the taxable income threshold, I'm taking a hard look at converting to an S corporation, paying a small salary, and maximizing the Section 199A deduction.

Treatment of A QBI Loss

1. What did we know? Not much. The statute did not specifically address how to compute the deduction for a taxpayer who operates multiple qualified trades or business, one or more of which generate qualified business income, and one or more of which generate a loss. It did provide rules for when the taxpayer's NET QBI was a loss, as follows:

"If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year."

2. What didn't we know? OK, the statute told us how to handle a *net* loss. But what if a taxpayer had one business kick off QBI and another a loss: what then? Because the deduction is determined on a business by business basis (at least until the new aggregation rules became available), as are the W-2 limitations, you could end up with some REALLY weird results. Consider the following example:

In 2018, A, a married taxpayer, is allocated $400,000 of qualified business income from business 1 and $300,000 of qualified business loss from qualified business 2. Assume that A's share of the W-2 wages paid by business 1 is $100,000, and that A's taxable income is in excess of $415,000, so that the W-2 limitations apply in full. A's tentative deduction attributable to business 1 of $80,000 is limited to $50,000 (50% of $100,000). Does A then compute a negative deduction of $60,000 attributable to the loss from business 2 (20% of a $300,000 qualified business loss), thereby leaving A with a Section 199A deduction of $50,000 attributable to business 1 but a "negative" Section 199A deduction of $60,000 attributable to business 2?

3. What do the Regulations Say? The IRS must have become aware of the problem in the statutory construction, because the proposed regulations devote several pages to the loss issue. First things first, let's skip the aggregation election for now, and assume each business stands on its own.

Under the proposed regulations, if the net amount of all positive and negative QBI is a loss, as was provided in the statute, no deduction is allowable in the current year and the net loss is carried forward to the next year. The regulations make clear, however, that no W-2 or basis amounts carry forward.

If the net of all positive and negative QBI is positive, however, but at least one business produces a loss, the loss must be allocated among all of the businesses that produce QBI in proportion to their respective amounts of QBI. Only after this allocation and netting takes place are the W-2 and basis limitations applied, and no part of the W-2 amounts or basis of property attributable to the loss business are taken into account by the income-producing businesses.

Consider the previous example. Under the regulations, the $300,000 of loss from business 2 would reduce the $400,000 of QBI from business 1 BEFORE application of the W-2 and property limitations. Thus, the net QBI is $100,000, and A's deduction is limited to the lesser of $20,000 (20% of $100,000) or $50,000 (50% of business 1's W-2 wages of $100,000), or $20,000.

By forcing a taxpayer to allocate a loss proportionately among multiple businesses that generate QBI, it prevents potential abuse.

In 2018, A, a married taxpayer, is allocated $100,000 of qualified business income from business 1 that pays $50,000 of W-2 wages. A is also allocated $100,000 of QBI from business 2 that has $0 in W-2 wages. Finally, A is allocated a $100,000 loss from business 3 that pays $70,000 in W-2 wages. Barring a rule to the contrary, A could try to net the $100,000 loss from business 3 with the $100,000 of income from business 2, because A knows he would not get a deduction attributable to business 2 in any case, because business 2 has paid no wages.

To prevent this result, the proposed regulations require the $100,000 loss from business 3 to be allocated to business 1 and business 2 in proportion to their QBI. Thus, each business is allocated a $50,000 loss. Business 1 has a net QBI of $50,000, and a deduction equal to the lesser of $10,000 (20% of $50,000) or $50,000 (50% of W-2 wages of $100,000). Business 2 has net QBI of $50,000 as well, but no deduction because business 1 paid no W-2 wages. A's total deduction is $10,000.

Of course, under the proposed regulations, as discussed above, a taxpayer may elect to group *qualifying* businesses together. If this is done, the QBI income and loss, W-2 wages, and basis of property are all combined; this will often prove advantageous, particularly when the loss company has W-2 wages.

Ex. Continuing the example above, if A is eligible to and elects to aggregate businesses 1, 2 and 3, A will simply compute one Section 199A deduction, using the following combined amounts: $100,000 of QBI and $120,000 of W-2 wages. A's deduction is the lesser of $20,000 or $60,000, or $20,000. Thus, by aggregating, A has increased his Section 199A deduction by $10,000.

Treatment of a Net PTP/REIT Dividend Loss

The regulations provide that if a taxpayer's PTP loss exceeds his or her qualified REIT dividends, this net loss does NOT reduce or any way impact QBI from a business; rather, the net loss is carried forward, and in the next year, that carryforward loss can only be used to offset PTP/REIT dividend income.

4. Takeaway These netting rules reach a logical result. Taxpayers will have to perform an analysis of multiple sources of QBI and determine their best option: to net or to aggregate?

When The Owner of A Specified Service Business Has Taxable Income In the Phase Out Range, Is The Owner Subject To One Phase-Out or Two?

1. What did we know? Once the taxable income of a business owners exceeds $315,000 (if married, $157,500 for everyone else), over the next $100,000 of income (if married, $50,000 for everyone else), two things happen:

- The ability to take the deduction is limited for the owner of a specified service business, and
- The W-2 and basis limitations are phased in.

If you'd like to see how these phase-outs and phase-ins work, check out this article.

2. What didn't we know? Some practitioners had questioned whether the owner of a specified service business with taxable income within the phase-out range had to apply BOTH limitations; i.e., first determine the reduced deduction amount under the SSTB rules, and THEN phase-in the W-2 limitations. It has always been my opinion that to reach an equitable result, you had to do both, but some had argued that only the former step was necessary.

3. What do the Regulations say? The proposed regulations make clear that the owners of a specified service business do in fact have to go through BOTH calculations. Don't believe me? Check out Example 6 of Regulation Section 1.199A-1(d)(4).

4. *Takeaway* Far be it for me to say "I told you so," but...

Treatment of Section 1231 Gain

1. What did we know? Certain investment-type income, including long-term capital gain, is not treated as QBI.

2. What didn't we know? What do we do about Section 1231 gains? In general, a Section 1231 asset is any depreciable asset or real property used in a trade or business for more than one year. A Section 1231 asset is specifically excluded from the definition of a capital asset. When an S corporation or partnership sells a Section 1231 asset, it is not characterized as long-term capital gain or loss at the business level; rather, the item simply retains its character as Section 1231 gain or loss as it passes through to the owners. At the individual owner level, the taxpayer must net together all Section 1231 gains and losses. A net gain is treated as long-term capital gain, while a net loss is deducted as an ordinary loss.

As you can see, a Section 1231 asset is a chameleon: if sold for a gain, that gain is capital. If sold for a loss, the loss is ordinary. Gain may be treated as ordinary, however, if the taxpayer has net Section 1231 losses over the previous five years that were deducted as ordinary losses. So what do we do about them from a QBI perspective? Are they capital? or something else?

3. What do the Regulations Say? In a conclusion I can't say I agree with, the proposed regulations state that if gain or loss is treated as capital under Section 1231, it is excluded from QBI. Strangely, the regulations then say that if a Section 1231 loss is treated as ordinary, it must reduce QBI. This would appear to put the taxpayer in a whipsawed position -- net Section 1231 gain WON'T be QBI, but a Section 1231 loss will REDUCE QBI.

4. Takeaway This has me confused; I must be missing something. This rule would appear to require the owner of the business to make the determination about the character of Section 1231 gain at the owner level, only after all Section 1231 gains or losses have been netted. But what if you have a large Section 1231 gain from business 1, and then an even bigger Section 1231 loss from business 2. At the individual level, the net result is an ordinary loss. Does that mean that both the gain from business 1 and the loss from business 2 are ordinary? I know I'm supposed to be providing answers in this article, and not posing questions, but I struggle to see how this one will work.

Miscellaneous Items

The proposed regulations also included the following items, which weren't really addressed by the statute in any way:

- Generally, a net operating loss carried into the current year does not factor into QBI at all.

- However, if a portion of the NOL is attributable to a loss denied under new Section 461(l) -- which limits a taxpayer's net business loss to $500,000 (if married, $250,000 for everyone else) -- that portion of the NOL does reduce QBI in the succeeding year. *Example: in 2018, A, a married taxpayer, has QBI of $100,000 from business 1 and a qualified business loss of $800,000 from business 2. Under Section 461(l), only $500,000 of the net $700,000 loss may be used to offset A's other sources of income; the remaining $200,000 of excess loss must be carried forward as an NOL. Assume A ends up with a total NOL of $400,000 in 2018, which is carried to 2019. In 2019, $300,000 of the $400,000 NOL must reduce A's QBI. The $100,000 of NOL that is not attributable to an excess business loss does not impact the QBI calculation.*
- When a taxpayer has a loss attributable to an activity suspended under either Sections 704 or 1366 (basis in a partnership and S corporation, respectively), Section 465 (at-risk limitation) or Section 469 (passive activity rules), the loss is carried forward to the next year. Under the proposed regulations, when those losses are allowed in a future year, they must be taken into account to reduce QBI. However, any suspended losses from years prior to 2018 are not taken into account.
- If a partner sells a partnership interest and some portion of the gain is recharacterized as ordinary income under the "hot asset" rules of Section 751, that gain is included in QBI.
- A step-up in basis of partnership assets under Section 743 or 734 is NOT treated as a qualifying asset for purposes of the alternate basis limitation.
- The unadjusted basis of qualified property is determined BEFORE any bonus depreciation or Section 179 expensing.

If the Section 1411 regulations governing the net investment income tax are any indication, the evolution of Section 199A is far from over. There will be comments aplenty from taxpayers and their advisors, and final regulations may look drastically different. For now, however, the release of the proposed regulations represent a huge step forward in FINALLY being able to make some sense of Section 199A.

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