QUALIFIED BUSINESS INCOME – ARE YOU ELIGIBLE FOR A 20% DEDUCTION? PART II: ADDITIONAL GUIDANCE

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On August 8, 2018, the I.R.S. issued much-awaited proposed regulations under new Code §199A, which was added by the 2017 Tax Cuts and Jobs Act, (the "Proposed Regulations"). The provision was initially discussed in detail in our February 2018 edition. At the time, many issues were unclear.[2] The Proposed Regulations shed much-needed light on many of those issues and provide examples and anti-avoidance guidance.

The regulations are intended to apply to taxable years ending after the date regulations are published in their final form; however, taxpayers are allowed to rely on the Proposed Regulations, in their entirety, until such time. The anti-abuse rules in the Proposed Regulations would apply to tax years ending after December 22, 2017, the date of enactment of the 2017 Tax Cuts and Jobs Act.

SUMMARY OF THE PROVISION

New Code §199A allows owners of pass-thru businesses to, subject to limitations, deduct up to 20% of their U.S. "Qualified Business Income" ("Q.B.I."). The provision is intended to benefit those not enjoying the reduced rate of taxation applicable to C-corporations (which are now subject to a 21% Federal income tax rate). The new deduction is available to individuals, and some trusts and estates, generating income from sole proprietorships, S-corporations, and partnerships, either directly or through another pass-thru entity.

Broadly described, the provision allows eligible taxpayers a 20% deduction applicable to the lesser of

- Q.B.I. plus 20% of the combined qualified real estate investment trust ("R.E.I.T.") dividends and qualified publicly traded partnerships ("P.T.P.") income, or
- the excess, if any, of the taxpayer's taxable income over the net capital gain.

Taxpayers whose taxable income exceeds a statutory threshold are limited based on (i) the type of trade or business, (ii) the amount of W-2 wages paid with respect to the trade or business, or (iii) the amount of W-2 wages and the unadjusted basis of qualified property held for use in the trade or business. The inclusion of qualified R.E.I.T. dividends and qualified P.T.P. income is not limited by the W-2 limitation or the unadjusted basis limitation.

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1 The authors wish to acknowledge the contribution of Neha Rastogi in the preparation of this article.

2 "Qualified Business Income – Are You Eligible for a 20% Deduction?" *Insights* 5, no. 2 (2018).

GUIDANCE IN THE PROPOSED REGULATIONS

The balance of this article, which focuses on guidance provided in the Proposed Regulations, is written in a question and answer format.

Q. 1: What is Q.B.I.?

Q.B.I. is generally defined as the net amount of qualified items of "income, gain, deduction, and loss" that are "effectively connected to a qualified trade or business in the U.S."[3] To be included in the computation of Q.B.I., the items of income, gain, deduction, and loss must be recognized when determining taxable income for the tax year. Q.B.I. does not include qualified R.E.I.T. dividends or qualified P.T.P. income. [4]

With respect to certain items of income, gain, deductions, and loss, it was previously unclear how they would influence the determination of Q.B.I. The Proposed Regulations offer some clarity:

- Any gain from a sale of a partnership interest that is treated as ordinary income under Code §§751(a) or (b) (*i.e.*, attributable to a partnership's "hot assets" – generally meaning unrealized receivables and inventory) is considered attributable to the trade or business of the partnership and may be Q.B.I.

- Guaranteed payments received by a partner from a partnership for the use of capital are not taken into account in computing Q.B.I.

- Notwithstanding the above, if a guaranteed payment to a partner for the use of capital is properly allocable to the trade or business and otherwise deductible, the corresponding deduction will be taken into account in determining Q.B.I. from that business.

- Adjustments for changes in accounting methods under Code §481 are taken into account in determining Q.B.I., provided that the adjustment arose in a taxable year ending after December 31, 2017.

- Previously disallowed losses or deductions that are allowed in the taxable year are also taken into account in determining Q.B.I. However, losses or deductions that were disallowed for taxable years beginning before January 1, 2018, are not taken into account for purposes of computing Q.B.I. in a later taxable year.

- Net operating loss carryforward or carryback allowed as a deduction under Code §172 is not accounted for in the determination of Q.B.I. (because it would have been taken into account in computing Q.B.I. in the year incurred); however, net operating loss attributable to deductions disallowed under the new excess business loss limitation of Code §461(l) must be taken into account in determining Q.B.I. (because the loss was not previously accounted for in computing taxable income).

- To the extent that Code §1231 causes gain or loss to be treated as ordinary, the gain or loss must be included in Q.B.I. To the extent the gain or loss is treated as capital, it will not be taken into account in determining Q.B.I.

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[3] For this purpose, the principles of Code §864(c) are applied.

[4] Code §199A(c)(3)(A)(i).

- Interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business and therefore is not accounted for in determining Q.B.I. Such income is from assets held for investment. However, interest on accounts receivable for services or goods provided by the trade or business is income received in the ordinary course of a trade or business and therefore included in Q.B.I.

- Expenses for all wages paid must be taken into account in determining Q.B.I., regardless of the application of the W-2 limitation, discussed above.

- Items attributable to several trades or businesses must be allocated to such trades or businesses using a reasonable method. Such method must be based on facts and circumstances and must be consistently applied each year. Different methods can be used for different items of income, gain, deduction, and loss.

Q. 2: Does a negative combined total of qualified R.E.I.T. dividends and P.T.P. income reduce Q.B.I.?

No. The Proposed Regulations provide that if an eligible taxpayer has an overall loss after combining the qualified R.E.I.T. dividends and qualified P.T.P. income, the portion of the taxpayer's deduction related to the qualified R.E.I.T. dividends and qualified P.T.P. income will be zero for the year. Thus, the overall loss from qualified R.E.I.T. dividends and qualified P.T.P. income does not affect the amount of the taxpayer's Q.B.I. Instead, the overall loss is carried forward and must be used to offset combined qualified R.E.I.T. dividends and qualified P.T.P. income in the succeeding taxable year or years.

Q. 3: What types of income are specifically excluded from the definition of Q.B.I.?

- **Reasonable Compensation** – 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 are treated as wages and thus excluded. The Proposed Regulations clarify that the reasonable compensation rule applies only to S-corporations and not extend to partnerships. It provides that this rule is merely a clarification that even if an S-corporation fails to pay a reasonable wage to its shareholder-employee, the shareholder-employee is nonetheless prevented from including an amount equal to reasonable compensation in Q.B.I.

- **Guaranteed Payments Under Code §707(c)** – Guaranteed payments to a partner for services rendered with respect to the trade or business are excluded from Q.B.I. The Proposed Regulations clarify that this rule applies regardless of whether the partner is an individual, an estate, a trust, or a pass-thru entity. Thus, a guaranteed payment from a lower-tier partnership to an upper tier partnership retains its character as a guaranteed payment and is not included in Q.B.I. of a partner of the upper-tier partnership, regardless of whether it is guaranteed to the ultimate recipient.

- **Payments to a Partner Under Code §707(a)** – Payments to a partner not acting in its capacity as partner for services rendered with respect to a trade or business should be treated in the same manner as guaranteed payments,

reasonable compensation, and wages and are thus excluded from Q.B.I. Similar to the rule for a guaranteed payment, this exclusion applies regardless of whether the partner is an individual or a pass-thru entity.

- **Income from a "Specified Trade or Business"** – See discussion in Q. 5.
- **The Trade or Business of Performing Services as an "Employee"** – See discussion in Q. 9.

Q. 4: To be included in Q.B.I., an item must be effectively connected with a trade or business in the U.S. What does that mean?

For purposes of Q.B.I., a trade or business must exist for income to be Q.B.I. The Proposed Regulations confirm that for a trade or business to exist, the requirements of Code §162 must be met. Generally, this means that the taxpayer must be involved in the income producing activity with "continuity and regularity" and a primary reason for engaging in the activity must be to produce income or profit in order for the income to qualify for Q.B.I.

Effectively connected income that is treated as such under a special provision in the Code but is not otherwise attributable to a trade or business may not be treated as Q.B.I. Thus, for example, a nonresident alien individual's income from real property in the U.S. with respect to which an election to treat the income as effectively connected income was made cannot be treated as Q.B.I. This may adversely affect foreign persons investing in U.S. real property through trusts, and taxpayers may find that a U.S. corporate blocker may prove to be more tax efficient.[5]

"The taxpayer must be involved in the income producing activity with 'continuity and regularity' and a primary reason for engaging in the activity must be to produce income or profit."

Similarly, the fact that a deduction is allowed for purposes of computing effectively connected taxable income (*e.g.*, a charitable contribution) does not necessarily mean that it is taken into account for purposes of determining Q.B.I.

An exception to the application of Code §162 applies in one set of circumstances only, relating to rental or licensing of tangible or intangible property to a commonly controlled trade or business. Such rental activity will be treated as a trade or business even if it doesn't otherwise rise to the level required under Code §162. This is designed to allow taxpayers to aggregate their trades or businesses with the associated rental.

Q. 5: What is a specified trade or business ("S.S.T.B.") that is generally not eligible for the deduction?

The definition of S.S.T.B. includes (i) any trade or business in a list of specified fields, as well as (ii) any trade or business that involves "investing and investment management trading or dealing in securities, partnership interests, or certain commodities."

The Proposed Regulations offer clarity on what constitutes an S.S.T.B. by referring to

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[5] In a public hearing conducted on October 16, 2018, by the Treasury Department and the I.R.S., the American Institute of C.P.A.'s ("AICPA") argued that when it comes to rental of real property, all such activities should be treated as a trade or business. They note that there is no clear definition as to when a trade or business exists in the rental real estate context and that the courts have also struggled to articulate a definitive line. Without firm guidance, inconsistent treatment among similarly situated taxpayers could result.

existing guidance under Code §§1202(e)(3)(A) and 448 and by expanding guidance by an objective interpretation to the statute. Included in the definition of S.S.T.B. are the following services in the following fields:

- **Health** – This means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and similar healthcare professionals performing medical services in such capacity who provide medical services directly to a patient. Not included are services that are not directly related to a medical field, even though they may relate to the customer's health. For example, the operation of a health club or health spa that provides physical exercise is not an S.S.T.B.

- **Law** – This means the performance of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such. Services provided in the field of law that do not require skills unique to the field of law (*e.g.*, printing, delivery services, or stenography services) are not an S.S.T.B.

- **Accounting** – This includes the provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such. There is no requirement that the service be provided by a licensed certified public accountant.

- **Actuarial Science** – This means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such. The provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial cost of risk or uncertainty of events is not an S.S.T.B.

- **Performing Arts** – This means the performance of services by individuals participating in the creation of performing arts. It includes actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. Services that do not require skills unique to the creation of performing art (*e.g.*, maintenance and operation of equipment or facilities for use in the performing arts or the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public) are not S.S.T.B.'s.

- **Consulting** – This means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems, including providing advice and counsel by lobbyists regarding advocacy with the intention of influencing a governmental agency and legislation. This does not include services other than advice and counsel such as sales or the provision of training and educational courses. The determination whether services are sales or economically similar services, or consulting services is based on facts and circumstances, including the manner in which the taxpayer is compensated for the provided services. Consulting services that are embedded in, or ancillary to, the sale of goods or the performance of services on behalf of a trade or business that is otherwise not an S.S.T.B. are also not S.S.T.B.'s, provided that there is no separate payment for the consulting services. For example, a contractor who remodels homes may provide consulting prior to remodeling a kitchen and a company that sells computers may provide

customers with consulting services relating to the setup, operation, and repair of the computers without having it treated as an S.S.T.B.

- **Athletics** – This means the performance of services by individuals who participate in athletic competition (such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing). The provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events or the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public, is not an S.S.T.B.

- **Financial Services** – This means the provision of services typically performed by financial advisors and investment bankers. It includes – among other similar financial services to clients – managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory, and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting or acting as a client's agent in the issuance of securities. Banking is not treated as an S.S.T.B.

- **Brokerage Services** – This includes services in which a person, for a commission or fee, arranges transactions between a buyer and a seller with respect to certain securities, such as shares of stock in a corporation, and other securities described under Code §475(c)(2). This includes services provided by stock brokers and other similar professionals. Services provided by real estate agents and brokers, or insurance agents and brokers, are not S.S.T.B.'s.

- **Investing and Investment Management** – This means any trade or business that earns fees (either in the form of a flat fee, or a fee calculated as a percentage of asset under management) for investment, asset management services, or investment management services, including providing advice with respect to buying and selling investments. Managing real property is not considered investment and investment management and, thus, is not an S.S.T.B.

- **Trading** – This means a trade or business of trading in securities, commodities, or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity, regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof. A taxpayer who engages in hedging transactions as part of their nontrading trade or business is not engaged in trading for these purposes (*e.g.*, if a manufacturer or a farmer engages in hedging as part of their trade or business of manufacturing or farming).

- **Dealing in Securities, Commodities, and Partnership Interests** – This means regularly purchasing and selling securities, commodities, or partnership interests from and to customers in the ordinary course of a trade or

business, or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities, commodities, or partnership interests with customers in the ordinary course of a trade or business. A taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans – and very rarely sells loans – will not be treated as dealing in securities due to such sales, provided that such sales are not more than a negligible amount.

- **Reputation or Skill** – Any trade or business where the principal asset is the "reputation or skill" of one or more of its employees or owners is an S.S.T.B. See discussion in Q. 10.

Q. 6: What is the effect of being an S.S.T.B.?

Unless an exception applies, if a trade or business is an S.S.T.B., none of its items of income are taken into account in determining Q.B.I. If the S.S.T.B. is operated through a partnership or an S-corporation, none of the income from the trade or business flowing to an owner of the entity is Q.B.I., regardless of whether the owner participates in the specified service activity. A direct or indirect owner of a trade or business engaged in an S.S.T.B. is treated as engaged in the S.S.T.B. regardless of whether the owner is passive or participated in the S.S.T.B.

Q. 7: What exceptions from S.S.T.B. treatment are available?

Taxpayers below the statutory threshold amounts are not subject to the restrictions with respect to S.S.T.B. and are therefore eligible for the new deduction notwithstanding that a trade or business is an S.S.T.B.

The statute provides for a phase-in range. Taxpayers within the phase-in range must calculate an applicable percentage that applies to limit the Q.B.I. amount as well as the W-2 and unadjusted basis limitation.

The application of the threshold amount is done at the individual owner level and not the partnership or S-corporation level. Therefore, if a partnership operates an S.S.T.B. and the partnership's taxable income is less than the threshold amount but each of the partnership's individual partners has income that exceeds the threshold amount, the S.S.T.B. restriction will begin to phase in. Once a partner's income exceeds the threshold amount plus $50,000 ($100,000 in the case of a joint return), no deduction will be available with respect to any income from the partnership's S.S.T.B. Likewise, no W-2 wages or unadjusted basis limitations relating to such S.S.T.B. may be used.

Additionally, a *de minimis* rule exists. A trade or business will not be considered to be an S.S.T.B. if less than 10% of the gross receipts (5% if the gross receipts are greater than $25 million in a taxable year) of the trade or business are attributable to the performance of services in a specified service activity.

Q. 8: If the *de minimis* rule doesn't apply, can the non-S.S.T.B. activities be separated?

No. A strategy of separating out parts of what otherwise would constitute an integrated business in an attempt to qualify those separate parts for the Q.B.I. deduction is inconsistent with the purpose of the provision and is thus disallowed by the Proposed Regulations.

For example, a law firm may not purchase office space via a separate L.L.C. that rents the office space to the law firm to generate Q.B.I. Likewise, a law firm may not employ its administrative staff under contract as employees of a separate L.L.C.

“An employment relationship exists when the person for whom the services are performed has the right to direct and control the individual who performs the services.”

The Proposed Regulations provide that if there is 50% or more direct or indirect common ownership between an S.S.T.B. and another business, any trade or business that provides at least 80% of its property or services to the S.S.T.B. is considered part of that S.S.T.B. If a trade or business that has 50% or more common ownership with a S.S.T.B. provides less than 80% of its property or services to the S.S.T.B., the portion of property or services provided to the S.S.T.B. will be treated as an S.S.T.B.

Finally, if a trade or business that would otherwise not be treated as an S.S.T.B. (i) has 50% or more common ownership with an S.S.T.B., (ii) has shared expenses with the S.S.T.B., and (iii) the gross receipts that represent no more than 5% of the total combined gross receipts of the trade or business and the S.S.T.B., then such trade or business is treated as incidental to the S.S.T.B. and thus a part of the S.S.T.B.

Q. 9: Since the trade or business of being an employee is specifically disallowed, the distinction between employee and independent contractor is important. How are they distinguished for purposes of the deduction?

Wages and compensation income earned by any employee are not Q.B.I. and are not eligible for the new deduction no matter the amount – even if the income is below the threshold. Therefore, there is an incentive to work as an independent contractor. However, changing an individual’s status in the company may not provide access to the deduction.

The Proposed Regulations confirm that the distinction between an employee and an independent contractor for purposes of Code §199A is governed by common law rules. Generally, under common law, an employment relationship exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. There is no requirement that the employer will actually direct or control the manner in which the services are performed. Having the right to control the manner of the services is sufficient for the employment relationship to exist.

The Proposed Regulations further provide that Federal employment tax classification of an employee as anything other than an employee is immaterial. Thus, if the employer treats a person as an independent contractor but the person otherwise qualifies as an employee under the statutory and common law principles, such person will be treated as an employee and no deduction will be allowed.

Because the new deduction would incentivize employees to become equity holders in partnerships or S-corporations, for purposes of Code §199A only, the Proposed Regulations provide a presumption applicable to former employees. Under the presumption, if an individual (i) was treated as an employee for Federal employment tax purposes by the person to whom the services are provided and (ii) is subsequently treated as other than an employee with regard to the direct or indirect provision of substantially the same services to that person (or a related person), the individual is presumed to be in the trade or business of performing such services as an employee. This presumption may be rebutted by the individual upon a showing that, under

Federal tax rules and common law rules, the individual is performing services in a capacity other than as an employee.

Q. 10: What guidance is available on the meaning of reputation or skill of one or more of employees or owners?

The Proposed Regulations provide that this seemingly catchall phrase was intended to address a narrow set of trades or businesses that were not otherwise covered by the S.S.T.B. fields but in which income is received based directly on the skill and/or reputation of the employees or owners. The I.R.S. believes that "reputation or skill" must be interpreted in a manner that is objective and administrable. Thus, the Proposed Regulations provide a narrow and exhaustive list of fact patterns that will meet the definition. A trade or business has the reputation or skill of one or more of its employees or owners as the principal asset in each of the following cases:

- A person receives fees, compensation, or other income for endorsing products or services, including an individual's distributive share of income or distributions from a pass-thru entity for which the individual provides endorsement services.
- 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, including an individual's distributive share of income or distributions from a pass-thru entity for which the individual contributed the right to use the individual's image.
- A person receives fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

The consideration for these trades or businesses need not be strictly monetary and may include the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain, or loss from the partnership or the receipt of stock of an S-corporation and the corresponding income, deduction, gain, or loss from the S-corporation stock.

The Proposed Regulations offer the example of a well-known chef who is the sole owner of multiple restaurants operating through L.L.C.'s, receives an endorsement fee of $500,000 for the use of his name on a line of cooking utensils and cookware. This income is clearly due to his reputation or skill and will be S.S.T.B. income not eligible for the deduction. However, the Proposed Regulations provide that this individual is also in the trade or business of being a chef and owning restaurants and imply that this trade or business is not an S.S.T.B. This means that while customers may come to a restaurant due to the chef's reputation, it does not disqualify that trade or business. The S.S.T.B. provision does not apply to that portion of the chef's income.

Q. 11: Is there a loss carryover if a Q.B.I. result is a negative number?

If a taxpayer has multiple trades or businesses, he or she must calculate the Q.B.I. from each trade or business and, before applying the deduction, net the amounts.

If the net Q.B.I. is negative, the amount is treated as a loss from a qualified trade or business in the succeeding taxable year. The Proposed Regulations provide that the carryover rules do not affect the deductibility of the losses for other purposes.

If a taxpayer has a negative Q.B.I. in one business but an overall Q.B.I. that is greater than zero, the taxpayer must offset the net income with the net losses before the taxpayer applies the W-2 wage and the unadjusted basis limitations. The net loss must be apportioned among the trades or businesses with positive Q.B.I. in proportion to the relative amount of Q.B.I. in such trade or businesses. The Proposed Regulations provide that the W-2 wages and the unadjusted basis in qualified property from the business that produced a negative Q.B.I. are not taken into account and are not carried over into subsequent years. However, see the discussion relating to aggregation of businesses in Q. 12 below. Under certain circumstances, a taxpayer may aggregate the businesses and take into account the W-2 wages and unadjusted basis of the losing business.

Q. 12: Can an eligible taxpayer that has more than one trade or business, or that operates its business through several entities, group businesses for purposes of applying Code §199A?

The Proposed Regulations provide aggregation rules that allow taxpayers to combine their businesses for purposes of applying the W-2 wage and the unadjusted basis limitations and to potentially maximize the deduction.

Aggregation is permitted but is not required. Eligible taxpayers can aggregate trades or businesses operated directly or through pass-thru entities. The aggregation is done at the owner level. Therefore, partnerships and S-corporations must compute and provide their owners with information regarding Q.B.I., W-2 wages, and the unadjusted basis of qualified property for each trade or business operated by the entity. One owner may elect to aggregate and another not to aggregate. Additionally, a taxpayer may aggregate some but not all attributable businesses.

Trades or businesses can be aggregated only if the individual can demonstrate that the following requirements are met:

- Each trade or business meets the requirements under Code §162.
- For the majority of the taxable year in which items attributable to a trade or business are included in income, the same person, or the same group of persons, must directly or indirectly own at least 50% of each trade or business to be aggregated. (Family attribution applies, so that an individual is considered to own the interest owned directly or indirectly by their spouse, child, grandchild, or parent. Note that non-majority owners may benefit from the common ownership and are permitted to aggregate.)
- All businesses aggregated must share the same tax year. (Short taxable years are not taken into account.)
- None of the aggregated trades or businesses can be an S.S.T.B.
- The aggregated trades or business must satisfy at least two of the requirements that demonstrate that the businesses are in fact part of a larger, integrated trade or business:
    - The trades or businesses provide services and products that are the same (*e.g.*, a restaurant and a food truck) or are usually offered together (*e.g.*, a gas station and a car wash).

- The trades or businesses share facilities or significant business elements (*e.g.*, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technologies).
- The trades or businesses are operated in coordination with, or reliance on, one or more of the other businesses in the aggregate group (*e.g.*, supply chain interdependencies).

If aggregation is elected, taxpayers must compute allocable Q.B.I., allocable W-2 wages, and allocable unadjusted basis of qualified property on a trade-or-business-by-trade-or-business basis. Only then can they be aggregated. The combined W-2 wages and combined unadjusted basis of qualified property allocable to the taxpayer for all aggregated businesses is used for applying the limitations.

“Eligible taxpayers can aggregate trades or businesses operated directly or through pass-thru entities.”

Finally, the aggregation must be consistently reported in all subsequent tax years, and the taxpayer must attach a statement to the taxpayer’s income tax return identifying each aggregated trade or business and providing certain information relating to each aggregated trade or business. Failure to disclose may result in the disallowance of the aggregation.

Q. 13: What new guidance is available with respect to W-2 wages?

- The Proposed Regulations allow a taxpayer to take into account any W-2 wages paid by another person, provided that the wages reported on the Forms W-2 were paid to the employees of the taxpayer for employment by the taxpayer. This provision enables taxpayers who use third-party vendors to pay W-2 wages (*e.g.*, Paychex) to include such wages in the Code §199A deduction computation. The person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for its Code §199A purposes.
- I.R.S. Notice 2018-64, issued on the same day as the Proposed Regulations, provides for three methods for calculating Form W-2 wages for purposes of Code §199A. The first method (the “unmodified Box method”) allows for a simplified calculation, and the second and third methods (the “modified Box 1 method” and the “tracking wages method,” respectively) allow for greater accuracy.
- The Proposed Regulations provide that if W-2 wages are allocable to more than one trade or business, the portion of the W-2 wages allocable to each business must be allocated among the trades or businesses using a reasonable method based on all the facts and circumstances.
- The Proposed Regulations provide for allocation of W-2 wages when a trade or business is acquired or disposed of that causes more than one taxpayer to be an employer of the employees of the acquired or disposed of trade or business during the calendar year. The allocation is based on the period during which the employees of the acquired or disposed of trade or business were employed by the taxpayer. The Proposed Regulations also clarify that acquisition or disposition include an incorporation, formation, liquidation, reorganization, or purchase or sale of assets.

Q. 14: What guidance was provided with respect to qualified property acquired in a Code §1031 exchange?

The Proposed Regulations provide that the unadjusted basis of a qualified property that is acquired in a "like-kind" exchange equals the adjusted basis of the relinquished property. In addition, the replacement property is treated as a Modified Accelerated Cost Recovery System ("M.A.C.R.S.") property, whose depreciable period generally is determined as of the date the relinquished property was first placed in service. As a result, the depreciable period under Code §199A for the exchanged basis of the replacement qualified property will end before the depreciable period for the excess basis of the replacement property ends. An election is available according to which the date the exchanged basis and excess basis in the replacement qualified property are first placed in service by the trade or business is the date on which the replacement qualified property is first placed in service by the taxpayer, with the unadjusted basis determined as of that date. In this case, the depreciable periods for the exchanged basis and the excess basis of the replacement property will end on the same day.

Q. 15: Are there additional rules worth mentioning?

- The incentive to divide assets among multiple non-grantor trusts to multiply the threshold amount was shut down by the Proposed Regulations, which provide that trusts formed or funded with a significant purpose of receiving a deduction under Code §199A will not be respected.

- An otherwise qualified R.E.I.T. dividend is ignored when computing the Code §199A deduction if the stock with respect to which it is received is held for fewer than 45 days. The day on which the stock is disposed is included in the period of holding; the day of acquisition is ignored. The holding period is further reduced for periods where the taxpayer did not bear the risk of loss. These anti-abuse rules aim at preventing dividend stripping and similar transactions by limiting what will be treated as qualified R.E.I.T. stock to R.E.I.T. stock held for a meaningful period of time allowing the taxpayer to have an economic exposure to the stock.

- The Proposed Regulations treat disregarding property as qualified property for purposes of the unadjusted basis limitation if the property is acquired within 60 days of the end of a taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days. If the taxpayer can demonstrate that the principal purpose of acquiring the property and disposing of the property was other than due to the Code §199A deduction, the property will not be disregarded.

- For purposes of determining Q.B.I., W-2 wages, and the unadjusted basis in qualified property allocated to a taxpayer from a pass-thru entity with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the taxpayer during the taxpayer's tax year during which the pass-thru's taxable year ends. This means that, in the case of a partnership or an S-corporation that has a fiscal year as a tax year, its owners may include their allocable share of the Q.B.I. from pre-2018 periods in their 2018 return.

- The Proposed Regulations provide that the Code §199A deduction does not reduce the net earnings from self-employment for the purposes of calculating self-employment tax or net investment income for the purpose of calculating the net investment income tax. Therefore, both taxes are calculated as

though there is no Code §199A deduction. Additionally, the Proposed Regulations provide that the Code §199A deduction is allowed in determining the alternative minimum tax liability.

CONCLUSION

The Proposed Regulations are extensive, with many examples, and provide for much needed interpretation as well as a number of anti-avoidance rules. This article attempts to familiarize the reader with the more important aspects of the regulations to enable the reader to explore the potential benefits of the new provisions. The Proposed Regulations were opened to a public hearing on October 16, 2018. Further changes will be reported in *Insights* when announced.

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