SECTION 199A UPDATE - WITH CASE STUDIES

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TABLE OF CONTENTS

This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

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SECTION 199A UPDATE - WITH CASE STUDIES[1]

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1. INTRODUCTION TO THE SECTION 199A DEDUCTION

In any discussion of an appropriate entity for a business, there are three elephants in the room:

- The Section 1202 exclusion, an modified in 2014,
- The Section 199A deduction, added by the 2017 TCJA, and
- The reduction in the maximum federal income tax rate for C corporations from a maximum rate of 35% to a flat rate of 21%, effected by the 2017 TCJA.

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[1] The authors acknowledge the insightful comments made on an earlier version of this outline by Jason Flashberg, **CPA**.

1.1 **Purpose of Section 199A**:

1.1(a) To align the reduction in the federal tax rate on the income of flow-through entities and sole proprietorships with the reduction in the effective federal tax rate on C corporation income taxed and the new 21% flat rate and then distributed to the shareholders as qualified dividends.[2]

1.1(b) For pass-throughs that get the deduction, the effective federal tax rate is 30% for shareholders active in the business and not subject to the net investment income tax ("**NIIT**") or 33% for inactive shareholders whose income is subject to the NIIT[3].

1.1(c) For a C corporation that distributes its income to its shareholders, the effective federal tax rate is 40%.[4]

1.2 **Who is affected by Section 199A**?

1.2(a) The Joint Tax Committee projects that for 2019:

- ◊ 39M returns will include business income on Schedules C, E or F.
- ◊ 27M returns (2/3) will take the Section 199A deduction.

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[2] Joint Committee on Taxation, GENERAL EXPLANATION OF PUBLIC LAW 115-97 (the "**Blue Book**") at 20 (2018).

[3] Note that Section 199A would not have been necessary in the 2017 tax act if the top tax rate on individuals had dropped to 30% instead of 37%.

The difference between the 30% rate and the 33% rate is less than 3.8% due to the effect of rounding.

[4] The rate is 36.8% if the Net Investment Income Tax is disregarded. However, the Section 3.8% federal NIIT applies to dividends whether or not the shareholder is active in the corporation's business. I.R.C. § 1411(c)(1)(A)(i). The effective tax rates for *combined* California and federal taxes corresponding to the 40% federal rate are 44%, 48% and 55%.

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◊ The Section 199A deduction will apply to 91% of the income reported on Schedules C, E or F.

◊ Of the taxpayers who take the Section 199A deduction, 95% will be under the $157,500/$315,000 taxable income threshold, but they will get only 1/3 of the tax benefit. The balance of the tax benefit (2/3) will go to the 5% of taxpayers whose taxable income exceeds the thresholds.[5]

1.3 **Overview**[6]

1.3(a) For 2018 to 2025 a taxpayer who is not a corporation is allowed a deduction equal to 20% of the taxable income from flow-through businesses and sole proprietorships.[7]

1.3(b) Sole proprietors, partners and shareholders of S corporations are eligible for the deduction (but not the partnership or S corporation), as are trusts and estates.[8]

◊ The income to which the deduction applies is "qualified business income" or "**QBI**."[9]

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[5] Staff of the Joint Committee on Taxation, OVERVIEW OF DEDUCTION FOR QUALIFIED BUSINESS INCOME: SECTION 199A at slides 28 to 31 (March 2019) ("**JCT Slides**").

[6] For a one-page overview, see the Section 199A flowchart attached to this outline.

[7] I.R.C. § 199A(a)(1)(A), (b)(1)(A), (b)(2)(A), (c)(1), (d)(1). This outline does not address REIT dividends, cooperative dividends, income of publicly traded partnerships, income from agricultural and horticultural cooperatives, and taxpayers in Puerto Rico, for which Section 199A and the regulations provide special rules.

[8] Treas. Reg. § 1.199A-1(e)(1); TAX CUTS AND JOBS ACT - CONFERENCE REPORT TO ACCOMPANY H.R. 1, H.R. Rep. 115–466 at 224 (2017) (the "**Conference Report**").

[9] I.R.C. § 199A(b)(2)(A).

- QBI must be effectively connected with the conduct of a U.S. trade or business.[10]

◊ The taxpayer does not need to itemize deductions to use the deduction.[11]

◊ The deduction does not apply to capital gain, interest income or dividend income.[12]

◊ The deduction cannot create a loss or a loss carryforward.[13]

1.3(c) The 20% deduction is determined by computing the deduction for each business and aggregating the results.[14]

◊ If the aggregate base amount is negative for a year, the loss is treated as a loss from a non-corporate business for the next year.[15]

1.3(d) If the taxpayer's taxable income is less than $157,500 ($315,000 for a joint return), then the entire 20% deduction is available, without regard to the type of business.[16]

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[10] I.R.C. § 199A(c)(3)(A)(i),

[11] I.R.C. § 63(b)(3).

[12] I.R.C. § 199A(c)(3)(B). The deduction does apply to "interest income which is properly allocable to a trade or business." I.R.C. § 199A(c)(3)(B)(iii). Subsection (a) of Section 199A appears to be a backstop to assure that the deduction applies only to ordinary income.

[13] I.R.C. §§ 172(c), (d)(8), 199A(c)(2).

[14] I.R.C. § 199(a)(1)(A), (b)(1).

[15] I.R.C. § 199(c)(2).

[16] I.R.C. § 199(b)(3)(A), (e)(2). The amounts are indexed for inflation.

◊ If the taxpayer's taxable income is more than $157,500 ($315,000 for a joint return), then the deduction phases out over the next $50,000 of taxable income ($100,000 for joint returns) for a "specified trade or business" (called an "SSTB" in the regs).[17]

1.3(e) For a trade or business that *is* in a SSTB, that's all the owner can get. So the maximum Section 199A deduction for that taxpayer is $31,500 (or $63,000 for a joint return).

◊ The IRS will probably check for SSTBs by the SIC code shown on the return. Preparers should document the rationale behind their choice of SIC code. Consider making disclosure of the rationale on Form 8275 to minimize the risk of prepared penalties.[18]

1.3(f) If the trade or business *is not* an SSTB, then the 20% deduction can cover bigger dollar amounts.

◊ The enhanced limits (called the "**Jobs Limits**" in this outline) are based on the yearly wages paid by of the business and the unadjusted basis of depreciable assets used in the business

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[17] I.R.C. § 199(b)(3)(B). An SSTB is 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 1 or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. I.R.C. § 199A(d)(2). The regs provide useful guidance. Treas. Reg. § 1.199A-5. See Section 5 (SSTBs) below.

[18] See Section 8.3 (Reasonable basis and adequate disclosure) below. If the historic SIC code is unfortunate, consider structural changes (incorporating, changing to an LLC, etc.) to move the business to a new tax form (from Schedule C to Form 1120S, or from Form 1120 to Form 1065, etc.).

and for which the useful life has not expired (called "**UBIA**" in the regs).[19]

◊ If a business has a large payroll and/or makes major investments in equipment or buildings, the Jobs Limits will not constrain the Section 199A deduction and the full 20% will be available.

◊ If a business has lower payroll and smaller equipment or building purchases, the owners won't necessarily get the whole 20% if the taxpayer has taxable income over the $157,500/$315,000 threshold.[20]

◊ The calculations are very fact specific.

◊ The Jobs Limits have two components and the greater applies.

- The first component is 50% of W-2 wages properly taken into account in determining the QBI of a trade or business.[21]

- The second component is 25% of W-2 wages, plus 2.5% of UBIA of "qualified property."[22]

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[19] I.R.C. § 199A(b(2)(B); Treas. Reg. § 1.199A-1(b)(14) ("UBIA" is from "unadjusted basis immediately after acquisition.").

[20] The Jobs Limits start phasing *in* for taxpayers with taxable income over $157,500 for single filers and $315,000 for married taxpayers filing jointly. They phase *in* completely at $207,500 and $415,000, respectively. I.R.C. § 199(b)(3)(B). The phase-*in* of the Jobs Limits happens over the same income as the phase-*out* of the Section 199A deduction for SSTBs -- leading to a complicated calculation for taxpayers in between the taxable income thresholds. See Treas. Reg. § 1. 199A-1(d)(4) Example 6 (phase-out and phase-in).

[21] I.R.C. § 199A(b)(2)(B)(i). The Joint Tax Committee calls this the "W-2 wage limitation." JCT Slides at slide 10.

1.3(g) The Section 199A deduction does not apply to compensation or guaranteed payments paid by the business to the taxpayer.[23]

1.4 Legislative history and administrative guidance

1.4(a) Section 199A is a horribly complex statute.[24] It was the subject of intense political negotiations. Sadly, it bears the scars from all the political compromises. The Conference Report tracks the development of the statutes in Congress.

1.4(b) The federal government has provided unusually prompt guidance in a variety of forms. Technical fixes were enacted and signed into law on March 23, 2018.[25] Notice 2018-64[26] and proposed regulations issued in August, 2018 provided some clarity.[27] The Blue Book published in December, 2018 provides a bit more clarity. A safe harbor Notice (discussed below) was issued in January. Final regulations were issued in January and published in the Federal Registers on February 8, 2019.[28] In January and February, 2019 the IRS added discussions of Section 199A to the instructions for individual, partnership and S corporation returns

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(footnote continued from previous page)

[22] I.R.C. § 199A(b)(2)(B)(ii). The Joint Tax Committee calls this the "W-2 wage and capital limitation." JCT Slides at slide 10.

[23] I.R.C. § 199A(c)(4)(A), (B).

[24] Comprehending Section 199A is a process, not an event.

[25] Consolidated Appropriations Act, 2018, Division T § 101, Pub. Law 115-141.

[26] Notice 2018-64, I.R.B. 2018-35, August 8, 2018. This Notice was released at the same time as the proposed regulations and provides guidance on how to compute W-2 wages for purposes of the deduction, along with FAQs.

[27] 83 Fed. Reg. 40884 (August 16, 2018) ("**Proposed Regs**").

[28] TD 9847 at 2953 ("The Treasury Department and the IRS received approximately 335 comments in response to the notice of proposed rulemaking." That's a lot.)

and in its publication about business expenses.[29] The Joint Tax Committee published a helpful slide deck in March, 2019.[30]

2. A DEEPER DIVE INTO SECTION 199A

2.1 Wages and guaranteed payments

2.1(a) While the **wages paid by an S corporation** to its shareholder *will not* qualify for the Section 199A deduction, the wages paid to a shareholder *will* increase the wage base for the Jobs Limits, possibly increasing the amount of the deduction.

- ◊ Because **guaranteed payments** are not wages, those payments do not have this benefit. The partners will deduct the guaranteed payments. But for the recipient the payments will be ordinary income, not subject to the deduction. Also, the guaranteed payments will not increase the wage base for the Jobs Limits of the other partners.

- ◊ Some recipients of guaranteed payments might be willing to have the **first profits** allocated to them instead of guaranteed payments. This will increase their risk, but allow the deduction to apply.

2.1(b) Wages paid for the "real" employer by professional employer organizations (PEOs), payroll agents and common paymasters can be used for the Jobs Limits by the "real" employer – but not by both the "real" employer and the PEO, agent or paymaster.[31]

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[29] Instructions to Form 1040 at pages 34 to 37, including a worksheet for taxpayers under the $157,500/$315,000 threshold, and to Schedule C (January, 2019 version); Instructions to 2018 Form 1120S at pages 38-39 (February, 2019 version); Instructions to 2018 Form 1065 at pages 46-47 (February, 2019 version); IRS Publication 535, 2018 Business Expenses at Chapter 12 (January, 2019 version).

[30] JCT Slides.

[31] Treas. Reg. § 1.199A-2(b)(ii).

2.1(c) The concept of unreasonably low compensation might be applied to S corporations to disallow some of the Section 199A deduction.[32]

2.2 **What is QBI**?

2.2(a) The Section 199A deduction applies to depreciation recapture.[33]

2.2(b) It does *not* apply to Section 1231 gain that is treated as capital gain.[34]

2.2(c) "[A] passive loss deferred under section 469 [affects QBI] in the year in which the taxpayer deducts the amount from taxable income."[35]

2.2(d) The deduction applies to an S corporation's income from publicly traded partnerships (which is useful to avoid excess passive receipts penalties).[36]

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[32] I.R.C. § 199A(c)(4)(A) refers to "reasonable compensation paid by" the business, which must be an S corporation (as compared to a partnership or proprietorship) if it pays wages to an owner. The Conference Report, describing the Senate version, which the Conference Committee adopted, notes "Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer." Conference Report at 215. Treas. Reg. § 1.199A-3(b)(2)(ii)(H) (similar statement). The issue is discussed in some detail in the preamble to the final regs. T.D. 9847, 84 Fed. Reg. 2952 at 2964 (February 8, 2019), Supplementary Information/Summary of Comments ant Explanation of Provisions ("**TD 9847**").

[33] I.R.C. § 199A(c)(3)(A)(ii). Depreciation recapture is included in income for the year and is not excluded, so it is included. Treas. Reg. § 1.199A-3(b)(2)(ii) (list of exclusions).

[34] Treas. Reg. § 1.199A-3(b)(2)(ii)(A). *See* TD 9847 at 2964-2965.

[35] JCT Slides at slide 4.

[36] I.R.C. § 199A(b)(1)(B). Section 199A is structured to allow the deduction for income from publicly traded partnerships and REIT dividends (neither of which is QBI), without reduction for losses from operating businesses.

2.3 The Jobs Limits – qualified property

2.3(a) Although the proposed regs did not include a Section 743 basis adjustment in "qualified property, the final regs treat 743(b) basis adjustments as qualified property to extent the section 743(b) basis adjustment reflects an increase in the value of the underlying qualified property.[37] "Otherwise, basis adjustments under sections 734(b) and 743(b) are not treated as qualified property."[38]

2.4 How Section 199A fits into the Internal Revenue Code

The Section 199A deduction:

2.4(a) Does not reduce stock basis, the S corporation's "accumulated adjustments account" or a partner's basis in the partnership interest (under Section 704(d));[39]

2.4(b) Reduces alternative minimum taxable income;[40]

2.4(c) Does not reduce net earning from self employment or net investment income;[41]

2.4(d) May be taken into account for employee's withholding allowances (Form W-4);[42]

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[37] Treas. Reg. § 1.199A-2(a)(3)(iv); TD 9847 at 2960.

[38] Treas. Reg. § 1.199A-2(c)(iii).

[39] Treas. Reg. § 1.199A-1(e)(1).

[40] Treas. Reg. § 1.199A-1(e)(5). The deduction is not an AMT adjustment or preference. I.R.C. §§ 56, 57.

[41] Treas. Reg. § 1.199A-1(e)(3).

2.4(e) Is not applied to determine "adjusted gross income";[43] and

2.4(f) Does not reduce "adjusted taxable income" for purposes of the business interest limitation under Section 163(j);[44]

2.4(g) Is not used in the "taxable income" limit for depletion deductions or the corporate deductions for contributions to charities or dividends received.[45]

2.5 Section 199A and choice of entity

2.5(a) For business owners in an SSTB or a business that is not labor- or capital-intensive, the full 20% Section 199A deduction for S corps and unincorporated businesses will not be available – even if the business generates high profits.

2.5(b) For them an S corporation, LLC or sole proprietorship will save a few percentage points over a C corporation in year-to-year income.

2.5(c) The exception is the *inactive* shareholder of an S corporation at *high federal and California tax rates* who *cannot* use the Section 199A deduction. That shareholder will pay somewhat more tax (about 1%) with S corporation than with the double tax on a C corporation's distributed profits. The effective tax rate for a partnership or sole proprietorship is a bit less (about 1%) than the C corporation effective rate for this taxpayer.

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[42] I.R.C. § 3402(m)(1).

[43] I.R.C. § 62(a) (flush language).

[44] I.R.C. § 163(j)(8)(A)(iv).

[45] I.R.C. §§ 170(b)(2)(D)(v), 246(b)(1), 613(a), 613A(d)(1)(B).

2.5(d) Because one of the limitations on the Section 199A deduction is the taxable income of the taxpayer, owners of SSTBs might have an additional incentive to use contributions to qualified plans that provide benefits to the owners. To the extent that the amounts contributed to the plans are deducible, the taxable income of the owner is reduced.

2.5(e) If the business will be sold for a multiple of its annual cash flow, the low federal long-term capital gains rate on the sale of goodwill is the giant benefit of pass-through (or sole proprietor) status.

◊ And the 100% gain exclusion of Section 1202 is the giant benefit of C corporation status.

◊ So from a planning standpoint, we arrive at the fork in the road when the entity is organized.

3. RENTAL REAL ESTATE OUTSIDE THE SAFE HARBOR

3.1 "Trade or business"

3.1(a) "'Trade or business' means a trade or business that is a trade or business under section 162 … other than the trade or business of performing services as an employee."[46]

3.1(b) Property rented to a business and owned by the owner of the business will be treated as used in a trade or business.[47]

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[46] Treas. Reg. § 1.199A-1(b)(14).

[47] *Id.*

3.2 **Outside the safe harbor**

3.2(a) The regulations refer to the body of existing law applicable in determining if a trade or business qualifies for deductions under Section 162.[48]

3.2(b) The regs recognize that in some cases rental or leasing might not "rise to the level of a Section 162 trade or business."[49]

3.2(c) The Blue Book[50] notes that the Section 162 test for a "trade or business" requires:

- ◊ Regular, continuous and substantial activity,
- ◊ A purpose of earning a profit, and
- ◊ Keeping a complete and separate set of books for each activity.[51]

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[48] Treas. Reg. § 1.199A-1(b)(13).

[49] This statement is made in the context that rental activity that fails the Section 162 test could still be treated as part of a trade or business if the property is rented to a business that his owned by the owner of the rented property. *Id.*

[50] The Blue Book for the 2017 Tax Act was published by the Joint Tax Committee in December, 2018 (after the proposed regs were issued and before the final regs were issued). The Blue Book is not law, but it is an expression of legislative intent. It is not as authoritative an expression as a Ways and Means or Finance Committee report, but those reports did not address the definition of a trade or business for purposes of Section 199A. Generally, courts look to legislative intent only when the plain meaning of the words used do not resolve the issue. Whether the pronouncements of the IRS and the Treasury Department outweigh legislative history (which would be *Chevron* deference to the agencies), should they conflict, is an evolving issue in federal courts.

[51] Blue Book at 14-15:

> Courts have held that for an activity to rise to the level of constituting a trade or business, the taxpayer must be involved in the activity with continuity and

(footnote continued on next page)

3.2(d) The preamble to the final Section 199A regulations indicate that the IRS struggled with this issue – and that they got a lot of comments about it. The preamble states:

> In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

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> regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. In order to meet this standard, the taxpayer must satisfy two requirements: (1) regular and continuous conduct of the activity; and (2) a primary purpose to earn a profit. Whether a taxpayer's activities meet these factors depends on the facts and circumstances of each case. While most activities determined to be trades or businesses are so treated because the taxpayer offers goods or services to the public, a trade or business may also include other activities if such activities are the source of the taxpayer's livelihood.
>
> …
>
> Treasury regulations [under Section 446 regarding accounting methods] provide that activities are not considered separate and distinct trades or businesses unless they each keep a complete and separable set of books and records. Courts evaluating whether activities are separate and distinct trades or businesses have looked to factors such as the existence of common management, use of shared office space (or lack thereof), use of shared employees (or the lack thereof), and the nature of each business. The IRS has ruled that an entity that is disregarded for Federal income tax purposes, and thus treated as a separate division of its owner (e.g., a single-member limited liability company or a qualified subchapter S subsidiary) may constitute a separate trade or business under section 446 depending on the taxpayer's facts and circumstances.

(Footnotes omitted.)

Providing bright line rules on whether a rental real estate activity is a section 162 trade or business for purposes of section 199A is beyond the scope of these regulations. Additionally, the Treasury Department and the IRS decline to adopt a position deeming all rental real estate activity to be a trade or business for purposes of section 199A.[52]

3.3 No Negative Inference

3.3(a) The preamble to the final regs also notes that "[A] failure to meet the proposed safe harbor would not necessarily preclude rental real estate activities from being a section 162 trade or business."[53]

4. SAFE HARBOR FOR RENTAL REAL ESTATE

4.1 Notice 2019-7

4.1(a) Notice 2019-7, released by the IRS on January 18, 2019, contains a proposed Revenue Procedure that taxpayers can use as a safe harbor to determine whether their rental real estate activity constitutes a "trade or business" for purposes of Section 199A.

4.1(b) "The Treasury Department and the IRS are aware that whether a rental real estate enterprise is a trade or business for purposes of section 199A is the subject of uncertainty for some taxpayers. To help mitigate this uncertainty," the IRS published the Notice.[54]

4.1(c) "If the safe harbor requirements are met, the real estate enterprise will be treated as a trade or business as defined in section 199A(d) for purposes of applying the regulations under section 199A."

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[52] TD 9847 at 2955.

[53] *Id*. at page 2956.

[54] All quotes in this Section 3 are from Notice 2019-7.

4.1(d) "Failure to satisfy the requirements of this safe harbor does not preclude a taxpayer from otherwise establishing that a rental real estate enterprise is a trade or business for purposes of section 199A."

4.2 Excluded real estate

4.2(a) The safe harbor does not apply to property:

- ◊ Used by the taxpayer (including an owner or beneficiary of a trust relying on the safe harbor) as a residence for any part of the year under IRC Section 280A; or

- ◊ Rented or leased under a triple net lease.

4.2(b) A "triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities."

- ◊ "This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant."

4.3 Requirements to use the safe harbor

4.3(a) Solely for purposes of the safe harbor, a "**rental real estate enterprise**" is an interest in real property held for the production of rents.

- ◊ It may consist of an interest in multiple properties.

4.3(b) The individual or entity using the safe harbor must hold the real property interest directly or through a disregarded entity.

4.3(c) The taxpayer must either treat each property held for the production of rents as a separate "enterprise" OR treat all similar prop-

erties held for the production of rents (except property excluded from the safe harbor) as a single "enterprise."[55]

◊ Commercial and residential real estate may not be part of the same enterprise.

◊ Taxpayers may not vary this treatment from year to year unless there has been a significant change in facts and circumstances.

4.3(d) The taxpayer must maintain separate books and records to reflect income and expenses for each rental real estate enterprise.

4.3(e) "For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services *are performed* (as described in this revenue procedure) per year with respect to the rental enterprise." (Emphasis added.)

◊ "For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services *are performed* (as described in this revenue procedure) per year with respect to the rental real estate enterprise." (Emphasis added.)

4.3(f) The taxpayer must maintain contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) *who performed* the services.

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[55] The similar properties joined into an "enterprise" to qualify as a "trade or business" are like *protons* and *neutrons* joining together to form an *atom*. Aggregating the trades or businesses under the -4 reg is like combining the *atoms* (the trades or businesses) into *molecules* (several trades or businesses treated as one aggregated trade or business).

◊ The records must be made available for inspection at the request of the IRS.

◊ The contemporaneous records requirement does not apply to taxable years beginning prior to January 1, 2019.

4.4 **Rental services**

4.4(a) Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.

4.4(b) "Rental services" for purpose of the safe harbor this revenue procedure include:

◊ Advertising to rent or lease the real estate;

◊ Negotiating and executing leases;

◊ Verifying information contained in prospective tenant applications;

◊ Collecting rent;

◊ Daily operation, maintenance, and repair of the property;

◊ Management of the real estate;

◊ Purchase of materials; and

◊ Supervision of employees and independent contractors.

4.4(c) "Rental services" do *not* include:

◊ Financial or investment management activities, such as arranging financing;

◊ Procuring property;

◊ Studying and reviewing financial statements or reports on operations;

◊ Planning, managing, or constructing long-term capital improvements; or

◊ Time spent traveling to and from the real estate.

5. SSTBs[56]

5.1 Legislative History

5.1(a) The Conference Report and Blue Book for the 2017 TCJA refer to the Section 448 regs to flesh out the SSTBs.[57]

5.2 The Section 199A Regulations

5.2(a) The Section 199A regs regarding SSTBs are "informed by existing interpretations and guidance under both Sections 1202 and 448 when relevant."[58].

◊ The Explanation to the Proposed Regs notes that if the purposes of the IRS Sections are different, the definition must conform to the purpose of the statute.[59]

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[56] See list of SSTBs at footnote 17

[57] Conference Report at 216; Blue Book at footnotes 123, 124 and 125.

[58] Proposed Regs at 40896. Section 448 permits qualified personal service corporations to use the cash method of accounting for tax purposes.

[59] Proposed Regs at 40896. Comparing the examples in the Section 199A regs with the similar examples in the Section 448 regs is helpful to see where the different purposes of the statute indicate a different result. Treas. Reg. §§ 1.199A-5(b)(3), 1.448-1T(e)(4)(iv)(B). See also PLR 89-13-12 (an undated Section 448 ruling).

◊ The preambles to both the proposed and final regs extensively discuss SSTBs.[60] Many comments were submitted in this area.

5.2(b) Some of the activities that the regulations address:[61]

Health clubs, spas; payment processing; Residential facility for seniors; Specialty surgical center; Medical testing; Research, testing, manufacture or sale or pharmaceuticals or medical devices	Not "health care"
Pharmacist	Is "health care"
Singer/songwriter	Publishing and recording royalties are "performing arts"
Movie producers and investors	Profits are "performing arts," even for passive investor
Printers, court reporters, delivery services	Not "law"
Payment processing and billing analysis	Not "accounting"
Maintaining or operating equipment or facilities; broadcasters	Not "athletics"
Sports team	Selling tickets and broadcast rights to games is "athletics"
Temp staff provider; Bicycle sales and repair shop with fabu-	Not "consulting"; not "reputation or skill"

60 Proposed Regs at 40895-901; TD 9847 at 2969-78.

61 Treas. Reg. § 1.199A-5(b)(2)(ii).

lous reputation, discussing which bike is best for the customer	
Famous chef gets an endorsement fee for a product	Running a restaurant as a chef is not as SSTB, but getting an endorsement fee is a separate SSTB
Celebrity endorses shoe and allows likeness to be used in shoe ads, gets partnership share and guaranteed payments	Is "reputation and skill" SSTB
Banks	Not "financial services"
Financial/investment adviser	Is "financial services"
Franchising a financial/investment adviser business	Not "financial services" for franchisor
Insurance and real estate brokers	Not "brokerage services"
Stock broker	Is "brokerage services"
Directly managing real property	Not "investing or investment management"
Originating loans not for sale	Not "dealing in securities"

5.2(c) Consulting "embedded in, or ancillary to, the sale of goods" is not the SSTB of "consulting" if no separate payment for the consulting services is made[62]

5.2(d) The regs address when a principal asset of the trade or business is the reputation or skill of one or more owners or employees. The regs limit this category of SSTB to those receiving income from endorsing products or services, licensing or receiving income for the use of an individual's image, likeness, etc., or receiving appearance fees or income.[63]

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[62] Treas. Reg. § 1.199A- 5(b)(2)(vii).

[63] Treas. Reg. § 1.199A-5(b)(2)(xiv).

5.2(e) A pass-through entity must ascertain whether it conducts an SSTB and disclose that determination to its owners.[64]

5.3 De Minimis Rule

5.3(a) The regs address the treatment of a business which predominantly is *not* a SSTB, but does engage in some SSTB activities.

5.3(b) If for a year a trade or business has gross receipts of $25 million or less (before aggregation) and less than 10% of the gross receipts are attributable to SSTB activities, the business is not an SSTB.[65]

- ◊ If gross receipts exceed $25 million, the trade or business is not an SSTB if less than 5% of its gross receipts are attributable to SSTB activities.[66]

5.3(c) The de minimis tests must be applied before the aggregation rules, because an SSTB cannot be aggregated with other trades or businesses.

5.3(d) Requests in comments to the proposed regs for a less "bright line" approach or a measure other than gross receipts were rejected.[67]

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64 Treas. Reg. § 1.199A-6(b)(2)(i), (3)(i)(B). See Section 7 (Reporting Rules) below.

65 Treas. Reg. § 1.199A-5(c)(1)(i).

66 Treas. Reg. § 1.199A-5(c)(1)(ii).

67 TD 9847 at 2975-2976.

6. AGGREGATING ACTIVITIES

6.1 Background

6.1(a) Separate treatment might create a problem for taxpayers maintaining many legal entities or an affiliated service company which provides management, accounting, purchasing, marketing and similar activities for a group of operating companies.

6.1(b) Section 199A applies to trades or businesses, but not to activities.

6.1(c) Unless trades or businesses can be aggregated for purposes of applying the Jobs Limits, a business might have more wages that needed but less UBIA than needed for a operating entity and less wages and too much ABIA in a rental real estate entity. Aggregation under the -4 reg is about efficiently and realistically allocating the wages and UBIA.

6.1(d) Distinguish joining similar properties together to create an "enterprise" that qualifies as a trade or business under the real estate safe harbor from aggregating trades or business for this purpose.[68]

6.1(e) The Regulations do not import the aggregation rules from the passive activity loss regulations.[69]

6.2 Conditions to Aggregate

6.2(a) To aggregate activities for purposes of Section 199A:[70]

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[68] See footnote 55 above for the proton, neutrons, atoms and molecules analogy.

[69] Preamble to Proposed Regs at 40894.

[70] Treas. Reg. § 1.199A-4(b).

◊ Each trade or business must itself be a "trade or business."

◊ The same persons or group of persons must directly or indirectly own a majority interest in each of the businesses – but non-majority owners can aggregate if the rule is satisfied.

◊ All of the individual items must be reported on tax returns with the same taxable years.

◊ None of the aggregated businesses can be SSTBs.[71]

6.2(b) Each of the trades or businesses aggregated must meet at least two of the three following factors:[72]

◊ The businesses provide products and services which are the same or which are ordinarily provided together.

◊ The businesses share facilities or significant centralized business elements (such as common personnel, accounting, legal, purchasing, human resources or information technology).

◊ The businesses are operated in coordination with or in reliance upon the other businesses in the aggregated group.

6.3 Aggregation by Individuals and Entities

6.3(a) Entities may aggregate trades or businesses operated directly or through lower-tier entities.[73]

◊ A parent entity is bound by the aggregation done by its subsidiary.[74]

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[71] So the *de minimis* test for SSTBs must be applied before aggregating.

[72] Treas. Reg. § 1.199A-4(b)(v).

[73] Treas. Reg. § 1.199A-4(b)(2)(ii).

6.3(b) Individuals can aggregate businesses owned directly and through entities.[75]

◊ The individual is bound by any aggregation done by an entity owned by the individual.[76]

◊ But if an entity *does not* aggregate, different owners of the entity need not aggregate in the same manner.[77]

6.3(c) Mechanics: The regulations provide rules on trades or business entering or leaving an aggregate group.[78]

6.3(d) Based on the foregoing, individuals owning real property in different legal entities must carefully review whether they can or should aggregate those real property interests. Triple net leased properties might not rise to the level of a trade or business; if not, it would not be possible to aggregate them with other real properties -- even if majority-owned by the same person or group of persons.

(footnote continued from previous page)

[74] That seems to be what this sentence means: "An [entity] may not subtract from the trades or businesses aggregated by a lower-tier [entity] but may aggregate additional trades or businesses with a lower-tier [entity]'s aggregation if the rules of [section 1.199A-4 of the regs] are otherwise satisfied." *Id.*

[75] Treas. Reg. § 1.199A-4(b)(2)(i).

[76] *Id.*

[77] Treas. Reg. § 1.199A-4(b)(2)(ii).

[78] Treas. Reg. § 1.199A-4(c).

7. REPORTING RULES

7.1 Entities and publicly trade partnerships

7.1(a) Entities and publicly trade partnerships must compute and report the qualified business income, and Jobs Limits for each trade or business.[79]

7.2 Trusts and estates

7.2(a) Trusts (other than grantor trusts) must allocate Sec 199A items to the trust and to beneficiaries and must report them. Similar rules apply to estates.[80]

7.2(b) The IRS can aggregate multiple trusts to avoid abuses.[81]

7.3 Effective date

7.3(a) The reporting rules apply to years ending after February 8, 2019.[82]

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[79] Treas. Reg. § 1.199A-6(b), (c). See Instructions to 2018 Form 1120S at pages 38-39 (February, 2019 version); Instructions to 2018 Form 1065 at pages 46-47 (February, 2019 version); IRS Publication 535, 2018 Business Expenses at Chapter 12 (January, 2019 version).

[80] Treas. Reg. § 1.199A-6(d).

[81] Treas. Reg. § 1.643(f)-1(a) ("[For income tax purposes], two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.").

[82] Treas. Reg. § 1.199A-6(e)(1).

8. ACCURACY PENALTY FOR UNDERPAYMENT OF TAX

8.1 General rule

8.1(a) Section 6662(a) provides a penalty for an underpayment of tax required to be shown on a return.

8.1(b) The penalty applies to the portion of any underpayment that is attributable to a substantial underpayment of income tax.[83]

8.1(c) A substantial understatement of tax is generally an understatement that exceeds the greater of 10% of the tax required to be shown on the return or $5,000.[84]

8.2 Special rule for Section 199A underpayments

8.2(a) The 2017 Tax Act includes a special rule: in the case of any taxpayer who claims the Section 199A deduction for the taxable year, 5% is substituted for 10%.[85]

8.2(b) One commenter asked the IRS for guidance on how this accuracy penalty would be applied if an activity was determined by the IRS not to be a trade or business for purposes of section 199A. The IRS did not to adopt this suggestion because guidance about the accuracy penalty was "beyond the scope of these regulations" – in other words, the worry of another part of the IRS.[86]

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83 I.R.C. § 6662(b).

84 I.R.C. § 6662(d)(1).

85 I.R.C. § 6662(d)(1)(C).

86 TD 9847 at 2957.

8.3 **Reasonable basis and adequate disclosure**

8.3(a) Consider filing Form 8275, Disclosure Statement, to set forth the facts that indicate that for an activity that does not qualify for the real estate safe harbor, there is nevertheless a reasonable basis to treat is as a "trade or business."

8.3(b) Having adequate disclosure and a reasonable basis for the position should prevent the application of accuracy-related penalties and preparer penalties.[87]

9. CASE STUDIES

9.1 **Joe's Plumbing**

9.1(a) Everyone calls Joe because he's such a good plumber and does so much advertising. Joe has a contractor's license.

9.1(b) Can Joe use the 20% Section 199A deduction? Or is the business an SSTB because it relies on Joe's personal reputation?

◊ Because Joe is not licensing his likeness or making personal appearances like a celebrity, his plumbing business is not an SSTB.[88]

9.2 **Gina's Creations**

9.2(a) Gina makes costumes for movies. Can she use the Section 199A deduction?

9.2(b) She "participates in the creation of perform arts" – an SSTB.[89]

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87 I.R.C. §§ 6662(d)(2)(B)(ii) (taxpayers), 6694(a)(2) (preparers).

88 Treas. Reg. § 1.199A-5(b)(2)(xiv), -5(b)(3) Examples 14, 15 and 16.

89 Treas. Reg. § 1.199A-5(b)(2)(vi).

9.2(c) But do her services "require skills unique to the creation of the performing arts"?[90]

9.2(d) Or are her services more like "the maintenance and operation of equipment or facilities for use in the performing arts"?[91] Probably, because making clothes does not require skills "unique to" the performing arts. Does that cover making period costumes? Monster costumes? Space alien costumes?

9.2(e) Note that if she has a profit participation in movie, her share of the profit will not get the Section 199A deduction.[92]

9.3 **Surfing Law**

9.3(a) Brian, Carl and Dennis really like surfing, so they become lawyers and practice surfing law in Manhattan Beach. The have a staff of 15 and several associates. They know that practicing law is an SSTB. They feel like maybe they should be doing something else, but they can't put it into words. Their accountant Murray suggests separating the law practice from the admin side so that the admin side, as a separate entity owned by Brian, Carl and Dennis can get the Section 199A deduction. If that works, they might pump up the fees that the law firm pays to the admin side. Does it work?

9.3(b) No, it doesn't, under the regs, because the admin entity will provide more than 80% of its services to a law firm, and at least 50% of the admin entity is owned by the partners in the law firm.[93]

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90 *Id.*

91 *Id.*

92 Treas. Reg. § 1.199A-5(b)(3) Example (vi) (movie producer).

93 Treas. Reg. § 1.199A-5(c)(2)(i).

9.3(c) Providing admin services to other law firms won't change this, because the other law firms are SSTBs, too.

9.3(d) The employees of the firm who become independent contractors and still provide services to the firm are still presumed to be employees of the firm for purposes of the rule that the Section 199A deduction does not apply to services as an employee.[94] Same result if an employee of the firm incorporates.

9.4 **FLP**

9.4(a) FLP is an LLC organized by Mom and Dad to hold several parcels of commercial real estate. The parcels were inherited by Mom and Dad and were developed in the 1960s and 1970s. There are buildings on the parcels and the parcels are rented to tenants on triple net leases. The properties were placed in service by Mom and Dad from the early 1970s to 2016. After a year or so, Mom and Dad give interests in the LLC to their children. The FLP has no payroll. Does FLP get the Section 199A deduction for 2019?

9.4(b) The FLP is not a corporation, so it's income is eligible for the Section 199A deduction.[95]

9.4(c) The business is a trade or business because it meets the definition of a business for Section 162.

◊ It can't use the safe harbor because its properties are leased on triple net leases.

9.4(d) Is the business of renting commercial real property an SSTB of investing or investment management ? No. "The performance

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[94] Treas. Reg. § 1.199A-5(d)(3)(i). The presumption is rebuttable. Treas. Reg. § 1.199A-5(d)(3)(ii).

[95] I.R.C. § 199A(a).

of services of investing and investment management does not include directly managing real property." It does not involve receiving fees for providing services or advice.[96]

9.4(e) The deduction available is the lesser of 20% of the income from the properties or "2.5% of the unadjusted basis immediately after acquisition of all qualified property."[97]

◊ "Qualified property" is tangible property subject to depreciation.[98] So the building might be qualified property, but the land is not.

◊ For non-residential real property, the recovery period is 39 years.[99] So the UBIA of buildings placed in service before 1980 would not count towards the 2.5% limit. The UBIA of building placed in service after 1980 would be included.[100]

◊ If a cost segregation study had been done, the basis allocated to assets placed in service more than ten years ago with applicable recovery periods of less than ten years would be *excluded* from the 2.5%.[101]

◊ The facts that the parcels were inherited by Mom and Dad or that they gave LLC interests to their children does not affect the Section 199A deduction.

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[96] Treas. Reg. § 1.199A-5(b)(2)(xi).

[97] I.R.C. § 199A(b)(2)(B)(ii).

[98] I.R.C. § 199A(b)(6)(A).

[99] I.R.C. § 168(c). The Section 199A regs look to the depreciable periods in Section 168(c) and not to the depreciable period in effect when the property was placed in service. Treas. Reg. § 1.199A-2(c)(2)(i)(B).

[100] I.R.C. § 199A(b)(6)(B).

[101] *Id.*

◊ The level of the activity of the parents and the children as LLC members does not affect the Section 199A deduction – unless they were relying on the safe harbor to confirm that the LLC conducts a "trade or business" – but in that case the activities of all of their agents would be included, not just their activities.[102] Contrast the tests for "material participation" for the passive activity loss rules.[103]

9.5 Widget Company

9.5(a) The promoters of a new company to manufacture widgets ask if they should use an S corp, C corp or LLC.

9.5(b) If they can use Section 1202 to escape gain on the sale of the stock (or the gain on the liquidating distributions if the C corporation sells its assets), that might be attractive. But with a C corporation they will have a higher effective tax rate on distribute profits, and there can be no certainty today that all of the requirement of Section 1202 will be satisfied when the business is sold.

9.5(c) If the business can use Section 199A, it probably makes sense to use an LLC, because there is no requirement to pay wages (that are not subject to the deduction) (as opposed to an S corporation that is required to pay no less than reasonable wages to the shareholders).

◊ On the other hand, not paying wages to the owners will reduce the wage component of the Jobs Limits.

◊ Guaranteed payments will be treated as ordinary income to the recipient (with no Section 199A deduction), will be de-

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[102] See Section 4.3(e) above.

[103] Temp. Treas. Reg. § 1.469-5T(a) (1988).

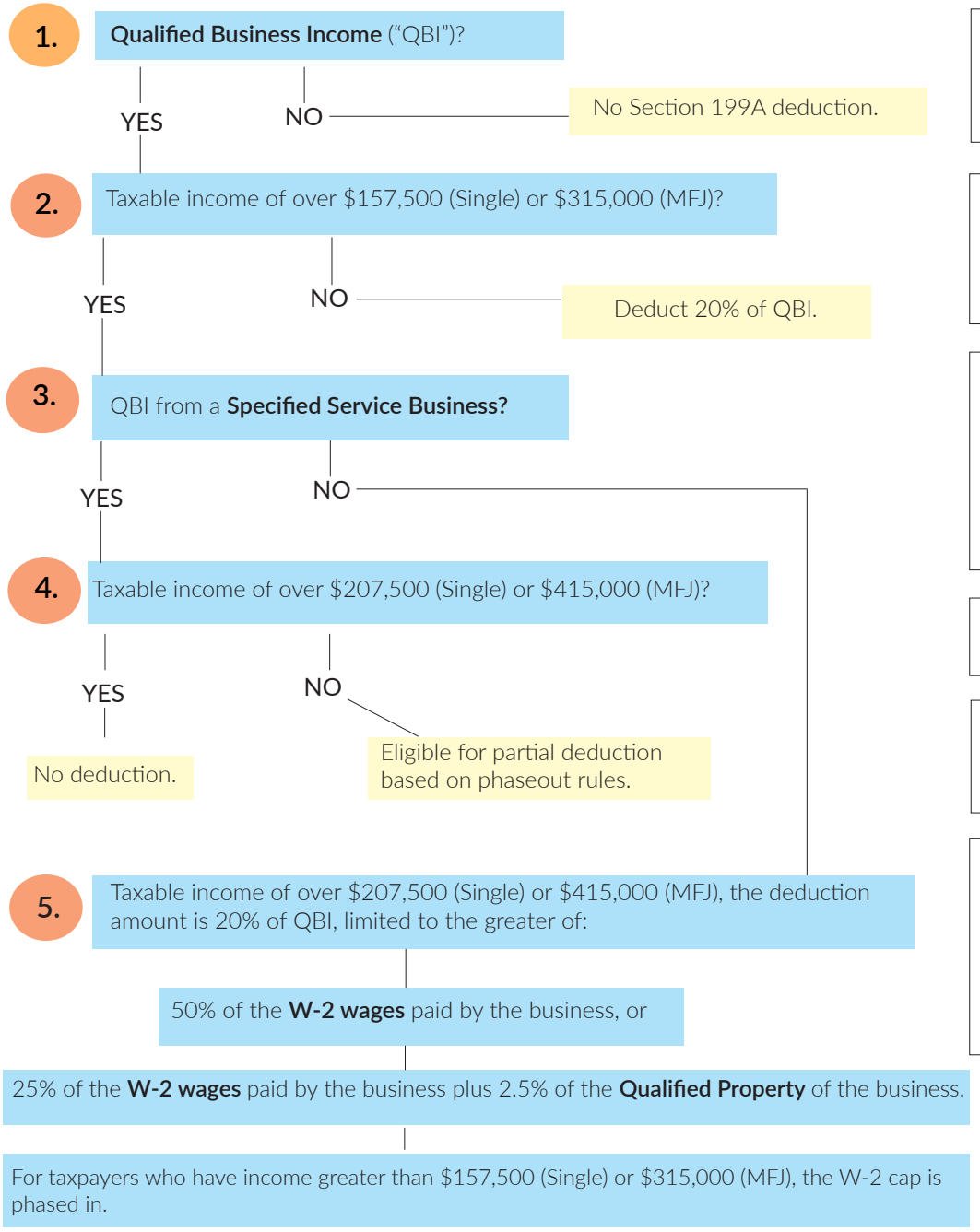
ductible by the other partners, and will not increase the wage component of the Jobs Limits.

9.5(d) If the business cannot use Section 199A, it might make sense to use an S corporation to minimize the 2.9% Medicare tax. However, using an S corporation risks becoming a C corporation, and thus paying higher taxes on operating income that is distributed to the shareholders and on the sale of the shares or assets (if Section 1202 does not apply). So the LLC might be attractive anyway.

9.5(e) If the promoters plan to take Widget Company public or to swap shares with a IPO candidate or a public company in a tax-free transaction, they will need to be a corporation. At some point the capital needs of the business will dictate whether it can stay an S corporation (with one class of shares and only humans and certain trusts as shareholders) or whether it must become a C corporation.

[End of Outline.]

Section 199A



Generally, QBI is the net amount of qualified items of income, gain, deduction and loss for each separate qualified trade or business of the taxpayer. Rental income earned in a trade or business activity, not simply as an investment, is included in QBI.

Qualified items do not include those items considered when determining net capital gain or loss, dividends, and interest income unless it is allocable to the trade or business. Also, to be QBI, any amount must be incurred in connection with the conduct of an active trade or business within the United States.

Specified Service Business includes any trade or business involving the performance of services in accounting, actuarial science, athletics, brokerage services, consulting, financial services, health, law, performing arts, or where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees. Also included are performance of services consisting of investing or investment management, trading or dealing in securties, partnership interests or commodities.

The regulations provide context and detail regarding terms.

W-2 wages encompass the total wages (subject to wage withholding), elective deferrals, and deferred compensation paid by the qualified trade or business with respect to the employees of the business.

Qualified Property consists of the original cost of any tangible property held by, and available for use in, the business, which is used in the production of QBI and for which the depreciable period has not ended before the close of the taxable year. The depreciable period ends on the later of (a) 10 years after the property is first placed in service or (b) the last day of the last full year in the applicable recovery period that would apply to the property under Section 168.

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