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???Passthrough Deduction??? Regulations Finalized

Tax Talks on **March 11, 2019**

On January 18, 2019, the U.S. Department of Treasury ("Treasury") and the Internal Revenue Service (the "IRS") released final regulations (the "Final Regulations") regarding the "passthrough deduction" for qualified trade or business income under section 199A of the Internal Revenue Code.[1] The Final Regulations modify proposed regulations (the "Proposed Regulations") that were released in August 2018. The Final Regulations apply to tax years ending after February 8, 2019, but taxpayers may rely on the Proposed Regulations for taxable years ending in calendar year 2018.

Section 199A was enacted in 2017 as part of the tax reform act.[2] Generally, section 199A provides a deduction (the "passthrough deduction") of up to 20% for individuals and certain trusts and estates of certain of the income from certain trades or businesses that are operated as a sole proprietorship, or through certain passthrough entities. The passthrough deduction provides a maximum effective rate of 29.6%.

This post provides background and summarizes some of the most important changes from the Proposed Regulations to the Final Regulations. For more information, please contact any of the Proskauer tax lawyers listed on this post or your regular Proskauer contact.

Summary of Changes in the Final Regulations

The most significant differences between the Final Regulations and the Proposed Regulations are:

???In order to maximize the passthrough deduction, a taxpayer may aggregate (or combine) trades or businesses and treat them as a single trade or business for purposes of calculating the passthrough deduction. The Final Regulations allow a taxpayer to aggregate multiple trades or businesses, if the taxpayer can demonstrate that:

???the same person, or group of persons (including a C corporation) directly or by attribution through the related party rules in sections 267(b) and 707(b)[3] owns 50% or more of each trade or business that will be aggregated;

???the ownership described in clause (i) existed for a majority of the taxable year, including the last day of the taxable year;

???all of the items attributable to each trade or business that will be aggregated are reported on returns with the same taxable year;

???none of the trades or businesses that will be aggregated are SSTBs; and

???the trades or businesses that will be aggregated satisfy at least two of the following three factors: (1) they provide products, property or services that are the same or customarily offered together, (2) they share facilities or significant centralized business elements like personnel, accounting and legal, and (3) they are operated in coordination with, or reliance upon one or more of the businesses in the aggregated group.

???The Proposed Regulations did not provide for aggregation at the entity level. The Final Regulations instead provide that aggregation is allowed at the entity level. Under the Final Regulations, a relevant passthrough entity may aggregate trades or businesses that it operates directly or through lower-tier RPEs. Furthermore, the Final Regulations provide that once an RPE aggregates two or more trades or businesses, an individual or upper-tier RPE must maintain the same aggregation.

???For purposes of section 199A, if a taxpayer is a married individual filing a joint return and has income in 2019 of more than $321,400, or $160,725 for married individuals filing separate returns (the “threshold amount”), and the trade or business is a “specified service trade or business” (an “SSTB”), then the taxpayer is not entitled to the passthrough deduction.[4] The Final Regulations provide that a professional sports club and its owners are engaged in an SSTB under section 199A and therefore an owner would not be entitled to the full passthrough deduction if he or she is a joint filer his or her income in 2019 is more than $321,400. However, the Final Regulations provide that taking deposits or making loans is not an SSTB. Therefore, a lending fund that employs individuals may generate a passthrough deduction for its owners regardless of their level of income.

???If a taxpayer’s income is above the threshold amount, the passthrough deduction is limited to the greater of:

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

(2) the sum of 25% of the W-2 wages, plus 2.5% of the taxpayer’s unadjusted basis immediately after acquisition (“UBIA”) of qualified property with respect to the trade or business.

For taxpayers who rely on clause (2) of the formula, the Final Regulations treat a taxpayer that purchases an interest in a partnership with a section 754 election in place whose qualified property has a value greater than its UBIA as having purchased additional qualified property equal to the difference.[5]

- ???Under the Final Regulations, if a non-specified service trade or business provides property or services to an SSTB and a taxpayer or group of taxpayers owns 50% or more of both the SSTB and non-SSTB trades or businesses, then the portion of the non-SSTB business that is providing the property or services to the SSTB business is treated as a separate SSTB only with respect to the taxpayer or group of taxpayers that make up the 50% or more common ownership. Under the Proposed Regulations, the rule applied to all the taxpayer owners of the non-SSTB business, whether they were in the majority ownership group or not. Thus, only the taxpayer or group of taxpayers that make up the 50% or more common ownership will be denied a deduction with respect to the separate SSTB if their incomes exceed the threshold amount.
- ???Under the Final Regulations, an individual who was an employee of a trade or business but becomes an independent contractor or is hired by another entity, and still performs substantially the same services to the same trade or business (or a related person), will be presumed to be in the trade or business of performing services as an employee of that trade or business for three years after ceasing to be an employee. The Proposed Regulations did not contain any specific time period limitation.
- ???Generally, an individual is entitled to a passthrough deduction for its share of the qualified business income (“QBI”) of a business operated by a relevant passthrough entity (“RPE”). Under the Proposed Regulations, the term RPE included only partnerships (other than publicly traded partnerships) and S corporations owned (directly or indirectly) by at least one individual, estate, or trust. The Final Regulations expand the definition of RPEs to include other passthrough entities that file an IRS Form 1065 and are owned, directly or indirectly, by at least one individual, estate, or trust. Thus, common trusts maintained by banks and certain religious or apostolic organizations that have a common treasury or community treasury may qualify as RPEs.

Background

Section 199A provides a deduction of up to 20% for individuals, (and certain trusts and estates) for an effective rate of 29.6% of (i) the combined qualified business income of a sole proprietorship, or a relevant passthrough entity, (ii) qualified real estate investment trust ("REIT") dividends, and (iii) qualified publicly traded partnership ("PTP") income. QBI is income earned from any trade or business other than the trade or business of performing services as an employee. As mentioned above, taxpayers with income above the threshold amount are not entitled to a passthrough deduction with respect to services provided in the following areas: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, dealing in securities, or a trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. These businesses are referred to as specified service trades or businesses (or "SSTBs"). [6] In addition, for taxpayers whose income is above the threshold, the passthrough deduction applies only to qualified business income that is the greater of (1) 50% of the W-2 wages with respect to the trade or business, or (2) the sum of 25% of the W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition of qualified property with respect to the trade or business. Section 199A applies to taxable years beginning after December 31, 2017 and ending on or before December 31, 2025.

The Final Regulations

Passthrough Deduction Calculation

Generally, the passthrough deduction calculation for taxpayers with income above the threshold amount can be divided into four steps.

<u>Step 1</u>: The taxpayer calculates qualified business income for each qualified trade or business (or aggregated trade or business, if the taxpayer chooses to aggregate) that it operates. If a taxpayer has multiple trades or businesses and the qualified business income ("QBI") from at least one trade or business is less than zero, the taxpayer must first offset that negative QBI with the QBI from businesses that produced a net positive QBI, and then use the adjusted QBI for that trade or business.[7] If the total QBI amount is less than zero, then the negative number is treated as a loss in the next succeeding taxable year for purposes of the passthrough deduction.[8] The taxpayer calculates 20% of the QBI ("gross QBI") for each trade or business.

Step 2: The taxpayer calculates the W-2 wages and the unadjusted basis immediately after acquisition (or UBIA) of qualified property for each trade or business (or aggregated trade or business, if the taxpayer chooses to aggregate).[9] Qualified property generally is depreciable property which (i) is held by and available for use in the trade or business as of the end of the taxable year, (ii) is used during the taxable year in the trade or business' production of QBI, and (iii) has a depreciable period that has not ended before the close of the individual's or RPE's taxable year.[10] The taxpayer then calculates the "QBI deduction limitations" of the QBI portion of the passthrough deduction (the "QBI deduction"). The gross QBI that can be used for the QBI deduction for each trade or business (or aggregated group of trades or businesses) is limited to the greater of:

(1) 50% of the W-2 wages with respect to the trade or business, or
(2) the sum of 25% of the W-2 wages, plus 2.5% of the UBIA of qualified property with respect to the trade or business.

As mentioned above, if the taxpayer's income is above the threshold amount, then the taxpayer is not entitled to any QBI deduction with respect to a specified service trade or business. Once the QBI deduction for each of the taxpayer's qualified trades or businesses is determined, they are added together. This sum is the "QBI deductible amount".

Step 3: The taxpayer calculates its qualified REIT dividends and qualified PTP income. The taxpayer then adds: (i) 20% of its combined qualified REIT dividends[11] and qualified PTP income,[12] and (ii) the QBI deductible amount. This amount is the "total deductible amount".

Step 4: The passthrough deduction, taken together for all of the taxpayer's trades or businesses, will be the lesser of (x) the total deductible amount and (y) 20% of the excess, if any, of the taxpayer's taxable income for the year over the taxpayer's net capital gain.

Relevant Passthrough Entities

An individual that conducts business through a sole proprietorship or a relevant passthrough entity may claim the passthrough deduction. The Final Regulations define a relevant passthrough entity as a partnership (other than a publicly traded partnership), an S corporation owned (directly or indirectly) by at least one individual, estate or trust, and any other passthrough entity or any entity that files an IRS Form 1065 and is owned, directly or indirectly, by at least one individual, estate or trust.[13] Thus, common trusts maintained by banks, and certain religious or apostolic organizations that have a common treasury or community treasury, and in the case of associations or corporations engage in business for the common benefit of the members, may qualify as RPEs.

Qualified Business Income

Only qualified business income gives rise to the passthrough deduction. QBI is the net amount of "qualified items" of income, gain, deduction, and loss with respect to any trade or business of the taxpayer.[14] Qualified items of income, gain, deduction, and loss are items of gross income, gain, deduction, and loss but only to the extent those items are "effectively connected with the conduct of a trade or business within the United States" and included or allowed to be included in the determination of taxable income for the taxable year,[15] and do not include certain passive items, such as capital gain or loss, dividend income, and interest income (other than interest income that is properly allocable to a trade or business).[16] Generally, income is effectively connected with the conduct of a trade or business within the United States if it is derived from assets which are used in or held for use in the United States, and the activities of the U.S. business were a material factor in the realization of the income.[17] The Final Regulations also provide that gains or losses attributable to unrealized receivables and inventory items of the partnership that give rise to ordinary income are attributable to the trades or businesses conducted by the partnership and are taken into account for computing QBI.[18] In addition, the Final Regulations provide that adjustments to taxable income as a result of a change in accounting method are taken into account for purposes of computing QBI if the adjustment rises in taxable years ending after December 31, 2017.[19]

The Final Regulations further provide that items that are attributable to one or more trades or businesses must be allocated among each trade or business to which they are attributable using a reasonable method that is applied consistently from one year to the next and clearly reflects the income and expense of each trade or business.[20]

Trade or Business

As provided above, for purposes of calculating the passthrough deduction, the taxpayer must calculate the qualified business income for each "trade or business" of the taxpayer. Under the Final Regulations, a "trade or business" is a trade or business under section 162 (a "section 162 trade or business"). The Final Regulations provide that renting or licensing tangible or intangible property to a related party is a trade or business but performing services as an employee is not.[21]

Treasury and the IRS recognized in the Preamble to the Final Regulations that taxpayers may experience difficulties in determining whether the taxpayer's real estate rental activities are sufficient to rise to the level of a trade or business. Accordingly, Treasury and the IRS released Notice 2019-07 concurrently with the Final Regulations. Notice 2019-07 proposes a safe harbor under which taxpayers may treat a "rental real estate enterprise" as a trade or business solely for the purposes of the passthrough deduction.[22] The safe harbor applies if at least 250 hours of "rental services" are performed with respect to the rental real estate enterprise either (i) each year (for tax years beginning on or before December 31, 2022), or (ii) in three of the prior five years (for tax years beginning after December 31, 2022) and certain recordkeeping requirements and other procedural requirements are met. Notice 2019-07 provides that the rental services can be performed on behalf of the rental real estate business by a property owner directly, or by employees, agents, or independent contractors of the owner. However, property subject to a "triple net lease"[23] and property used by the taxpayer as a residence for part of the year under section 280A[24] are excluded from the safe harbor.[25] A more detailed explanation of this notice is provided **here**.

The Unadjusted Basis Immediately After Acquisition of Qualified Property

The gross qualified business income that can be used for the QBI deduction for each trade or business (or aggregated group of trades or businesses) is limited to the greater of:

(1) 50% of the W-2 wages with respect to the trade or business, or (2) the sum of 25% of the W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition of qualified property with respect to the trade or business.

As mentioned above, for each trade or business (or aggregated group of trades or businesses) of a taxpayer with income above the threshold amount, the taxpayer's passthrough deduction with respect to qualified business income ("QBI") is limited to the greater of:

(i) 50% of the W-2 wages with respect to the trade or business, or (2) the sum of 25% of the W-2 wages, plus 2.5% of the UBIA of qualified property with respect to the trade or business.

UBIA is the basis on the date the qualified property is placed in service.[26] Qualified property generally is depreciable property which (i) is held by and available for use in the trade or business as of the end of the taxable year, (ii) is used during the taxable year in the trade or business' production of QBI, and (iii) has a depreciable period that has not ended before the close of the individual's or RPE's taxable year.[27]

As mentioned above, in a change from the Proposed Regulations, the Final Regulations provide that the portion of a 743(b) adjustment that exceeds what the section 743(b) basis adjustment[28] would have been (under the same facts and circumstances) if the partnership's inside basis step-up was calculated using the UBIA instead of the tax basis of the property (i.e., the excess section 743(b) basis adjustment) is treated as a separate item of qualified property.[29] This change under the Final Regulations allows taxpayers to treat the portion of the 743(b) basis adjustment that reflects an increase in the fair market value of the underlying qualified property as qualified property.

Also, under the Final Regulations, qualified property does not include property acquired within 60 days of the end of the taxable year and disposed within 120 days from the date of acquisition without having been used in a trade or business for at least 45 days.[30]

Under the Final Regulations, if property is transferred to a corporation or partnership in a non-recognition transaction,[31] the UBIA of the qualified property transferred generally carries over.[32] Also, the UBIA of qualified like-kind property received in a 1031 like-kind exchange also generally carries over from the relinquished property.[33] Similarly, the UBIA of qualified property received in an involuntary conversion[34] is generally the UBIA of the converted property.[35] Finally, the UBIA for qualified property acquired from a decedent and immediately placed in service is the fair market value at the decedent's death under section 1014.[36]

The Final Regulations provide that in the case of qualified property held by a partnership, a partner's share of the UBIA of the qualified property is determined using the partnership's depreciation rules on the last day of the taxable year.[37] In the case of an S corporation, the shareholder's share of UBIA is the share of the UBIA proportionate to the ratio of the shares in the S corporation held by the shareholder on the last day of the taxable year over the total shares of the S corporation.[38]

Aggregation Rules

The Final Regulations allow a taxpayer to aggregate multiple trades or businesses and treat them as a single trade or business for purposes of calculating QBI and calculating the QBI deduction limitations, if the taxpayer can demonstrate that:

- ???the same person, or group of persons[39] directly or by attribution through the related party rules in sections 267(b) and 707(b)[40] owns 50% or more of each trade or business that will be aggregated;[41]
- ???the ownership described in clause (i) existed for a majority of the taxable year, including the last day of the taxable year; [42]
- ???all of the items attributable to each trade or business that will be aggregated are reported on returns with the same taxable year;[43]
- ???none of the trades or businesses that will be aggregated are SSTBs;[44] and
- ???the trades or businesses that will be aggregated satisfy at least two of the following three factors: (1) they provide products, property or services that are the same or customarily offered together, (2) they share facilities or significant centralized business elements like personnel, accounting and legal, and (3) they are operated in coordination with, or reliance upon one or more of the businesses in the aggregated group.[45]

The aggregation rules for the QBI deduction may allow certain businesses to achieve more favorable tax results. For example, a taxpayer with a business with low W-2 wages might aggregate that business with a low-income business with high W-2 wages and achieve a passthrough deduction with respect to the low W-2 wage business without affecting the passthrough deduction of the high W-2 wage business.

In a significant change from the Proposed Regulations, the Final Regulations allow aggregation at the entity level if the aggregation rules described above are satisfied. Under the Final Regulations, a relevant partnership entity may aggregate trades or businesses that it operates directly or through lower-tier RPEs (to the extent that the aggregation is not inconsistent with the lower-tier RPEs aggregation).[46] An RPE may not disaggregate trades or businesses that were aggregated by a lower-tier RPE but the RPE may aggregate additional businesses that were not aggregated by the lower-tier RPE's aggregation as long as the aggregation rules are satisfied.[47]

An individual may aggregate trades or businesses that it operates directly as well as the individual's shares of trades or businesses operated through relevant passthrough entities, so long as the aggregation is not inconsistent with the aggregation of an RPE.[48] An individual may not disaggregate trades or businesses that were aggregated by an RPE but the individual may aggregate additional businesses that were not aggregated by an RPE as long as the aggregation rules described above are satisfied.[49]

Once an individual or an RPE chooses to aggregate multiple trades or businesses, these must be reported consistently in subsequent years.[50] The individual or RPE may change a previous aggregation only if there is a change in facts or circumstances that invalidates the previous aggregation.[51] Taxpayers who have not reported businesses as aggregated on a tax return may aggregate businesses on a tax return for a future taxable year.[52] However, taxpayers cannot choose to aggregate business on an amended return (other than an amended return for the 2018 taxable year) if the taxpayer did not aggregate these businesses on the original return.[53]

The Final Regulations impose annual disclosure requirements on both individuals and RPEs that identify the aggregated trades or businesses and additional information specified in the regulations.[54]

Specified Services Trade and Businesses

For purposes of section 199A, an SSTB is a trade or business that performs services in the following areas: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, dealing in securities, or a trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.[55] If a trade or business is an SSTB then, for a taxpayer whose income exceeds the threshold amount, no passthrough deduction is permitted with respect to the specified trade or business.

The Final Regulations clarify certain aspects of the SSTB limitations and provide additional guidance on the meaning of each of these listed SSTBs.[56]

Health. Medical services include the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and similar healthcare professionals.[57] Unlike the Proposed Regulations, the Final Regulations do not require that the services be provided directly to the patient.[58] Health services do not include the provision of services not directly related to a medical field, even though the services may relate to the health of the service recipient.[59] For example, the Final Regulations provide that managing the operations and performing the administrative functions of specialty surgical centers are not considered health services for purposes of section 199A. Also, services in the field of health exclude health clubs and spas, as well as research, testing, manufacture and or sales of pharmaceuticals or medical devices.[60] Thus, services in these fields are not SSTBs, and taxpayers may claim the passthrough deduction with respect to the QBI earned from them, regardless of the taxpayer's income.

A trade or business where the principal asset is the reputation or skill of one or more employees or owners. The Final Regulations define a trade or business where the principal asset is the reputation or skill of one or more employees or owners to include only services where an individual or RPE is (a) receiving fees, compensation or other income for endorsing products or services, (b) licensing or receiving fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, or (c) receiving appearances fees, compensation or other income.[61]

The Final Regulations contain an example where a chef who owns multiple restaurants receives endorsement fees for the use of his or her name on a line of cooking products, and concludes that the endorsement fees are from an SSTB (and therefore will not qualify for the passthrough deduction), but the income from the restaurant businesses are not from an SSTB (and therefore may qualify for the passthrough deduction).[62]

The Final Regulations adopted the Proposed Regulations with no material changes in this area.

Athletics. Athletic services include the performance by participants in athletic competitions, including the athletes, coaches, and team managers. However, the term excludes services that do not require skills unique to athletic competition, like the maintenance and operation of the equipment and facilities, and services relating to the broadcasting, video and audio of the athletic events.[63] Treasury and the IRS rejected requests to exclude sports clubs and their owners from the definition of performance of services in the field of athletics. Therefore, a partnership that solely owns and operates a professional sports team is engaged in an SSTB in the field of athletics.[64] As a result, a partner's share of income from that business is not eligible for the passthrough deduction if the partner's income is above the threshold amount.[65]

Financial Services. Financial services include services typically performed by financial advisors and investment bankers, including wealth management, providing advice with respect to a client's finances, developing retirement plans and wealth transition plans, advisory services regarding valuations, mergers, acquisitions, dispositions and raising financial capital by underwriters.[66] They also include arranging lending transactions between a lender and borrower.[67] However, they specifically exclude taking deposits or making loans.[68] Therefore, owners of funds that originate loans and S corporation banks may qualify for the passthrough deduction regardless of their level of income. Furthermore, Treasury and the IRS noted in the Preamble to the Final Regulations that the provision of advisory and other similar services by insurance agents will generally not be considered financial services to the extent that they are ancillary to the commission-based sale of an insurance policy, and therefore the income from providing these services may qualify for the passthrough deduction regardless of the taxpayer's level of income.

Investing and Investment Management. Under the Final Regulations, investing and investing management is a trade or business (operated through agents, employees, or independent contractors) that earns fees for investment, asset management services, or investment management services, whether receiving a commission, flat fee or investment management fee based on a percentage of assets under management. Directly managing real property is not investing or investment management, and therefore taxpayers who manage real estate may qualify for the passthrough deduction regardless of income.[69]

The Final Regulations adopted the Proposed Regulations with no material changes in this area.

Trading or Dealing in Securities. Under the Final Regulations, trading or dealing in securities is a trade or business of trading in securities, commodities, or partnership interests.[70] Dealing in securities and partnership interests is defined as regularly purchasing securities and partnership interests from and selling securities and partnership interests to customers in the ordinary course or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities and partnership interests with customers in the ordinary course.[71] The Final Regulations provide that the performance of services to originate a loan is not treated as the purchase of a security from the borrower for purposes of determining whether the lender is dealing in securities.[72]

Under the Final Regulations, dealing in commodities is regularly purchasing commodities from and commodities to customers in the ordinary course or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course. However, under the Final Regulations, dealing in commodities excludes sales of commodities in the active conduct of a commodities producer, processor, merchant, or handle. These activities are referred to as “qualified active sales”. However, the term “qualified active sale,” excludes a sale by a trade or business of commodities held for investment or speculation.[73]

De minimis Rule

Under the Final Regulations (as under the Proposed Regulations) a trade or business is not an SSTB if the trade or business had gross receipts of $25 million or less in the taxable year and less than 10% of the gross receipts of the trade or business is attributable to the performance of services in an SSTB.[74] Also, a trade or business is not an SSTB if the trade or business had gross receipts of more than $25 million in the taxable year and less than 5% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.[75]

Anti-abuse Rule

The Final Regulations changed the anti-abuse rules for SSTBs contained in the Proposed Regulations. Under the Proposed Regulations, an SSTB included any trade or business (not otherwise an SSTB) with 50% or more common ownership that provides 80% or more of its property or services to an SSTB. Furthermore, if a trade or business (not otherwise an SSTB) had 50% or more common ownership with an SSTB but did not meet the 80% rule above, then any portion of the property of services provided to an SSTB was treated as an SSTB. The Final Regulations made some changes to this rule. Under the Final Regulations, a non-SSTB trade or business that provides property or services to an SSTB (direct or indirectly) and a taxpayer or group of taxpayers owns 50% or more of both the SSTB and non-SSTB trades or businesses, then the portion of the non-SSTB business that is providing the property or services to the SSTB business is treated as a separate SSTB only with respect to the taxpayer or group of taxpayers that make up the 50% or more common ownership. The Final Regulations narrowed the application of this rule to only the taxpayer or group of taxpayers that create the 50% or more common ownership. This rule applies to taxable years ending after December 22, 2017.[76]

Also the Proposed Regulations contained a second anti-abuse rule, which provided that if a trade or business (not otherwise an SSTB) has 50% or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, it is treated as part of an SSTB if the trade or business represents no more than 5% of gross receipts of the combined business. The Final Regulations did not adopt this rule.

Performing Services as an Employee

Under section 199A, income from the trade or business of performing services as an employee is ineligible for the passthrough deduction.[77] This includes all wages and other income earned in a capacity as an employee. [78] The Final Regulations include an anti-abuse rule which provides that if an individual who was an employee of a trade or business for federal employment tax purposes but becomes an independent contractor or is hired by another entity and still performs substantially the same services to the same trade or business (or a related person), the individual is presumed to be in the business of performing services as an employee to that trade or business for three years after ceasing to be an employee.[79] The Proposed Regulations did not contain any specific time period limitation

This presumption, which is applicable to taxable years ending after December 22, 2017, can be rebutted by providing records (e.g., contracts or partnership agreements) that corroborate the individual's status as a non-employee.[80] So, for example, assume that an associate is employed by a law firm (which is a partnership) as an employee and is treated as an employee for federal employment tax purposes. The associate quits her job in 2018 and enters into a contract with the law firm in the same year to provide substantially the same services that the associate provided in her capacity as an employee. The associate is presumed, until 2021, for section 199A purposes to be engaged in the trade or business of performing service as an employee with regard to her services performed for the law firm.

Qualified REIT Dividend

Qualified REIT dividends are entitled to the passthrough deduction. For purposes of section 199A, a dividend from a REIT is a qualified REIT dividend that qualifies for the passthrough deduction if: (i) it is received during the taxable year, (ii) it is not a capital gain dividend, (ii) not qualified dividend income, (iii) it is received with respect to a share of REIT stock that is held by more than 45 days during the 91-day period which begins 45 days before the ex-dividend date; and (iv) the shareholder is not under an obligation to make payments under a swap with respect to the dividend or otherwise obligated to make "related payments" with respect to positions in "substantially similar or related property."[81] Treasury and the IRS have issued additional Proposed Regulations (the "RIC Proposed Regulations") that address the payment by regulated investment companies ("RICs") of dividends that certain shareholders may include as qualified REIT dividends.[82] The RIC Proposed Regulations permit RICs to passthrough to their non-corporate shareholders qualified REIT dividends eligible for the passthrough deduction if the shareholder meets the holding period requirements for its shares in the RIC.

Specifically, the RIC Proposed Regulations treat any dividend that a RIC pays to its shareholders and reports as a section 199A dividend as a "section 199A dividend" eligible for the passthrough deduction to the extent it is derived from the aggregate amount of qualified REIT dividends includible in the RIC's taxable income for the taxable year less expenses properly allocable to the qualified REIT dividends. Furthermore, the RIC Proposed Regulations require the shareholder to hold the dividend-paying share for at least 46 days of the 91-day period beginning 45 days before the share becomes ex-dividend, and prohibit the shareholder from being under an obligation to make related payments with respect to a position in substantially similar or related property. Taxpayers are entitled to rely on this portion of the RIC Proposed Regulations immediately. The RIC Proposed Regulations reserve on extending the same treatment to PTP income, and solicit comments on how to extend the treatment to qualified PTP income earned through RICs.

Qualified Publicly Traded Partnership Income

Qualified PTP income qualifies for the passthrough deduction. Qualified PTP income is the sum of the taxpayer's net allocable share of income, gain, deduction and loss from a PTP that is not taxable as a corporation plus any gain or loss attributable to unrealized receivables and inventory items of the PTP that give rise to ordinary income, which are attributable to the trades or businesses conducted by the PTP.[83] The Final Regulations also clarify that the SSTB limitations apply to qualified income that an individual receives from a publicly traded partnership.[84]

RPEs and PTPs Reporting Requirements

Relevant passthrough entities must report to their owners and the IRS their QBI, W-2 wages, the unadjusted basis immediately after acquisition of their qualified property for each trade or business, and whether any of its trades or businesses is an SSTB.[85] RPEs must also report qualified REIT dividends and qualified PTP income received.[86] Additionally, publicly traded partnerships must determine and report their qualified business income for each trade and business in which the PTP is engaged and whether any of its trades or businesses are SSTBs.[87] PTPs must also report qualified REIT dividends and qualified PTP income received from another PTP.[88] However, PTPs do not need to report the W-2 wages or the UBIA of qualified property for their trades and businesses.[89]

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[1] All references to section numbers are to the Internal Revenue Code or the Final Regulations.

[2] Pub. L. No. 115-97, 115 Stat. 2054 (2017).

[3] Under sections 267(b) and 707(b), related parties are: (i) members of a family (including: husband and wife; brothers and sisters; ancestors; and lineal descendants); (ii) an individual and a corporation in which the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock; (iii) two corporations which are members of the same controlled group; (iv) grantor and a fiduciary of any trust; (v) a corporation and a partnership if the same persons own more than 50% of the value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership; (vi) an S corporation and another S corporation, if the same persons own more than 50% of the value of the outstanding stock of each corporation; (vii) an S corporation and a C corporation, if the same persons own more than 50% of the value of the outstanding stock of each corporation; (viii) a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or the profits interest, in such partnership; and (ix) two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests. The capital or profits interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries. Additionally, an individual is considered to own the stock owned, directly or indirectly, by or for his family.

[4] The threshold amount adjusts each year based on inflation. This rule does not apply to taxpayers whose income is below the threshold amount. Additionally, taxpayers with income within "phase-in range" (for 2019, between $321,400 and $414,999 for joint filers and between $160,700 and $207,499 for other filers) can only take into account a certain "applicable percentage" of QBI, W-2 wages, and UBIA of qualified property from an SSTB.

[5] If a partnership has a section 754 election in place, and a taxpayer purchases an interest in the partnership for an amount in excess of the partnership's inside bases in its assets, under section 743(b), the partnership "steps up" the inside basis in its assets with respect to the taxpayer under section 743(b). This adjustment to the partnership inside basis in its assets is known as a "section 743(b) adjustment".

[6] Furthermore, taxpayers with income within the "phase-in range" (for 2019, between $321,400 and $414,999 for joint filers and between $160,700 and $207,499 for other filers) can only take into account a certain "applicable percentage" of QBI, W-2 wages, and UBIA of qualified property from an SSTB.

[7] Treas. Reg. §1.199A-1(d)(2)(iii)(A).

[8] Treas. Reg. §1.199A-1(d)(2)(iii)(B).

[9] As mentioned above, QBI is income earned from any trade or business, other than the trade or business of performing services as an employee.

[10] Treas. Reg. §1.199A-2(c)(1)(i).

[11] See infra text accompanying note 95 for definition of qualified REIT dividends.

[12] See infra text accompanying note 97 for definition of qualified publicly traded partnership income.

[13] Treas. Reg. § 1.199A-1(b)(10). The Final Regulations specifically include (i) common trusts maintained by banks and (ii) religious or apostolic organizations that have a common treasury or community treasury, and in the case of associations or corporations that engage in business for the common benefit of the members, only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares of taxable income.

[14] Treas. Reg. § 1.199A-3(b)(1).

[15] Treas. Reg. § 1.199A-3(b)(2).

[16] The full list of excluded items are: (i) any item of capital gain or loss (either short-term or long-term); (ii) any dividend, dividend equivalent or payment in lieu of dividends; (iii) any interest income, other than interest income that is properly allocable to a trade or business; (iv) any item of gain or loss in connection with commodities transaction and any excess foreign currency gains over foreign currency losses; (v) any items of income, gain, deduction or loss in connection with notional principal ;(vi) any amount from an annuity that is not in connection with the trade or business; (vii) qualified REIT dividends and qualified publicly traded partnership income; (viii) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer in an S corporation; (ix) payments to a partner for services or the use of capital that are determine without regard to the income of the partnership ("guaranteed payments"), including a guaranteed payment from a partnership to a partner that is also partnership; (x) income attributable to a guaranteed payment for the use of capital (unless properly allocable to a trade or business); (xi) payments made by a partnership to a partner for services rendered to the partnership other than in the partner's capacity as a partner with respect to the trade or business, regardless if the partner is an individual or an RPE; and (xii) net operating loss deduction under section 172. Treas. Reg. § 1.199A-3(b).

A notional principal contract is a financial instrument that is based upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Treas. Reg. § 1.446-3(c)(1)(i).

[17] See I.R.C. § 864(c).

[18] Treas. Reg. § 1.199A-3(b)(1)(i). I.R.C. § 751(a) and (b).

[19] Treas. Reg. § 1.199A-3(b)(1)(iii). The adjustments are known as "section 481 adjustments." I.R.C. § 481.

In addition, disallowed losses (i.e., losses that the taxpayer was not able to deduct in a previous taxable year) are used in order from the oldest to the most recent on a first-in, first-out basis. Previously disallowed losses include losses under sections 465, 469, 704(d) and 1366(d). Treas. Reg. § 1.199A-3(b)(1)(iv). The Proposed Regulations did not specify the order in which the losses would be used. Only disallowed losses incurred in taxable years beginning on or after January 1, 2018 are taken into account for purposes of calculating QBI. Treas. Reg. § 1.199A-3(b)(1)(iv).

Finally, under the Final Regulations, excess business losses under section 461(l) are treated as a net operating loss carryover to the following taxable year and are taken into account for purposes of computing QBI in the subsequent year in which the loss is actually used. Treas. Reg. § 1.199A-3(b)(1)(v).

[20] Treas. Reg. § 1.199A-3(b)(5).

[21] Treas. Reg. § 1.199A-1(b)(14).

[22] IRS Notice 2019-07, https://www.irs.gov/pub/irs-drop/n-19-07.pdf

[23] For purposes of IRS Notice 2019-07, 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." The word "include" suggests that other leases may be treated as triple net leases; however, IRS Notice 2019-07 may simply contemplate that a lease arrangement under which the lessor pays some expenses may still qualify as a triple net lease.

[24] Under section 280A(d), a taxpayer uses a "dwelling unit" as a "residence" if the taxpayer "uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of (A) 14 days, or (B) 10 percent of the number of days during such year for which such unit is rented at a fair rental." For the purposes of section 280A(d), a "dwelling unit" includes "a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit." I.R.C. § 280A(f)(1)(A).

[25] IRS Notice 2019-07.

[26] Treas. Reg. § 1.199A-2(c)(3).

[27] Treas. Reg. § 1.199A-2(c)(1)(i).

[28] A section 743(b) adjustment is an adjustment to the partnership inside basis in its assets. See supra note 7.

[29] Treas. Reg. § 1.199A-2(c)(1)(iii).

[30] Treas. Reg. § 1.199A-2(c)(1)(iv).

[31] For purposes of section 199A, these transactions include a complete liquidation of a subsidiary under section 332, contribution of property under 351, distribution under section 361, contribution of property under section 721 and distribution under section 731.

[32] Treas. Reg. § 1.199A-2(c)(3)(iv). Any portion of the transferee's UBIA in the qualified property that exceeds the transferor's UBIA in the same property is treated as separate qualified property that is placed in service on the date when the property was first placed in service by the individual or RPE receiving the property

[33] Treas. Reg. § 1.199A-2(c)(3)(ii) and (iii). Any property or portion of a property received in a 1031 like-kind exchange transaction that exceeds the individual's or RPE's UBIA in the relinquished or converted property is treated as separate qualified property that is placed in service on the date when the property was first placed in service by the individual or RPE receiving the property.

[34] An involuntary conversion is property received compulsory or involuntary as a result of destruction, theft, seizure, condemnation, requisition, threat, or imminence. I.R.C. § 1033.

[35] Treas. Reg. § 1.199A-2(c)(3)(ii). Any property or portion of a property received in an involuntary conversion transaction that exceeds the individual's or RPE's UBIA in the converted property is treated as separate qualified property that is placed in service on the date when the property was first placed in service by the individual or RPE receiving the property.

[36] Treas. Reg. § 1.199A-2(c)(3)(v).

[37] Treas. Reg. § 1.199A-2(a)(3)(ii).

[38] Treas. Reg. § 1.199A-2(c)(3)(iv).

[39] The Final Regulation clarified that the group may include a C corporation.

[40] See supra note 3.

[41] Treas. Reg. § 1.199A-4(b)(1)(i). Ownership is measured in the case of an S corporation by the amount of outstanding shares of the corporation and in the case of a partnership by capital or profits in the partnership.

[42] Treas. Reg. § 1.199A-4(b)(1)(ii). The requirement that the ownership exists on the last day of the taxable year was added in the Final Regulations.

[43] Treas. Reg. § 1.199A-4(b)(1)(iii).

[44] Treas. Reg. §1.199A-4(b)(1)(iv).

[45] Treas. Reg. §1.199A-4(b)(1)(v).

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

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

[48] Treas. Reg. § 1.199A-4(b)(2)(i).

[49] Treas. Reg. § 1.199A-4(b)(2)(i).

[50] Treas. Reg. § 1.199A-4(c).

[51] Treas. Reg. § 1.199A-4(c).

[52] Treas. Reg. § 1.199A-4(c).

[53] Treas. Reg. § 1.199A-4(c).

[54] Treas. Reg. § 1.199A-4(c).

[55] Treas. Reg. § 1.199A-5(b)(1). The Final Regulations clarify that the rules regarding SSTBs solely apply for purposes of section 199A and they are not to be taken into account in applying any other provision unless section 199(d) or Treas. Reg. § 1.199A-5(b)(2) is expressly referenced. Treas. Reg. § 1.199A-5(b)(2)(i)(A).

[56] The Final Regulations also clarify that the SSTB limitations apply to qualified income that an individual receives from a publicly traded partnership. Treas. Reg. § 1.199A-5(a)(2).

[57] Treas. Reg. § 1.199A-5(b)(2)(ii).

[58] Treas. Reg. § 1.199A-5(b)(2)(ii).

[59] Treas. Reg. § 1.199A-5(b)(2)(ii).

[60] Treas. Reg. § 1.199A-5(b)(2)(ii).

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

[62] Treas. Reg. § 1.199A-5(b)(3)(xv).

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

[64] Treas. Reg. § 1.199A-5(b)(2)(viii).

[65] Treas. Reg. § 1.199A-5(b)(2)(viii).

[66] Treas. Reg. §1.199A-5(b)(2)(ix).

[67] Treas. Reg. §1.199A-5(b)(2)(ix). This language was added in the Final Regulations.

[68] Treas. Reg. §1.199A-5(b)(2)(ix). This language was added in the Final Regulations.

[69] Treas. Reg. §1.199A-5(b)(2)(xi).

[70] Treas. Reg. § 1.199A-5(b)(2)(xiii).

[71] Treas. Reg. § 1.199A-5(b)(2)(xiii).

[72] Treas. Reg. § 1.199A-5(b)(2)(xiii) (A).

[73] Treas. Reg. § 1.199A-5(b)(2)(xiii)(B).

[74] Treas. Reg. § 1.199A-5(c)(1)(i).

[75] Treas. Reg. § 1.199A-5(c)(1)(ii).

[76] Treas. Reg. § 1.199A-5(e).

[77] Treas. Reg. § 1.199A-5(d)(1).

[78] Treas. Reg. § 1.199A-5(d)(1) (including the cash value of payments made in any medium other than cash, to an employee by his employer in the course of the trade or business of the employer, as provided in Treas. Reg. § 1.6041-2(a)(1)).

[79] Treas. Reg. § 1.199A-5(d)(3)(i).

[80] Treas. Reg. § 1.199A-5(d)(3)(ii).

[81] Treas. Reg. § 1.199A-3(c)(2). This is the same rule as section 246(c)(1)(A).

[82] https://www.irs.gov/pub/irs-drop/reg-134652-18.pdf

[83] Treas. Reg. § 1.199A-3(c)(3). I.R.C. § 751(a) and (b).

[84] Treas. Reg. § 1.199A-5(a)(2).

[85] Treas. Reg. § 1.199A-6(b).

[86] Treas. Reg. § 1.199A-6(b).

[87] Treas. Reg. § 1.199A-6(c).

[88] Treas. Reg. § 1.199A-6(c).

[89] Treas. Reg. § 1.199A-6(c).

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