Qualified Business Income Deduction

A. Introduction

1. Many American businesses are organized as pass-through entities. These companies account for roughly 30 million entities or 90% of all enterprises in the United States.

2. Congress passed the Qualified Business Income Deduction as part of the Tax Cuts and Jobs Act, effective January 1, 2018, through December 31, 2025. The Treasury Department issued proposed regulations on August 8, 2018 -- 184 pages. Taxpayers may rely on the rules set forth in the proposed regulations in their entirety until the date a Treasury decision adopting these regulations as final regulations is published in the Federal Register.

3. Law is anything but simple. QBI deduction is not guaranteed to business owners. Navigation a tangle of limitations, terms of art, thresholds, and phase-ins and phase-outs.

B. Basics of the QBI Deduction

1. The QBI deduction allows individuals a 20% deduction of the qualified business income of a qualified passthrough entity.

   a. The owners then pay tax at their personal income tax rate on the remainder.

2. COMPONENTS OF INDIVIDUAL RETURNS

   Gross Income
   - Deductions for Adjusted Gross Income (Business Deductions)
   Adjusted Gross Income
   - Itemized Deductions or Standard Deduction
   - Qualified Business Income Deduction
   Taxable Income
   x Tax Rate
   Tax Liability
   -Tax Credits and Prepayments
   Net Tax Due or Refund

3. Qualified Pass-Through Entities

   a. Sole proprietorships,

   b. S corporations,

   c. Partnerships,

d. Trusts, and

e. Estates.

4. C corporation do not qualify for the Qualified Business Income Deduction

5. Qualified Business Income (QBI) does not include the following items of investment income: [Sec. 199A(c)(3)(B)]

   a. Short-term capital gain or loss;

   b. Long-term capital gain or loss;

   c. Dividend income;

   d. Interest income;

   e. Net gain from foreign currency transactions and commodities;

   f. Income from notional principle contracts;

   g. Any amount received from an annuity which is not received in connection with a trade or business; and

   h. Any deduction or loss properly allocable to the items above.

6. Qualified Business Income does not include any wages or guaranteed payments earned as an employee [Sec. 199A(c)(4)].

7. The QBI deduction has an overall limitation equal to the sum of:

   a. The lesser of:

      1) 20% of the “combined qualified business income” of the taxpayer, or

         a) A taxpayer’s combined qualified business income amount for a tax year equals the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer.

      2) 20% of the excess of taxable income over the sum of any net capital gain;

         a) Taxable income is computed without the 20% deduction.

b. Plus the lesser of:

1) 20% of qualified cooperative dividends, or

2) 20% of the excess of taxable income over the sum of any net capital gain.

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

d. A taxpayer's combined qualified business income amount equals the sum of the deductible amount determined for each qualified trade or business carried on by the taxpayer.

8. The QBI Deduction is Limited to:

a. The sum of:

1) The lesser of:

a) 20% of the taxpayer's "qualified business income" or

b) The greater of:

(1) 50% of the W-2 wages with respect to the business, or

(2) 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of all qualified property.

2) 20% of the combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

9. W-2 Wages

a. The W-2 wage rules of proposed §1.199A-2 generally follow the rules under former section 199. Section 199, which was repealed by the TCJA, provided for a deduction with respect to certain domestic production activities and contained a W-2 wage limitation similar to the one in section 199A.

b. W-2 wages are exactly that: wages paid to an employee, including any elective deferrals into a Sec. 401(k)-type vehicle or other deferred compensation.

c. W-2 wages do not include, however, amounts like payments to an independent contractor or management fees, because new Sec. 119A(b)(4)(C) clearly states that an amount is not a W-2 wage for these purposes unless it shows up on a payroll tax return.

d. W-2 wages must be properly allocable to QBI to be taken into account [Sec. 199A(b)(4)].

    1) W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI.

e. In the case of a trade or business conducted by a relevant passthrough entity, a partner's or shareholder's allocable share of wages must be determined in the same manner as the partner's allocable share or a shareholder's pro rata share of wages expense [Sec. 199A(f)(1)(A)(iii) and Prop. Reg. 1.199A-2(b)(4)].

10. Wages Paid by Others

    a. Taxpayers may take into account wages reported on Forms W-2 issued by other parties provided that the wages reported on the Forms W-2 were paid to employees of the taxpayer for employment by the taxpayer [Prop. Reg. 1-199-2(a)(2)].

        1) The person paying the W-2 wages and reporting the W-2 wages on Form W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person.

    b. Persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under Sec. 7705, statutory employers under Sec. 3401(d)(1), and agents under Sec. 3504. In the case of wages allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined to be in the same proportion to total W-2 wages as the deductions associated with those wages are allocated among the particular trades or businesses [Prop. Reg. 1.199A-2].

11. Qualified Property

    a. Qualified property is defined as tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the tax year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the tax year. Land, inventory, and intangibles do not qualify.

b. Qualified property is the unadjusted basis of the property immediately after acquisition (UBIA). “Immediately after acquisition” means as of the date the property is place in service because Sec. 199A provides that “qualified property” must be used in the production of QBI. In order to be used in the production of QBI, the qualified property necessarily must be placed in service.

c. Unadjusted Basis of Qualified Property

1) The use of the unadjusted basis of property begins on the date the property is placed in service and ends on the later of:

a) 10 years, or

b) The last day of the last full year in the asset’s “regular” (not ADS) depreciation period.

12. W-2 Wage Limit

a. The W-2 wages/qualified property limit does not apply if the taxpayer’s taxable income for the tax year is equal to or less than a $191,950 threshold amount for 2024 ($383,900 for taxpayers filing a joint return). Fully phased out at $241,950/$483,900.

1) Taxable income before any potential 20% deduction.

13. Partnerships and S Corporations

a. The qualified business income deduction for non-C corporate taxpayer is applied to partnerships and S corporations at the partner or shareholder level. Thus, each partner or shareholder must take into account his or her allocable share of each qualified item of income, gain, deduction, and loss and is treated as having W-2 wages equal to his or her allocable share of the W-2 wages of the partnership or S corporation for the tax year. A partner’s or shareholder’s allocable share of W-2 wages is determined in the same manner as the partner’s or shareholder’s allocable share of wage expense, and a partner’s or shareholder’s allocable share of the unadjusted basis of qualified property is determined in the same manner as the partner’s or shareholder’s allocable share of depreciation.

b. Some partners and shareholders may be eligible to take the deduction while others in the same partnership or S corporation may not because of the taxable incomes of each.

14. Each Separate Business

    a. The 20% deduction is be required to be computed with respect to each separate business owned by the individual.

    b. Only use the W-2 wages and qualified property of that business.

15. Domestic Business

    a. Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States.

    b. The term “United States” includes the Commonwealth of Puerto Rico [Prop. Reg. 1.199A-1(e)(3)].

    c. Sec. 199A applies to both U.S. citizens and resident aliens as well as nonresident aliens that have QBI.

16. Qualified Trade or Business

    a. A qualified trade or business means any trade or business other than a specified service trade or business (SSTB) and other than the trade or business of being an employee.

    b. Specified Service Activity [Sec. 199A(2)]

        1) A “Specified Service Activity” normally includes:
        Health;
        Law;
        Accounting;
        Actuarial Science;
        Performing Arts;
        Consulting;
        Athletics;
        Financial Services;
        Brokerage Services;
        Investing and Investment Management;
        Trading;
        Dealing in Securities, Partnership Interests, or Commodities; and
        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.

2) Specified service trade or business is taken from Sec. 1202.

3) Financial services and investing categories were added by Sec. 199A.

4) These businesses offer services – they do not sell or build goods.

5) The definition of "Specified Service Activity" was modified from Sec. 1202 to exclude engineering and architecture services. Architects and engineers are an integral part of actually building something.

6) Reputation or Skill

   a) 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 – The Treasury Department and the IRS believe that the "reputation or skill" clause as used in Sec. 199A was intended to describe a narrow set of trades or businesses, not otherwise covered by the enumerated specified services, in which income is received based directly on the skill and/or reputation of employees or owners.

   b) Additionally, the Treasury Department and the IRS believe that "reputation or skill" must be interpreted in a manner that is both objective and administrable.

   c) Thus, Prop. Reg. 1.199A-5(b)(2)(xiv) limits the meaning of the "reputation or skill" clause to fact patterns in which the individual or relevant passthrough entity is engaged in the trade or business of: (1) receiving income for endorsing products or services, including an individual's distributive share of income or distributions from a relevant passthrough entity for which the individual provides endorsement services; (2) licensing or receiving 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 relevant passthrough entity to which an individual contributes the rights to use the individual's image; or (3) receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players).

c. SSTB rule put in to prevent the conversion of personal service income into qualified business income. Similar to wages -- wages are not QBI. If you have an entire business that provides services, it should follow that all of the income generated by the business should be taxed the same way as wages. Takes aim at business owners, rather than employees.

d. The two W-2-based limitations also do not apply when taxable income is below the thresholds ($191,950/$383,900).

e. A disallowance of the deduction with respect to specified service trades or businesses is also phased in above the threshold amount ($191,950/$383,00) of taxable income.

17. The deduction is allowed only for Federal income tax purposes.

    a. The QBI deduction does not reduce net earnings from self-employment under Sec. 1402 or net investment income under Sec. 1411.

18. The Deduction Does Not Reduce Adjusted Gross Income

    a. The 20% deduction is not allowed in computing adjusted gross income, and instead is allowed as a deduction reducing taxable income.

    b. Thus, for example, the 20% deduction does not affect limitations based on adjusted gross income.

    c. The deduction is available to both non-itemizers and itemizers.

    d. The deduction is taken after the itemized/standard deduction on Form 1040.

19. Net Operating Loss

    a. Sec. 172(d) has been amended to provide that a net operating loss does not include the Sec. 199A deduction.

20. Deduction Does Not Reduce Passthrough Entity Owner's Basis

    a. The Sec. 199A deduction has no effect on the adjusted basis of the partner's interest in a partnership.

    b. The Sec. 199A deduction has no effect on the adjusted basis of a stockholder's stock in an S corporation or the S corporation's accumulated adjustments account.

21. Accuracy-Related Penalty

    a. A taxpayer who claims the Code Sec. 199A deduction may be subject to the 20-percent accuracy-related penalty for a substantial understatement of income tax if the understatement is more than the greater of five percent (not 10 percent) of the tax required to be shown on the return for the tax year, or $5,000 [Sec. 6662(d)(1)(C)]. The income tax shown on the return would have to be more than $100,000; otherwise the understatement of tax must be more than $5,000.

22. Acquisition or Disposition of a Trade or Business

    a. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2. For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in Prop. Reg. 1.199A-2(b).

23. Trade or Business

    a. The proposed regulations incorporate the rules under Sec. 162 for determining whether a trade or business exists for purposes of Sec. 199A. A taxpayer can have more than one trade or business for purposes of Sec. 162.

    b. The Sec. 199A deduction is not based on the level of a taxpayer's involvement in the trade or business. Both active and passive owners of a trade or business may be entitled to a Sec. 199A deduction if they otherwise satisfy the requirements of Sec. 199A.

    c. Under Sec. 199(d)(1)(B), the trade or business of performing services as an employee is not a qualified trade or business. Unlike an SSTB, there is no threshold amount that applies to the trade or business of performing services as an employee. Thus, wage or compensation income earned by any employee is not eligible for the Sec. 199A deduction no matter the amount. An individual is an employee for Federal employment tax purposes if he or she has the status of an employee under the usual common law and statutory rules applicable in determining the employer-employee relationship. The regulations and Sec. 3014(c) state, generally, that an officer of a corporation (including an S corporation) is an employee of the corporation.

    d. Proposed Reg. 1.199A-5(d)(3) provides that for purposes of section 199A, if an employer improperly treats an employee as an independent contractor or other non-employee, the improperly classified employee is in the trade or business of performing services as an employee notwithstanding the employer's improper classification.

1) Individuals who cease being treated as employees of an employer, but subsequently provide substantially the same services to the employer (or a related entity) but claim to do so in a capacity other than as an employee is an issue of particular importance.

2) Proposed §1.199A-5(d)(3) provides that, solely for purposes of section 199A(d)(1)(B) and the regulations thereunder, an individual who was treated as an employee for Federal employment tax purposes by the person to whom he or she provided services, and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services.

3) This presumption may be rebutted only upon a showing by the individual that, under Federal tax rules, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities. This presumption is solely for purposes of section 199A and does not otherwise change the employment tax classification of the individual.

24. W-2 Wages

a. The determination of W-2 wages must be made for each trade or business by the individual or relevant passthrough entity that directly conducts the trade or business before applying the aggregation rules of §1.199A-4. In the case of W-2 wages paid by a relevant passthrough entity, the relevant passthrough entity must determine and report W-2 wages for each trade or business conducted by the relevant passthrough entity. W-2 wages are presumed to be zero if not determined and reported for each trade or business [Prop. Reg. 1.199-2(a)(2)].

1) A notice of proposed revenue procedure, Notice 2018-64, 2018-35, which provides three methods for calculating W-2 wages is being issued concurrently with this notice of proposed rulemaking. The three methods in the notice are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869, for purposes of calculating “paragraph (e)(1) wages” (that is, wages described in §1.199-2(e)(1) issued under former section 199). The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide for greater accuracy.

25. Qualified Property

a. The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business.

b. Form 1065, K-1 Box 20

Z - Section 199A qualified business income
AA - Section 199A W-2 wages from the trade or business
AB - Section 199A unadjusted basis on acquisition of qualified property
AC - Section 199A REIT dividends
AD - Qualified publically traded partnership (PTP) income
AH - Other information

c. Form 1120S, K-1 Bpx 18

V - Section 199A qualified business income
W - Section 199A W-2 wages from the trade or business
X - Section 199A unadjusted basis on acquisition of qualified property
Y - Section 199A REIT dividends
Z - Qualified publically traded partnership (PTP) income
AC - Other information

26. Income and Deductions

a. Prop. Reg. 1.199A-3(b)(1)(i) clarifies that any gain attributable to assets of a partnership giving rise to ordinary income under Sec. 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and therefore, may constitute QBI if the other requirements of Sec. 199A and Prop. Reg. 1.199A-3 are satisfied.

b. Sec. 481 adjustments will constitute QBI to the extent the requirements of Sec. 199A, including Prop. Reg. §1.199A-3, are satisfied. Sec. 481 adjustments arising in a taxable year ending before January 1, 2018, do not constitute QBI.

c. Prop. Reg. 199A-3(b)(1)(iv) provides that, to the extent that any previously disallowed losses or deductions are allowed in the taxable year, they are treated as items attributable to the trade or business. However, losses or deductions that were disallowed for taxable years beginning before January 1, 2018, are not taken into account for purposes of computing QBI in a later taxable year.

d. Generally, items giving rise to a net operating loss are allowed in computing taxable income in the year incurred. Because those items would have been taken into account in computing QBI in the year incurred, the net operating loss should not be treated as QBI in subsequent years. Otherwise, the same loss could be taken into account in multiple tax years. However, losses disallowed by Sec. 461(l) give rise to a net operating loss without ever having been allowable in computing taxable income.

Thus, if deductions are disallowed by reason of Section 461(l), those disallowed deductions will not be included in the QBI computation in the year incurred (because they are not includable in taxable income), and, if the resulting net operating loss also is not included in the QBI computation, the deduction would permanently escape the QBI rules. This result would be inappropriate. Accordingly, Prop. Reg. 1.199A-3(b)(1)(v) provides that generally, a deduction under Sec. 172 for a net operating loss is not considered attributable to a trade or business and therefore, is not taken into account in computing QBI. However, to the extent the net operating loss is comprised of amounts attributable to a trade or business that were disallowed under Sec. 461(l), the net operating loss is considered attributable to that trade or business, and will constitute QBI to the extent the requirements of Sec. 199A, including Prop. Reg. 1.199A-3, are satisfied.

e. Sec. 1231 Gains

1) Sec. 199A(c)(3)(B)(i) excludes capital gains or losses, regardless of whether those items arise from the sale or exchange of a capital asset. The legislative history of Sec. 199A provides that QBI does not include any item taken into account in determining net long-term capital gain or net long-term capital loss. [Conference Report page 30.] Accordingly, Prop. Reg. 1.199A-3(b)(2)(ii)(A) clarifies that, to the extent gain or loss is treated as capital gain or loss, it is not included in QBI. Specifically, if gain or loss is treated as capital gain or loss under Sec. 1231, it is not QBI. Conversely, if Sec. 1231 provides that gains or losses are not treated as gains and losses from sales or exchanges of capital assets, Sec. 199A(c)(3)(B)(i) does not apply and thus, the gains or losses must be included in QBI (provided all other requirements are met).

a) Gains – capital gains; not included in QBI.
b) Losses – ordinary; included in QBI.

f. Interest Income

1) Sec. 199A(c)(4)(C) provides that QBI does not include any interest income other than interest income that is properly allocable to a trade or business. The Treasury Department and the IRS believe that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business, and therefore should not be included in QBI, because such interest income, although held by a trade or business, is simply income from assets held for investment. Accordingly, Prop. Reg. 1.199A-3(b)(2)(ii)(C) provides that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business. In contrast, interest income received on accounts or notes receivable for services or goods provided by the trade or business is not income from assets held for investment, but income received on assets acquired in the ordinary course of trade or business.

g. Deductions Must be Attributable to a Trade or Business

1) The fact that a deduction is allowed for purposes of computing effectively connected taxable income does not necessarily mean that it is taken into account for purposes of Sec. 199A. For example, for purposes of computing effectively connected taxable income, Sec. 873(b) allows certain deductions, including for theft losses of property located within the United States and charitable contributions allowed under Sec. 170, to be taken into account regardless of whether they are connected with income that is effectively connected with the conduct of a trade or business within the United States. However, for purposes of Sec. 199A, these items would not be taken into account because Sec. 199A only permits a deduction for income that is both attributable to a trade or business and that is also effectively connected income.

h. Reasonable Compensation

1) Proposed Reg. 1.199A-3(b)(2)(ii)(H) provides that QBI does not include reasonable compensation paid by an S corporation but does not extend this rule to partnerships. Because the trade or business of performing services as an employee is not a qualified trade or business under Sec. 199A(d)(1)(B), wage income received by an employee is never QBI. The rule for reasonable compensation is merely a clarification that, even if an S corporation fails to pay a reasonable wage to its shareholder- employees, the shareholder-employees are nonetheless prevented from including an amount equal to reasonable compensation in QBI.

i. Guaranteed Payments

1) Sec. 199A(c)(4)(B) provides that QBI does not include any guaranteed payment described in Sec. 707(c) paid by a partnership to a partner for services rendered with respect to the trade or business. Proposed Reg. 1.199A-3(b)(2)(ii)(I) restates this statutory rule and clarifies that the partnership's deduction for such guaranteed payment is an item of QBI if it is properly allocable to the partnership's trade or business and is otherwise deductible for Federal income tax purposes. It may be unclear whether a guaranteed payment to an upper-tier partnership for services performed for a lower-tier partnership is QBI for the individual partners of the upper-tier partnership if the upper-tier partnership does not itself make a guaranteed payment to its partners. Sec. 199A(c)(4)(B) does not limit the term “partner” to an individual. Consequently, for purposes of the guaranteed payment rule, a partner may be a relevant passthrough entity.

Accordingly, Prop. Reg. 1.199A-3(b)(2)(ii)(I) clarifies that QBI does not include any guaranteed payment described in Sec. 707(c) paid to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or a relevant passthrough entity. Therefore, for the purposes of this rule, a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient.

j. Sec. 707(a) Payments

1) Sec. 199A(c)(4)(C) provides that QBI does not include, to the extent provided in regulations, any payment described in Sec. 707(a) to a partner for services rendered with respect to the trade or business. Sec. 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. Within the context of Sec. 199A, payments under Sec. 707(a) for services are similar to, and therefore, should be treated similarly as, guaranteed payments, reasonable compensation, and wages, none of which is includable in QBI. In addition, consistent with the tiered partnership rule for guaranteed payments described previously, to the extent an upper-tier relevant passthrough entity receives a Sec. 707(a) payment, that income should not constitute QBI to the partners of the upper-tier entity. Accordingly, Prop. Reg. 1.199A-3(b)(2)(ii)(J) provides that QBI does not include any payment described in Sec. 707(a) to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or a relevant passthrough entity.

27. Qualified Property

a. UBIA is determined without regard to any adjustments described in Sec. 1016(a)(2), any adjustments for tax credits claimed by the taxpayer (for example, under Sec. 50(c)), or any adjustments for any portion of the basis for which the taxpayer has elected to treat as an expense (for example, under Secs. 179, 179B, or 179C). Therefore, for purchased or produced qualified property, UBIA generally will be its cost under Sec. 1012 as of the date the property is placed in service. For qualified property contributed to a partnership in a Sec. 721 transaction and immediately placed in service, UBIA generally will be its basis under Sec. 723. For qualified property contributed to an S corporation in a Sec. 351 transaction and immediately placed in service, UBIA generally will be its basis under Sec. 362. Further, for property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death under Sec. 1014. However, Prop. Reg. 1.199A-2(c)(3) provides that UBIA does reflect the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business.

b. Partnership special basis adjustments are not treated as separate qualified property [Prop. Reg. 1.199A-2(c)(1)(iii)].

c. Prop. Reg. 1.199A-2(c) (1)(iv) provides that property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Sec. 199A deduction.

d. The Treasury Department and the IRS believe that existing general principles used for like-kind exchanges and involuntary conversions under §1.168(i)-(6) provide a useful analogy for administrable rules that are appropriate for the purposes of Sec. 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them.

    1) Accordingly, subject to one exception, Prop. Reg. 1.199A-2(c)(2)(iii) provides that, for purposes of determining the depreciable period, the date the exchanged basis in the replacement qualified property is first placed in service by the trade or business is the date on which the relinquished property was first placed in service by the individual or relevant passthrough entity and the date the excess basis in the replacement qualified property is first placed in service by the individual or relevant passthrough entity is the date on which the replacement qualified property was first placed in service by the individual or relevant passthrough entity. As a result, the depreciable period under Sec. 199A for the exchanged basis of the replacement qualified property will end before the depreciable period for the excess basis of the replacement qualified property ends.

    2) The exception is that Prop. Reg. 1.199A-2(c)(2)(iii)(C) provides that, for purposes of determining the depreciable period, if the individual or relevant passthrough entity makes an election under Reg. 1.168(i)-6(i)(1) (the election not to apply Reg. 1.168(i)-6)), 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 individual or relevant passthrough entity, with UBIA determined as of that date. In this case, the depreciable periods under Sec. 199A for the exchanged basis and the excess basis of the replacement qualified property will end on the same date.

3) Thus, unless the exception applies, qualified property acquired in a like-kind exchange or involuntary conversion will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is actually placed in service; for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the relinquished property was first placed in service.

4) Subsequent improvements to qualified property are generally treated as a separate item of property under Sec. 168(i)(6). The Treasury Department and the IRS do not believe a different approach is necessary for purposes of Sec. 199A. Accordingly, Prop. Reg. 1.199A-2(c)(1)(ii) provides that, in the case of any addition to, or improvement of, qualified property that is already placed in service by the taxpayer, such addition or improvement is treated as separate qualified property that the taxpayer first placed in service on the date such addition or improvement is placed in service by the taxpayer for purposes of determining the depreciable period of the qualified property.

e. In the case of a trade or business conducted by a relevant passthrough entity, Sec. 199A(f) provides that a partner's or shareholder's allocable share of the UBIA of qualified property is determined in the same manner as the partner's allocable share or shareholder's pro rata share of depreciation. Prop. Reg. 1.199A-2(a)(3) provides that, in the case of qualified property held by a relevant passthrough entity, each partner's or shareholder's share of the UBIA of qualified property is an amount that bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the entity's total tax depreciation attributable to the property for the year. In the case of qualified property of a partnership that does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to Secs. 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. In the case of qualified property of an S corporation that does not produce tax depreciation during the year, each shareholder's share of the UBIA of the qualified property is a share of the UBIA proportionate to the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation. The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business.

1) Prop. Reg. 1.199A-3(b)(5) provides that, if an individual or a relevant passthrough entity directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the taxpayer or entity must allocate those items among the several trades or businesses to which they are attributable using a reasonable method that is consistent with the purposes of Sec. 199A. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income of each trade or business. There are several different ways to allocate expenses, such as direct tracing or allocating based on gross income, but whether these are reasonable depends on the facts and circumstances of each trade or business. The Treasury Department and the IRS are considering whether "reasonable method" should be defined to include the direct tracing method, allocations based on gross income, or other methods, within appropriate parameters.

28. Qualified Business Loss

    a. If the net amount of qualified income, gain, deduction, and loss is less than zero, the loss is carried over to the next tax year. Any deduction allowed in the next tax year is reduced (but not below zero) by 20% of any carryover qualified business loss. Proposed §1.199A-1(c)(2)(i) provides that the section 199A carryover rules do not affect the deductibility of the losses for purposes of other provisions of the Code.

29. Total Positive QBI with One or More Negative Individual QBIs

    a. If an individual has QBI of less than zero from one trade or business, but has an overall QBI greater than zero when all of the individual's trades or businesses are taken together, then the individual must offset the net income in each trade or business that produced net income with the net loss from each trade or business that produced net loss before the individual applies the limitations based on W-2 wages and unadjusted basis immediately after acquisition of qualified property [Prop. Reg. 1.199A-1(d)].

    b. For purposes of applying the limitation based on W-2 wages and qualified property, the net gain or income with respect of each trade or business (as offset by the apportioned losses) is the taxpayer's QBI with respect to that trade or business. The W-2 wages and qualified property from the trades of businesses which produced negative QBI are not taken into account with respect to each positive QBI business and are not carried over into the subsequent year [Prop. Reg. 1.199-1(d)(iii)(a)].

    c. If there is more than one positive QBI entity, the losses from the negative entities are allocated to the positive entities in proportion to their QBI amounts to the total of the positive QBIs.

30. Total Negative QBI

    a. If an individual's QBI from all trades or businesses combined is less than zero, the QBI component is zero for the taxable year. This negative amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of Sec. 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not taken into account and are not carried over to the subsequent year [Prop. Reg. 1.199-1(d)(iii)(B)].

31. Allocation of Items Among Directly-Conducted Trades or Businesses

    a. If an individual or a relevant passthrough entity directly conducts multiple trades or businesses, and has items of QBI which are properly attributable to more than one trade or business, the individual or relevant passthrough entity must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances. The individual or relevant passthrough entity may use a different reasonable method for different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations.

32. Specified Service Trade or Business (SSTB)

    a. Sec. 199A(c)(1) provides that only items attributable to a qualified trade or business are taken into account in determining the Sec. 199A deduction for QBI. Sec. 199A(d)(1) provides that a “qualified trade or business” means any trade or business other than (A) an SSTB, or (B) the trade or business of performing services as an employee.

    b. Consistent with Sec. 199A, Prop. Reg, 1.199A-5(a)(2) provides that, unless an exception applies, if a trade or business is an SSTB, none of its items are to be taken into account for purposes of determining a taxpayer's QBI. In the case of an SSTB conducted by an entity, such as a partnership or an S corporation, if it is determined that the trade or business is an SSTB, none of the income from that trade or business flowing to an owner of the entity is QBI, regardless of whether the owner participates in the specified service activity. Therefore, a direct or indirect owner of a trade or business engaged in an SSTB is treated as engaged in the SSTB for purposes of Sec. 199A regardless of whether the owner is passive or participated in the SSTB. Similarly, none of the W-2 wages or UBIA of qualified property will be taken into account for purposes of Sec. 199A.

c. For example, because the field of athletics is an SSTB, if a partnership owns a professional sports team, the partners' distributive shares of income from the partnership's athletics trade or business is not QBI, regardless of whether the partners participate in the partnership's trade or business.

d. Under Sec. 199A(d)(3), individuals with taxable income below the threshold amount are not subject to a restriction with respect to SSTBs. Therefore, if an individual or trust has taxable income below the threshold amount, the individual or trust is eligible to receive the deduction under Sec. 199A notwithstanding that a trade or business is an SSTB. The exclusion of QBI, W-2 wages, and UBIA of qualified property from the computation of the Sec. 199A deduction is subject to a phase-in for individuals with taxable income within the phase-in range. The application of this phase-in is determined at the individual, trust, or estate level, which may not be where the trade or business is operated. Therefore, if a partnership or an S corporation operates an SSTB, the application of the threshold does not depend on the partnership or S corporation's taxable income but rather, the taxable income of the individual partner or shareholder claiming the Sec. 199A deduction. For example, if the partnership's taxable income is less than the threshold amount, but each of the partnership's individual partners have income that exceeds the threshold amount plus $50,000 ($100,000 in the case of a joint return) then none of the partners may claim a Sec. 199A deduction with respect to any income from the partnership's SSTB.

e. A relevant passthrough entity conducting an SSTB may not know whether the taxable income of any of its equity owners is below the threshold amount. However, the relevant passthrough entity is best positioned to make the determination as to whether its trade or business is an SSTB. Therefore, reporting rules under Prop. Reg. 1.199A-6(b)(3)(B) requires each relevant passthrough entity to determine whether it conducts an SSTB and disclose that information to its partners, shareholders, or owners. With respect to each trade or business, once it is determined that a trade or business is an SSTB, it remains an SSTB and cannot be aggregated with other trades or business. In the case of a trade or business conducted by an individual, such as a sole proprietorship, disregarded entity, or grantor trust, the determination of whether the business is an SSTB is made by the individual.

f. Prop. Reg. 1.199A-5(c)(1) provides that a trade or business (determined before the application of the aggregation rules in Prop. Reg. 1.199A-4) is not an SSTB if the trade or business has gross receipts of $30 million or less (in a taxable year) for 2024 and less than 10 percent of the gross receipts of the trade or business is attributable to the performance of services in an SSTB. For trades or business with gross receipts greater than $30 million (in a taxable year), a trade or business is not an SSTB if less than 5 percent of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.

g. Separate Parts of Otherwise Integrated SSTB

1) The Treasury Department and the IRS are aware that some taxpayers have contemplated a strategy to separate out parts of what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the Sec. 199A deduction. Such a strategy is inconsistent with the purpose of Sec. 199A. Therefore, in accordance with Sec. 199A(f)(4), in order to carry out the purposes of Sec. 199A, Prop. Reg. 1.199A-5(c)(2) provides that an SSTB includes any trade or business with 50 percent or more common ownership (directly or indirectly) that provides 80 percent or more of its property or services to an SSTB. Additionally, if a trade or business has 50 percent or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (meaning the income will be treated as income from an SSTB).

a) 50 percent or more common ownership includes direct and indirect ownership by related parties. [Prop. Reg. 1.199A-5(c)(2)(iii)]

2) Additionally, Prop. Reg. 1.199A-5 provides a rule that if a trade or business (that would not otherwise be treated as an SSTB) has 50 percent or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, it is treated as incidental to an SSTB and, therefore, part of the SSTB, if the trade or business represents no more than five percent of gross receipts of the combined business [Prop. Reg. 1.199A-5(c)(3)(I)].

33. Aggregation Rules

a. Under Prop. Reg. 1.199A-4, aggregation is permitted but is not required. However, an individual may aggregate trades or businesses only if the individual can demonstrate that the requirements in Prop. Reg. 1.199A-4(b)(1) are satisfied. First, consistent with other provisions in the proposed regulations, each trade or business must itself be a trade or business as defined in §1.199A-1(b)(13). Second, the same person, or group of persons, must directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. All of the items attributable to the trades or businesses must be reported on returns with the same taxable year (not including short years). Prop. Reg. 1.199A-4(b)(3) provides rules allowing for family attribution. Because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate. The Treasury Department and the IRS considered certain reporting requirements in which the majority owner or group of owners would be required to provide information about all of the other pass-through entities in which they held a majority interest.

b. Due to the complexity and potential burden on taxpayers of such an approach, Prop. Reg. 1.199A-4 does not provide such a reporting requirement. Third, none of the aggregated trades or businesses can be an SSTB. Prop. Reg. 1.199A-5 addresses SSTBs and trades or businesses with SSTB income. Fourth, individuals and trusts must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors include: (1) the businesses provide products and services that are the same (for example, a restaurant and a food truck) or they provide products and services that are customarily provided together (for example, a gas station and a car wash); (2) the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (3) the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies).

c. The grouping rules under Sec. 469 are not appropriate for determining a trade or business for Sec. 199A purposes.

d. If an individual chooses to aggregate trades or businesses, the individual must combine the QBI, W-2 wages, and UBIA of qualified property of each trade or business within an aggregated trade or business prior to applying the W-2 wages and UBIA of qualified property limitations.

e. Prop. Reg. 1.199A-4(c)(1) requires that once multiple trades or businesses are aggregated into a single aggregated trade or business, individuals must consistently report the aggregated group in subsequent tax years. Prop. Reg. 1.199A-4(c)(1) provides rules for situations in which the aggregation rules are no longer met as well as rules for when a newly created or acquired trade or business can be added to an existing aggregated group.

f. Required Annual Disclosure

    1) For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated.

    2) The statement must contain —

        a) A description of each trade or business;

        b) The name and EIN of each entity in which a trade or business is operated;

        c) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year; and

d) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

3) Failure to Disclose

a) If an individual fails to attach the statement required in paragraph (c)(2)(i) of this section, the Commissioner may disaggregate the individual's trades or businesses.

34. Alternative Minimum Tax

a. Sec. 199A(f)(2) provides than when computing alternative minimum taxable income under Sec. 55, “qualified business income” is determined without taking into consideration any AMT adjustments or preferences as provided in Sec. 56-59. QBI is the same for AMT as it is for regular tax, and thus, the 20% deduction is computed the same way. The determination of alternative minimum taxable income starts with taxable income, and the amended Code provides no specific add-back to AMTI for the 20% deduction. [Sec. 199A-(f)(2)]

35. Computational Steps for Relevant Passthrough Entities (RPEs) and Publically Traded Partnerships (PTPs)

a. Although relevant passthrough entities cannot take the Sec. 199A deduction at the relevant passthrough entity level, each relevant passthrough entity must determine and report the information necessary for its direct and indirect owners to determine their own Sec. 199A deduction. Prop. Reg. 1.199A-6(b) follows the rules applicable to individuals with taxable income above the threshold amount set forth in §1.199A-1(d) in directing relevant passthrough entities to determine what amounts and information to report to their owners and the IRS, including QBI, W-2 wages, the UBIA of qualified property for each trade or business directly engaged in, and whether any of its trades or businesses are SSTBs. Relevant passthrough entities must also determine and report qualified REIT dividends and qualified PTP income received directly by the relevant passthrough entities. Prop. Reg. 1.199A-6(b) (3) then requires each relevant passthrough entities to report this information on or with the Schedules K-1 issued to the owners. Relevant passthrough entities must report this information regardless of whether a taxpayer is below the threshold.

C. Rev. Proc. 2019-38 provides a safe harbor for treating rental real estate as a trade or business.

1. It is clearly stated that this is only a safe harbor, and a taxpayer can still try to claim trade or business treatment under Sec. 199A even if outside the safe harbor.

2. The three key requirements under the safe harbor are that:

   a. Separate books and records are maintained for each rental real estate enterprise,

      1) A rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties.

   b. For rental real estate enterprises in existence for less than four years, 250 or more hours of rental services are performed per year. For rental real estate enterprises in existence for at least four years, 250 or more hours of rental services are performed per year in any three of the five consecutive tax years that end with the tax year, and

   c. Contemporaneous records are maintained, including time reports, logs, or similar documents (the contemporaneous requirement does not apply to tax years that begin before January 1, 2020) covering:

      1) Hours of services performed,
      2) Description of all services performed,
      3) Dates on which services were performed,
      4) Who performed the services.

3. A rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties.

4. For each tax year for which it relies on the safe harbor, the taxpayer or relevant passthrough entity (RPE) must attach a statement to a timely filed original return (or an amended return for the 2018 tax year only) that includes:

   a. A description (including the address and rental category) of all rental real estate properties in each rental real estate enterprise;

   b. A description (including the address and rental category) of rental real estate properties acquired and disposed of during the tax year; and

   c. A representation that the requirements of Rev. Proc. 2019-38 have been satisfied.

5. Rental services that qualify toward the 250 hours total include:

    a. Advertising to rent or lease,
    b. Negotiating and executing leases,
    c. Verifying information contained in lease applications,
    d. Daily operation, maintenance, and repair of property,
    e. Purchase of materials, and
    f. Supervision of employees and independent contractors.

6. Examples of activities that do not qualify include:

    a. Arranging financing for the property,
    b. Purchase of the property,
    c. Studying and reviewing financial statements and reports of operations,
    d. Planning, managing, or constructing long-term capital improvements, or
    e. Hours spent traveling to and from the real estate.

7. Real estate used for personal purposes and triple net leases do not qualify under the safe harbor.

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

9. Once a taxpayer treats interest in similar commercial properties or similar residential properties as a single rental real estate enterprise, the taxpayer must continue to treat interests in all similar properties including newly acquired properties, as a single rental real estate enterprise.

    a. A taxpayer that chooses to treat its interests in each residential or commercial property as a separate rental real estate enterprise may choose to treat its interests in all similar commercial or all similar residential properties as a single rental real estate enterprise in a future year.

10. Real estate trades and businesses are required to file Forms 1099 for vendor payments in excess of $600 and to complete the questions at the top of Schedule E, *Supplemental Income and Loss*, regarding the requirement to file the forms and whether they were filed.

D. Choice of Entity [Optimal Choice of Entity for the QBI Deduction, The Tax Adviser, March 2020]

1. Taxable income at or below the threshold amount

a. When taxable income is at or below the threshold amount, neither the specialized service trade or business (SSTB) limitation nor the wages/qualified property limitation applies, and the QBI deduction is equal to 20% of QBI (subject to the overall modified taxable income limitation). As such, at this taxable income level, an LLC will always obtain a QBI deduction that is equal to or greater than that of an S corporation, regardless of whether the entity is an SSTB or a non-SSTB.

b. This preference is related to the requirement that the QBI of an S corporation be reduced by reasonable compensation to shareholder/employees. While guaranteed payments similarly reduce QBI, there is no requirement under the Sec. 199A rules (or other law) that guaranteed payments be made to owner-operators.

2. Taxable income within the phase-in range

a. When taxable income is within the phase-in range, the planning opportunities are less clear-cut. This is a result of the phase-in rules for both the SSTB limitation and the wages/qualified property limitation. Within the phase-in range, planning must be done on an entity-by-entity approach; however, some general planning guidelines apply in the selection of the passthrough entity that will generate the larger QBI deduction. For an SSTB and taxable income at the lower end of the phase-in range, an LLC can result in a larger QBI deduction than a similarly situated S corporation.

b. For taxable income at the higher end of the phase-in range, however, the SSTB limitation is mostly phased in, and the effect of the wages/qualified property limitation phase-in becomes more pronounced. In such cases, S corporation shareholder/employee compensation helps mitigate the phase-in of the wages/qualified property limitation and results in a larger QBI deduction than for an LLC.

For a non-SSTB and taxable income within the phase-in range, the focus is solely on the phase-in of the wages/qualified property limitation. When there are adequate nonowner wages for a non-SSTB, an LLC will generally provide a larger QBI deduction than an S corporation. For both types of passthrough entities, the phase-in of the wages/qualified property limitation is mitigated or eliminated by the nonowner wages. However, an S corporation's QBI must be reduced by reasonable shareholder/ employee compensation, thus resulting in a lower QBI deduction.

c. For taxable income within the phase-in range and a non-SSTB with minimal nonowner wages, the LLC again will generally provide the greater QBI deduction, especially at the lower end of the phase-in range. This is due to the mechanical operation of the wages/qualified property limitation that allows an LLC to partially recover the QBI deduction at the lower end of the phase-in range.

3. Taxable income over the phase-in range

a. When taxable income exceeds the phase-in range, there is no QBI deduction for an SSTB and, thus, there is no difference between an S corporation and an LLC. However, a QBI deduction is available when taxable income exceeds the phase-in range for a non-SSTB that has W-2 wages and/or qualified property. In such cases and assuming nominal qualified property, an S corporation will usually obtain a larger QBI deduction than an LLC when there are substantial owner compensation and minimal nonowner wages. Again, this is because S corporation shareholder/employee compensation counts as W-2 wages for purposes of the wages/qualified property limitation, while guaranteed payments do not. However, with adequate nonowner wages, an LLC will usually result in a larger QBI deduction because LLCs are not required under the Sec. 199A rules to pay reasonable compensation or guaranteed payments to owners.