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On August 8, the IRS has issued highly anticipated guidance regarding the brand-new code Sec. 199A which resulted from the Tax Cuts and Jobs Act ("TCJA"). As a quick refresher before discussing the recent guidance, the following is a very brief summary of the basic rules of Sec. 199A:

For tax years beginning after 2017 and before 2026, the deduction under Sec. 199A is available to individuals and certain trusts, and estates that:

- Own one or more qualified trades or businesses through a sole proprietorship, a single member LLC, any entity taxed as a partnership, a trust or an S corporation that generate qualified business income ("QBI")
- Have investments in publicly-traded partnerships ("PTPs") that generate qualified income or real estate investment trusts ("REITS") that generate qualified dividends[i]

Although the deduction is generally presented as 20% of qualified income generated from the above sources, several requirements and limitations apply that may reduce or possibly eliminate the deduction for many taxpayers. Qualified income includes only U.S. sourced income and excludes investment type income. The first limitation is based on qualifying wages and property for each trade or business and is phased in for higher income taxpayers (those with taxable income between $315,000 - $415,000 (MFJ) and $157,500 - $207,500 for all others). Note that this limitation applies only to QBI, not to PTP or REIT income. For these same higher income taxpayers, there is a phase-out of the deduction to the extent that the income is generated from certain specified service trades or businesses ("SSTB"). A final limitation caps the total Sec. 199A deduction to 20% of the taxpayer's taxable income, reduced by taxable income that is already subject to favorable capital gains tax rates.

Thus, in order to determine the amount of the actual deduction, one needs to wade through numerous definitions and limitations. Not to worry though, the IRS projects that the total annual reporting burden across all taxpayers is going to be a mere 25 million hours. Unfortunately, we believe that's a low estimate, especially given the complexity of this newly-issued guidance.

That guidance came in the form of proposed regulations, frequently asked questions (FAQs), and a Notice. This update will highlight some of the key points within the guidance. Gluttons for punishment are welcome to read the nearly 200 pages of proposed regulations here, the FAQs here, or the Notice here. We expect this document to be updated and/or addendums issued as we continue to analyze this guidance and identify the strategic opportunities and foot-faults it may present.[ii]

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Definition of Trade or Business

To begin the Sec. 199A calculation, we start with the IRS' definition of "trade or business" in the proposed regulations, which provide that a "trade or business" means a trade or business as defined under Sec. 162. Sec. 162 requires that the taxpayer must be involved in the trade or business with continuity and regularity and the primary purpose for engaging in the activity must be for income or profit. Whether this definition is satisfied is dependent on the specific facts and circumstances of each taxpayer, which leaves taxpayers with a great degree of uncertainty.

Unfortunately, the regulations' reference back to the previously existing Sec. 162 to define a trade or business results in even greater uncertainty for many rental activities, as they do not fit neatly into Sec. 162. For example, can a single triple net lease be a trade or business? Can multiple triple net leases make up a trade or business? What level of special services must be provided to reach the level of a trade or business? Does it matter if the property is personal versus real, residential versus commercial? Sec. 162 does not contain a bright-line test for taxpayers that qualify as real estate professionals under the passive loss rules of Sec. 469 and these proposed regulations did not provide such a provision either. We can only hope that the final regulations will provide such a provision for real estate professionals, which is exactly what happened with the Net Investment Income Tax (the 3.8% tax on investment income) proposed regulations versus final regulations. One point the proposed regulations do make clear, however, is that the rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a Sec. 162 trade or business can still be treated as a trade or business anyway for purposes of Sec. 199A if the property is rented/licensed to a qualified trade or business that is commonly controlled under the aggregation rules described below. Even a triple-net lease to such a commonly controlled business would be considered a trade or business for purposes of the QBI deduction under this provision.

Specified Service Trades or Businesses ("SSTB")

Under 199A, any trade or business involving the performance of services in one or more of the following fields is considered a SSTB, and higher income taxpayers may get a reduced or even no §199A benefit for income generated by the trade or business: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management services, trading, dealing in securities, partnership interests, or commodities. This list is pulled from the pre-exiting list found in Sec. 1202, but specifically excludes architects and engineers. The proposed regulations provide additional guidance around each of these twelve fields specific to the application of Sec. 199A, including examples of what activities do and do not fall into each of these disqualified fields. Despite the limited examples provided in these regulations, there is obviously a wide variety of businesses that will still need to make judgement calls regarding their status as an SSTB.

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Section 199A also included what appeared to be a catch-all category if the principal asset of the trade or business is “the reputation or skill of one or more employees or owners”. The proposed regulations have, thankfully, narrowly interpreted this category to mean any trade or business that consists of the receipt of fees, compensation or other income for any of the following: (i) endorsing products or services, (ii) the use of an individual’s image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual’s identity, or (iii) appearing at an event or on radio, television, or another media format. Thus, this catch-all category will apparently apply to certain income that is earned by famous athletes, Donald Trump and the Kardashian-Jenner sisters.

The proposed regulations also provide two sets of rules to address situations in which a trade or business or group of trades or businesses may receive a portion, but not all, of its income from the performance of services in a field designated as an SSTB.

- ***De minimis rule –***

  A trade or business will not be considered an SSTB merely because it provides a small amount of services in a specified service activity. A trade or business that has $25 million or less in gross receipts will not be treated as an SSTB if less than 10% of the gross receipts are from one of the designated service fields. A trade or business that has more than $25 million in gross receipts must substitute 5% for the 10% threshold. This de minimis rule applies prior to the aggregation rules discussed below.

- ***Anti-abuse/Anti-cracking rule –***

  When Sec. 199A came out, many entities that had both an activity that was an SSTB and an activity that was not an SSTB immediately considered splitting the entity into two separate entities, one that would be an SSTB and one that would not be an SSTB. For example, a law firm would spin off its building or its non-legal service activities into a separate entity, that would in turn charge the law firm for rent or services provided. The thought was that the rent or service income generated in the spun-off entity would therefore be eligible for the 20% deduction.

The proposed regulations put an end to this strategy with anti-cracking rules.

- An SSTB will include any otherwise qualifying trade or business if that trade or business provides *80% or more* of its property or services to an SSTB and there is 50% or more common ownership of the trades or businesses.
- If an otherwise qualifying trade or business provides *less than 80%* of its property or services to a related SSTB (applying the 50% common ownership rule), the portion of the income generated from services provided to that commonly controlled SSTB will be considered SSTB income, but the remaining amount will not.

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- If an otherwise qualifying trade or business shares expenses, including wages or overhead expenses with a related SSTB (applying the 50% common ownership rule), that trade or business will be deemed an SSTB itself if its gross receipts are not more than 5% of the gross receipts of the combined business.

For purposes of determining whether 50% common ownership exists, the related party attribution rules of 267(b) and 707(b) apply, making avoidance of these anti-abuse rules difficult.

<u>Computation of QBI</u>

QBI is defined under Sec. 199A as the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer, so long as those items are connected with the conduct of a trade or business within the U.S. and included or allowed in determining taxable income for the year. QBI does not include certain investment income; reasonable compensation paid to the taxpayer by any qualified trade or business; any guaranteed payment received by a partner for services rendered to the partnership under Sec. 707(c); or any payment received by a partner for services rendered to the partnership other than in their capacity as a partner under Sec. 707(a). The proposed regulations provide further clarification on the impact on QBI of the following specific items:

- ***Interest income*** is excluded from QBI unless it is properly allocable to a trade or business. The proposed regulations provide that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business and therefore is not included in QBI. However, interest income received on accounts or notes receivable for services or goods provided by the trade or business is properly allocable to a trade or business and therefore is included in QBI.

- ***Depreciation recapture that results in ordinary income*** (Sec. 1245 and Sec. 1250 recapture) is included in QBI when such income relates to a qualified business.

- ***Ordinary income from Sec. 751 gain*** (gain that is attributable to unrealized receivables and inventory items in certain partnership transactions) is included in QBI when such income relates to a qualified business.

- ***Sec. 481 adjustments*** (positive or negative) that result from the taxpayer's change in accounting method are included in the computation of QBI, provided the adjustment arises in taxable years ending after 12/31/17. Sec. 481 adjustments related to accounting method changes in a tax year ending before 1/1/18 do not constitute QBI.

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- ***Under Sec. 1231, net*** gains are classified as capital gains and net losses are classified as ordinary losses. The proposed regulations provide that Sec. 1231 gains are not included in QBI, but Sec. 1231 losses reduce QBI.

- ***Guaranteed payments for services*** received by a taxpayer are not considered to be attributable to a trade or business and therefore are not included in QBI. The partnership's deduction for such guaranteed payments, however, is deducted when computing QBI, provided the deduction is attributable to a trade or business. The proposed regulations indicate that 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 the QBI of a partner of the upper-tier partnership regardless of whether it is paid as a guaranteed payment to that partner or not. The same rules apply for Sec. 707(a) payments made by a lower-tier partnership to an upper tier partnership.

- ***Guaranteed payments for the use of capital*** are not considered to be attributable to a trade or business; they are akin to interest income and therefore are not included in QBI. The partnership's deduction for such guaranteed payments, however, is deducted when computing QBI provided the deduction is attributable to a trade or business.

- ***Reasonable compensation*** is not included in QBI under Sec. 199A. In an S corporation setting, the corporation must pay shareholder-employees reasonable compensation for services performed prior to making tax-free dividend distributions out of accumulated earnings. The proposed regulations provide that if the S corporation does not pay a reasonable wage to its shareholder-employees, the income of the S corporation will need to be reduced by such shortfall when determining the amount of S corporation income that is included in QBI. This will require the analysis of shareholder-employee compensation in every S corporation and the determination of the appropriate reasonable compensation amount for purposes of determining QBI. The proposed regulations do not extend this requirement for the payment of reasonable compensation for services rendered by a partner to a partnership. Therefore, it appears that priority distributions rather than guaranteed payments could be used to strategically maximize partners' QBI and thus their Sec. 199A deduction. The regulations also do not extend the reasonable compensation exclusion to sole proprietorships, creating further planning opportunities.

- ***Suspended losses or deductions*** that were disallowed under the basis limitation rules, at-risk rules, or passive activity rules in tax years beginning before 1/1/18 do not reduce QBI when they become available. However, suspended losses and deductions that are disallowed under these same rules for tax years beginning after 12/31/17 will reduce QBI in the year they become allowable.

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- ***NOL carryovers deducted in a subsequent year*** must be examined to determine whether any portion consists of excess business losses under new Sec. 461(l), which disallows a current year deduction for net business losses in excess of $500,000 (MFJ) or $250,000 (all other filers). Any business loss in excess of these limits is carried forward to the taxpayer's following year as an NOL. The following explains why the examination of NOL carryovers being utilized in a current year is therefore required:

    - Generally, deductions and losses giving rise to an NOL are deducted in computing taxable income in the year incurred. Because those items would also have been deducted in computing QBI in the year incurred, an NOL carryover that is deducted in a subsequent year should not be treated as QBI in that subsequent year. To do so would allow the deduction for such items twice for QBI.

    - However, to the extent that the NOL carryover allowed as a deduction in a current year includes previously disallowed amounts under the new excess business loss rules of Sec. 461(l), that portion of the NOL is treated as QBI for purposes of computing that year's QBI deduction. Because the Sec. 461(l) excess business loss amount has never been deducted when computing either taxable income or QBI in a prior year, allowing the portion of the NOL deduction that is attributable to that excess loss to be deducted in a later year does not result in the deduction of that item twice for QBI. Because of this, the portion of NOL carryovers that is attributable to excess business losses will need to be separately tracked for purposes of the QBI computation.

- An individual/entity that conducts multiple trades or businesses and has items of QBI which are properly attributable to more than one trade or business must allocate the items using a reasonable method based on all facts and circumstances. Different methods may be used for different items, but the methods must be consistently applied from one year to another. 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.

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The Wage and Property Limitations

Although the deduction is advertised as being 20% of flow-through business income, the next hurdle for higher income taxpayers is that the deduction can't exceed 50% of wages (as defined). Taxpayers that don't pay significant or even any wages can instead apply a limit of 25% of wages plus 2.5% of the sum of the unadjusted basis of certain depreciable assets. Of course, neither term has a straightforward definition, so we will summarize each term below.

- *Definition of W-2 wages –*

The term W-2 wages includes the total amount of: wages subject to income tax withholding as defined in Sec. 3401(a), elective deferrals as defined in Sec. 402(g)(3), deferred compensation as defined under Sec. 457, and designated Roth contributions as defined under Sec. 402A. W-2 wages can include amounts paid by another entity, provided the wages were paid to common law employees or officers of the business claiming the Sec. 199A deduction. This will allow wages paid by professional employer organizations (PEO's), employee leasing firms, etc. to be allocated to the entity where the employees provided their services. The PEO, employee leasing firm, etc. would then obviously need to have a corresponding reduction in its W-2 wages for purposes of its own Sec. 199A deduction.

In addition to the guidance included in the proposed regulation regarding the determination of W-2 wages, the IRS also issued Notice 2018-64 to provide three alternative methods for determining for calculating W-2 wages. These rules are similar to the rules for determining W-2 wages that applied for the now obsolete Sec. 199 (Domestic Production Activities Deduction, or DPAD). The easiest of the three alternatives, and therefore most likely to be utilized by most taxpayers, is the one referred to as the "unmodified box method". Under this method, W-2 wages are equal to the lesser of (a) the total entries in Box 1 of all the W-2s filed by the taxpayer or (b) the total entries in Box 5 of all the W-2s filed by the taxpayer.

- *Depreciable asset limitation –*

For taxpayers using the alternative limitation of 25% of wages plus 2.5% of the basis in depreciable assets, the proposed regulations introduce a new term: the "unadjusted basis immediately after the acquisition of qualified property ("UBIA"). The proposed regulations contain detailed rules for calculating UBIA. Generally, it's the purchase price for purchased assets, the tax basis for property acquired in a like-kind exchange, carryover basis of assets acquired in a tax-free exchange (such as a capital contribution to a partnership); date of death value for inherited depreciable property (unless DOD was in 2010), etc. Bonus depreciation and Sec. 179 deductions do NOT reduce basis for this purpose. Partnership level basis adjustments under Sec. 734(b) or 743(b), related to partnership interest sales and redemptions, are not treated as qualified property and therefore are not considered in determining UBIA.

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Also, remember that the TCJA provided that only assets that are used in the production of QBI, that are owned on the last day of the tax year and whose depreciable period has not ended before the end of the tax year can be included in this limitation. An asset's depreciable period begins on the date the property is placed in service and ends on the later of (a) 10 years after the date placed in service or (b) the last day of the last full year in the asset's GDS tax life, ignoring the ADS life. Thus, the UBIA of personal property will generally be included in the limitation for 10 years, while the UBIA of real property will generally be included in the limitation for 27 or 39 years, for residential and nonresidential property respectively. Special rules are contained in the proposed regulations for determining the date placed in service for like kind exchange property and other nonrecognition transfers involving transferred basis property, as well as for improvements that are made to property that was already owned by the taxpayer.

Netting and Carryover Rules

The proposed regulations provide various netting rules. First, the regulations provide that QBI goes into one silo and REIT dividends and PTP income go into another silo. Those two silos are never netted against each other; netting will only occur within each separate silo. Netting within a silo occurs as follows:

- *Net negative QBI –*

  If the net QBI for all of the businesses combined is negative, there is no current year QBI deduction. The net negative QBI amount is carried to the succeeding taxable year and treated as negative QBI from a separate trade or business in that year solely for purposes of determining the subsequent year's QBI deduction.

- *Net negative REIT dividends and PTP income –*

  If the net amount of REIT dividends and PTP income combined is negative, there is no current year deduction related to REIT and PTP income. The net negative REIT and PTP amount is carried to the succeeding taxable year and used to offset the combined REIT dividends and PTP income in the succeeding year solely for purposes of determining the subsequent year's QBI deduction.

- *Net positive QBI, but at least one trade or business is negative –*

  If there is a net positive QBI from multiple trades or businesses, but at least one trade or business has a negative QBI, that negative QBI must reduce each positive QBI proportionately. This reduced QBI is then used when applying the wage and UBIA limitations to that trade or business.

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Aggregation Election Rules

The proposed regulations outline a new set of rules which allow individuals (but not entities) to aggregate their various trades or businesses for purposes of applying calculation limitations. Unfortunately, the rules do not follow the same aggregation rules that already exists under the passive loss rules of Sec. 469, further complicating tax return planning and preparation. On the other hand, by not being pigeon-holed by the passive activity grouping rules, there may be more planning opportunities. To aggregate trades or businesses under Sec. 199A, the aggregated trades or businesses must meet the following requirements:

1) The same person or group of persons, directly or indirectly, must own 50% or more of each trade or business for a majority of the taxable year. It is not necessary that the individual who is aggregating the businesses own more than 50% of each business or even be in the group that owns 50% or more of each business. Family attribution rules apply for this purpose, with an individual considered to own an interest in each business owned by their spouse, children, grandchildren, and parents.
2) All business must have the same taxable year, not taking into account short tax years.
3) None of the trades or businesses can be an SSTB.
4) The trades or businesses satisfy at least two of the following three factors:
   (i) They provide products and services that are the same or customarily offered together;
   (ii) They share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and/or
   (iii) They operate in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

If the above tests are satisfied, the aggregation combinations are quite flexible. An individual can aggregate trades or business that they own/operate directly with trades or businesses that they own thru passthrough entities. A strategic “pick and choose” approach for each taxpayer can be taken; there is not an “all or nothing” requirement (as is required for the grouping of real estate rentals by a real estate professional under the passive loss rules).

An individual is required to disclose aggregated groups <u>annually</u> by attaching a statement to their returns identifying the aggregated group(s). Information required to be disclosed includes a description of each trade or business, the name and EIN of each entity in which a trade or business is operated, and information identifying any trade or business that was formed, acquired or disposed of during the taxable year. Failure to disclose could result in disaggregation by the IRS.

Individuals must then consistently report the aggregated trades or businesses in all subsequent tax years. However, newly created or acquired trades or businesses may, but are not required to, be added to an existing group as long as they meet the aggregation requirements above. Additionally, if there is a change in facts or circumstances such that a prior aggregation no longer qualifies, the taxpayer must reapply the rules to determine a new aggregation.

We suspect that a failure to aggregate in 2018 will be treated as an aggregation election and the taxpayer will be unable to aggregate those businesses in the future, without a significant change in facts and circumstances.

When businesses are aggregated, the W-2 limit (or W-2 plus UBIA limit) is also applied on an aggregated group basis. Therefore, this aggregation rule can strategically be used to benefit taxpayers who may have their payroll in a different legal entity than their operations or who have one operating entity with significant income but low wages and/or property and another operating entity with minimal income but high wages and/or property. Taxpayers will no longer have to consider restructuring their legal entities or their business operations to maximize their Sec. 199A deduction.

Since aggregation can be done only at the individual level, flow-through entities that conduct multiple trades or businesses are now required to disclose the QBI, W-2 wages and UBIA, as well as any PTP income or REIT dividends, with respect to each separate trade or business to each partner, shareholder or beneficiary. This will often require significant extra time and therefore cost when preparing flow-thru tax returns. You will recall the discussion, above, related to the relative lack of definition of a trade or business for purposes of QBI. Of course, that means there is also a lack of definition with respect to multiple trades or businesses within an entity.

<u>Relevant Passthrough Entity (RPE) Rules</u>

An RPE means a partnership, S corporation, and some estates or trusts. While an RPE is not able to claim the Sec. 199A deduction itself, it must determine and report the necessary information to its owners/beneficiaries so that they can calculate the Sec. 199A deduction on their own returns. The proposed regulations require RPEs to determine QBI, W-2 wages, UBIA, qualified PTP and REIT income, and whether any of its trades or businesses are SSTBs. Each item is then required to be reported on or with the Schedules K-1 issued to owners/beneficiaries. Such information must be reported by the RPE even if it is aware the owner/beneficiary is below the income threshold. If an item is not reported by the RPE to its owners/beneficiaries, the item is deemed to be zero.

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Anti-Abuse Provisions

In addition to the anti-abuse/anti-cracking rules discussed above with respect to splitting a single business into two businesses to get around the SSTB rules, the proposed regulations contain several other anti-abuse provisions:

- Rules preventing former employees from converting to independent contractors in order to make their compensation eligible for the 20% deduction by creating a rebuttable presumption that they are still an employee for purposes of Sec. 199A if they are providing substantially the same services they provided as an employee. To rebut this provision, the employee must show that under pre-existing tax rules, regulations, and principles (including common-law employee classification rules), that they are performing services in a capacity other than as an employee.

- Rules preventing taxpayers from claiming the 20% deduction on REIT dividends without having exposure to the REIT stock for a meaningful period of time. This rule is similar to the holding period requirements of Sec. 246 with respect to the exclusion of certain dividends from the dividends received deduction.

- Rules preventing taxpayers from acquiring property with the principal purpose of increasing their Sec. 199A deduction. These rules exclude property from their UBIA total if the property was acquired within 60 days of the end of the tax year and disposed of within 120 days without having been used in a trade or business for at least 45 days.

Effective Dates

These proposed regulations under Sec. 199A would apply to taxable years ending after the date on which they are finalized. However, taxpayers are permitted to rely on the proposed regulations in their entirety until that date. To prevent abuse, the anti-abuse rules are proposed to apply to tax years ending after 12/22/17, the date of enactment of the TCJA.
Fiscal-year RPEs:

- If an individual receives QBI, W-2 wages, or UBIA of qualified property from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, the items are treated as having been incurred during the individual's taxable year in which the RPE's tax year ends. Thus, a fiscal year RPE is not required to bifurcate its QBI, W-2 wages or UBIA of qualified property between the portion of its year that occurred before and after January 1, 2018.

- Also, it appears that there is the strategic potential for the doubling up of Sec. 199 and Sec. 199A on a portion of the income from a fiscal year RPE, since income prior to January 1, 2018 qualified for both Sec. 199 and Sec. 199A.

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- A fiscal year RPE filing a tax return for its tax year starting in 2017 and ending in 2018 does so on 2017 tax forms. Obviously, the additional reporting that is required under Sec. 199A has not been incorporated into the 2017 tax forms and the RPE will therefore have to provide K-1 attachments to report the required Sec. 199A information.

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[i] This Update does not address the Sec. 199A implications of cooperative dividends. If you have cooperative dividend income, please contact your Wipfli relationship executive directly.

[ii] A separate Update will be issued with respect to special computational and anti-abuse rules specifically for trusts, estates, and beneficiaries that are contained in the proposed regulations.