TAX NEWS & COMMENT
August 2019

A JOURNEY THROUGH IRC SECTION 199A: WASN'T THE CODE TO BE SIMPLIFIED?

David L. Silverman

CONTENTS

A JOURNEY THROUGH IRC SECTION 199A: WASN'T THE CODE TO BE SIMPLIFIED?

***David L. Silverman*, J.D., LL.M.**[1]

I. INTRODUCTION

Section 199A allows a deduction of up to 20 percent to owners of passthrough entities such as partnerships, S corporations and sole proprietorships, and to beneficiaries of certain trusts and estates, until tax years ending December 31, 2025. The statute seeks to level the playing field between C corporations, taxed at 21 percent, and owners of passthrough entities, taxed at significantly higher rates. Section 199A provides up to a 20 percent reduction in a taxpayer's tax rate through a "qualified business income" deduction. A taxpayer in the 37 percent tax bracket could expect to see a maximum reduction to 29.6 percent. Although 29.6 percent exceeds 21 percent, when one considers that dividends from C corporations may be taxed again at 20 percent, the disparity is reduced. While partners are not subject to that double tax, they benefit from there being no requirement that the partnership pay reasonable compensation, which would otherwise result in employment tax. Thus, the deduction may not achieve tax parity for owners of passthrough entities, but it does narrow the gap in a progressive manner. Section 199A is however, complicated. Still, accordingly to the IRS, more than 20 million taxpayers will be eligible for the deduction, and the vast majority will be in the favored Tier 1,

---

[1] David L. Silverman graduated from Columbia Law School and received an LL.M. in Taxation from NYU School of Law. He was formerly associated with Pryor Cashman, LLP, and is a former editor of the ABA Taxation Section Newsletter. Mr. Silverman's practice encompasses all areas of federal and New York State taxation, including tax and estate planning, federal and NYS tax litigation and appellate advocacy, criminal tax, probate and estate administration, wills and trusts, will contests, trust accounting, like kind exchanges, asset protection, real estate transactions, and family business succession. David is the author of *Like Kind Exchanges of Real Estate Under IRC §1031* (2008), now in its third edition, and many other tax publications. He writes and lectures frequently to tax professionals in his areas of practice. His office also publishes *Tax News & Comment*, a federal tax quarterly. He has been licensed by the State of New York Department of Education, State Board for Public Accountancy to provide Continuing Education Credits to Certified Public Accountants, since 2007. In that capacity, David has lectured extensively in many areas of involving income and fiduciary taxation, tax litigation, and trusts and estates. His articles, treatises and publications may be viewed at www.nytaxattorney.com. David may be contacted at (516) 466-5900 or by email at dsilverman@nytaxattorney.com.

which the statute treats most benevolently.

The complexity of calculations required to arrive at the Section 199A deduction for taxpayers whose income is below the "threshold amount" is also far less labored than for taxpayers whose income is above the threshold amount, currently $160,700 for single filer and $321,400 for joint filers. Several preliminary points: It is important to note that if net capital gain equals or exceeds taxable income, no Section 199A deduction will be possible. Also, taxable income for purposes of applying Section 199A is computed without regard to Section 199A itself: Once the Section 199A deduction is calculated, reportable taxable income will be adjusted downward to reflect the deduction. To the extent a taxpayer can increase the gap between taxable income and net capital gains, deductions under the statute may increase. The benefit of Section 199A for shareholders and partners engaged in businesses which depend on their skill will see their deduction vaporize as their income crosses the threshold into Tier 2, and then Tier 3. Tier 1 taxpayers, whose income does not reach such rarefied levels will be unaffected by "SSTB" rules, the "Alternative Limitation" and the "Reduction Amount," which hinder Tier 2 and Tier 3 taxpayers. Introducing as it does many concepts, the story of Section 199A cannot be told all at once. When first studying the statute, the availability of reference to key formulas and tables may be helpful. These Formulas and Tables are included in Section II, before discussing the statute, because they will help crystalize the concepts. They will be referred to throughout this paper.

II. Key Terms and Formulas

The operative provisions can be expressed by six or so formulas. Each is interdependent on the others and incorporates new concepts. Although somewhat abstruse, the formulas will be illuminated by the discussion and illustrations that follow. The significance of each Formula will be explored throughout the paper as the statute reveals itself. Before turning to the six formulas, several tables will introduce (i) the three "Tiers" of taxable income; (ii) the limitations on "SSTBs" and how they vary by Tier; (iii) the three limitation and phaseout provisions that accomplish progressivity; and (iv) a summary of calculations required to determine the "QBI Component" — which generates the lion's share of QBI deductions.

TABLE 1

Taxable Income Tiers
(Indexed for Inflation)

Threshold Amount (2019)
$160,700 (single filer)
or $321,400 (joint filer)

Phase-in Limit =
Threshold Amount + $50,000
(single filer)

Phase-in Limit =
Threshold Amount + $100,000
(joint filer)

TIER 1
Taxable Income ≤ Threshold Amount
Taxable Income ≤ $160,700

TIER 2
Threshold Amount < Taxable Income
Phase-in Limit ≥Taxable Income

Taxable Income > $321,400
Taxable Income ≤ $421,400

TIER 3
Taxable Income > Phase-in Limit
Taxable Income > $421,400

TABLE 2

Phase-in Range

Tier 2
(Range Spans Tier 2)

\$160,700 + (0 to \$50,000) or
\$160,700 to \$210,700
(single filer)

\$321,400 + (0 to \$100,000) or
\$321,400 to \$421,400
(joint filer)

Phase-in Limit

Tier 1
Taxable Income > \$210,700 (single)
Taxable Income > \$421,400 (joint)

TABLE 3

Specified Service Trades
or Businesses (SSTBs)

Tier 1
SSTB Qualified Trade or Business
All QBI, W-2 Wages, UBIA
& PTP Allocations Allowed

Tier 2
SSTB Qualified Trade or Business
But: QBI, W-2 Wages, UBIA &
PTP Income Phased Out as
Taxable Income Approaches
Phase-in Limit
[Phase-out proportional to
percentage encroachment
In Phase-in Range]

Tier 3
SSTB Not Qualified Trade or Business
Phase-out Complete
All QBI, W-2 Wages, UBIA
& PTP Income Disallowed
[Unless Exception Applies]

<u>TABLE 4</u>

Phaseout Provisions:

-

Alternative Limitation
Always Applies to Tiers 2 & 3
(see Formula 3B)

Applicable Percentage
Always Applies to Tier 2
If Business is an SSTB
(See Formula 6)

Reduction Amount
Always Applies to Tier 2 if
20 percent of QBI is Greater
than Alternative Limitation
(Regardless of SSTB Status)
(See Formula 4)

TABLE 5

Calculating the QBI Component (Formulas 3A, 3B, 3C) for a Single Trade or Business

	Tier 1	**Tier 2**	**Tier 3**
Alternative Limitation	N/A	YES	YES
Applicable Percentage	NO	YES*	NO†
SSTB Allocations Ignored?	NO	Phased Out	YES
Reduction Amount	N/A	YES**	NO
Excess Amount	N/A	YES***	N/A
Apply Applicable Percentage Before Reduction Amount?	N/A	YES****	N/A

* Only required if Allocation is from an SSTB. [Reduces QBI, Qualified W-2 Wages, UBIA of Qualified Property, and PTP Income

** Only Necessary if 20% of QBI > Alternative Limitation

*** Term in Formula for Reduction Amount; Therefore Only Where Reduction Amount Required

**** Only if Calculation of Applicable Percentage is Actually Required [i.e., SSTB & Tier 2]

† Can ignore, since Applicable Percentage Phase-out has eliminated all SSTB allocations upon taxable income crossing threshold into Tier 3. Nothing left for Applicable Percentage to reduce.

TABLE 6

Key Formulas:

Formula 1
All Tiers
Final Step in Calculating Deduction

The Section 199A deduction equals the lesser of (i) the Combined QBI Amount and (ii) 20 percent of difference between Taxable Income and Net Capital Gain.

§199A deduction = lesser of
[CQBI Amount and .2(TI − NCG)]

Formula 2
All Tiers
Combined QBI Amount

The Combined QBI Amount equals the sum of the taxpayer's QBI Components (for each qualified trade or business) plus 20 percent of the sum of aggregate qualified REIT dividends and aggregate qualified PTP income.

CQBI Amount =
∑QBI Components +
.2(∑REIT dividends + ∑PTP income)

Formula 3A
Tier 1
Determining QBI Component
(For Each Trade or Business)
Taxable Income ≤ Threshold Amount

All SSTB Allocations of QBI,
W-2 Wages & UBIA Disallowed
QBI Component = .2(QBI)
Alternative Limitation Applies

For Tier 1 taxpayers, the QBI Component (for each qualified trade or business) equals 20 percent of QBI. The Alternative Limitation and SSTB Limitations are inapplicable. All QBI allocations "count."

QBI Component = .2(QBI)

Formula 3B
Tier 3
QBI Component
Taxable Income > Phase-in Limit
SSTB Allocations Disregarded

For Tier 3 taxpayers, provided the trade or business is not an SSTB, the QBI Component equals the lesser of 20 percent of QBI and the Alternative Limitation.

QBI Component = lesser of [.2(QBI) & Alternative Limitation]

The Alternative Limitation equals the greater of (i) 50 percent of Qualified W-2 Wages or (ii) 25 percent of the sum of Qualified W-2 Wages and 2.5 percent of UBIA of Qualified Property.

Alternative Limitation = greater of .5(W-2 Wages) and [.25(W-2 Wages) + .025(UBIA)]

Formula 3C
QBI Component
Tier 2

Threshold Amount < Taxable Income
Phase-in Limit ≥Taxable Income

Trade or Business Not an SSTB:

Must initially determine whether business is an SSTB. If the business is not an SSTB, then determine Alternative Limitation. (See Formula 3B, above). If 20 percent of QBI is less than the Alternative Limitation, the QBI Component is that amount. If 20 percent of QBI is greater than the Alternative Limitation, the Reduction Amount must be determined per Formula 4. In order to compute the Reduction Amount, the Excess Amount must be determined per Formula 5. QBI reduced by the Reduction Amount will yield the QBI Component.

Trade or Business is an SSTB:

If the business is an SSTB, determine the Applicable Percentage first. QBI, Qualified W-2 Wages, and UBIA of Qualified Property must be reduced by the Applicable Percentage. Next, determine Alternative Limitation. (See Formula 3B). If 20 percent of QBI is less than the Alternative Limitation, the QBI Component is that amount. If 20 percent of QBI is greater than the Alternative

Limitation, the Reduction Amount must be determined per Formula 4. In computing the Reduction Amount, one must first compute the Excess Amount per Formula 5. QBI reduced (further) by the Reduction Amount will yield the QBI Component.

Formula 4
Reduction Amount
Tier 2, Where 20 Percent of QBI
Exceeds Alternative Limitation

Calculation of the Reduction Amount is necessary if 20 percent of QBI exceeds the Alternative Limitation <u>and</u> the Taxpayer is in Tier 2. The Reduction Amount equals the Excess Amount times taxable income minus the Threshold Amount over the Phase-in Amount.

Stated algebraically:

Reduction Amount = Excess amount times [(Taxable Income − Threshold Amount) ÷ Phase-in Amount]

Formula 5
Excess Amount
(Variable in Formula 4)

The Excess Amount is only required if calculation of the Reduction Amount is necessary. The Excess Amount equals 20 percent of QBI minus the Alternative Limitation.

Formula 6
Applicable Percentage
(Tier 2 with Allocation
of QBI From SSTB)

The Applicable Percentage applies only to Tier 2 Taxpayers with QBI allocations from an SSTB. The phaseout reduces allocated QBI, Qualified W-2 Wages, and UBIA of Qualified Property. If the Reduction Amount is also required, the Applicable Percentage Phaseout must be applied to reduce QBI first. The Applicable Percentage equals 1 minus the difference between taxable income and the threshold amount, over the phase-in amount.

Expressed Algebraically: $\text{Applicable Percentage} = 1 - \frac{(\text{Taxable Income} - \text{Threshold Amount})}{\text{Phase-in Amount}}$

III. Qualified Business Income and Qualified Trades or Businesses

Qualified Business Income (QBI) is the net amount of qualified items of income, gain, deduction, and loss with respect to an *active business* within the United States. The term "income" includes some items not otherwise associated with income for federal income tax purposes, including (i) gain or loss in partnership transactions involving unrealized receivables or inventory of a partnership resulting in ordinary income ("hot assets" under Section 751), (ii) Section 481 adjustments after the 2017 tax year, and (iii) net operating losses disallowed under Section 461. *In general, net operating losses are ignored when calculating QBI, because the deductions giving rise to those losses have already been allowed in computing taxable income.*

A "relevant passthrough entity" (RPE) is a passthrough entity such as an S corporation, partnership (other than a publicly traded partnership) or sole proprietorship that operates as a qualified trade or business and passes through qualified items of income, gain, loss, or deduction to shareholders, partners, or sole proprietors. An RPE is also a passthrough entity that does not operate as a qualified trade or business but rather passes through qualified items from lower-tier RPEs. The regulations refer to the recipients of these items of income, gain, etc., as "individuals." They will be referred to as taxpayers in this paper. Estates and nongrantor trusts may also be RPEs which pass through items of income, etc., to beneficiaries.

QBI is determined at the shareholder or partner level. Neither the inside basis of a partner's interest in the partnership nor the basis of a shareholder's S corporation stock is affected by Section 199A. The final regulations issued in January state that an entity disregarded under Regs. 301.7701-3 is also disregarded for purposes of Section 199A. Therefore, trades or businesses conducted by a disregarded entity are treated as being conducted directly by the owner of the entity. Regs. 1.199A-1(e)(2).

QBI from a qualified business may be negative. Positive and negative QBI is netted in calculating total QBI for the taxable year. The regulations provide that QBI cannot be less than zero. If netting yields a negative number, QBI for the year will be zero, the loss will be treated as coming from a separate qualified trade or business, and will be carried forward to the following year where it may offset positive QBI. Regs. 1.199A-1(d)(2)(iii)(B).

Previously disallowed losses or deductions, including losses under Sections 465, 469, 704(d) and 1366(d) are taken into account for purposes of computing QBI provided the losses were incurred in a tax year on or after January 1, 2018. Losses incurred before January 1, 2018 (which would reduce QBI) need not be taken into account when computing QBI.

Some items which might otherwise constitute income are excluded under Section 199A. Some of these are investment-type items. The rationale for excluding these items is that Section 199A is intended to benefit business owners, but not investors or employees of businesses. Excluded items include: (i) dividends and interest income (unless allocated to a qualified trade or business); (ii) short and long term capital gains and losses, (iii) Section 1231 gains and losses; (iv) gains or losses from foreign commodities transactions or foreign currency gains; (v) notional principal contracts unless qualifying under Section 1221(a)(7); (vi) annuity amounts that are not received in connection with a trade or business; (vii) qualified REIT dividends; (viii) qualified PTP income; (ix) reasonable compensation paid by an S Corporation to a shareholder, (x) guaranteed payments to partners under IRC Sec. 707(c) for services rendered to the partnership business; and (xi) payments to a partner for services rendered in a capacity other than as a partner.

Reasonable compensation paid to a shareholder of an S Corporation, as well as guaranteed payments made to a partner, or payments made to a partner for services rendered in a capacity other than as a partner, are excluded when computing QBI, provided the payment is allocable to the trade or business and is deductible to the partnership or S corporation.

However, reasonable compensation paid to a partner *qua* partner will not reduce QBI, since a partner can never be an employee of a partnership. The disparity in treatment between shareholders of S corporations and partners, with partners being treated more favorably, lay in the fact that while reasonable compensation must be paid to an S corporation shareholder (Rev. Rul. 74-44), the same is not true for partners who by definition cannot be employees of a partnership. (Rev. Rul. 69-184).

The QBI deduction was intended to apply to business profits, and not to wages. Accordingly, Section 199A(c)(4) excludes items more resembling wages than profits. While it may have been advantageous for sole proprietors to elect S Corporation status prior to the enactment of Section 199A when the primary consideration was the avoidance of self-employment tax, that decision may now be more difficult.

Still militating in favor of the S corporation form is the fact that wage income paid to S corporation shareholders, although reducing QBI, may produce a benefit under the Alternative Limitation, whereas guaranteed payments to partners are not wages, and will thus produce no comparable benefit. The Alternative Limitation, though intended as a brake to QBI, will still increase the QBI Component, and thus the Section 199 deduction, in many cases if it is higher. The QBI Component is not necessarily dependent upon QBI, and can be significant, even if QBI from the qualified trade or business is zero. (See Formula 3B).

To take the analysis a step further, even if the QBI Component is zero (or negative), a Section 199A deduction will still result if the taxpayer has qualified PTP (publicly traded partnership) income or qualified REIT income. This reflects the fact that although the QBI Component may be zero (Formula 3), the

Combined QBI Amount (Formula 2) will reflect positive PTP and REIT income. A positive Combined QBI Amount will always generate some Section 199A deduction provided taxable income exceeds net capital gain.

However, if the Combined QBI Amount is zero, the buck stops there: No Section 199A deduction will be possible, even if taxable income is high and there is no net capital gain. (See Formula 1).

For example, assume the taxpayer has $100,000 in qualified PTP income, $100,000 in taxable income, but has negative $20,000 QBI, and no net capital gain. Negative QBI is not netted against PTP income. Therefore, the taxpayer will have a positive Combined QBI Amount per Formula 2. Since taxable income is greater than net capital gain, both sides of the equation in Formula 1 will be positive, and a Section 199A deduction will result even though the taxpayer has no QBI. The taxpayer has a positive Combined QBI Amount because of PTP income.

The proposed regulations state that previously disallowed losses under Sections 465, 469, 704(d) and 1366(d) will affect the computation of QBI provided they were incurred in a tax year beginning after December 31, 2017. New amended proposed regulations treat previously suspended losses as a separate trade or business for Section 199A purposes. Reg. 1.199A-3(b)(1)(iv); Proposed Amended Reg. 134652-18. The final regulations provide that some deductions, such as those for self-employment tax under Section 164, or for health insurance under Section 162 for those who are self-employed, will reduce QBI in proportion to the extent they are attributable to the qualified trade or business. Regs. 1.199A-3(b)(1)(vi).

The QBI Component (Formula 3) and the Combined QBI Amount (Formula 2) may sound similar, but they are very different. A taxpayer may have multiple qualified trades or businesses. The QBI Component must be calculated for each qualified trade or business. (In calculating the QBI Component, one may encounter the Alternative Limitation, the Reduction Amount, the Applicable Percentage, the Excess Amount, qualified W-2 wages, UBIA of qualified property, and another hazard, the "Specified Trade or Business" or SSTB limitation. The sum of the QBI Components yields the Combined QBI Amount. (Formula 2).

The Combined QBI Amount is far less grandiose than the QBI Component, as it is simply a clearinghouse for the total of all QBI Components, with the addition along the way of 20 percent of the sum of aggregate qualified REIT Dividends and aggregate qualified PTP income. (Formula 2). The Section 199A deduction is the lesser of the Combined QBI Amount and twenty percent of what remains after subtracting net capital gain from taxable income. (Formula 1).

[It is not necessary to take twenty percent of the QBI Components in Formula 2 when calculating the Combined QBI Amount, because the twenty percent has already been applied when determining the QBI Component in

Formula 3.]

Qualification as a trade or business under Section 199A is governed in general by principles governing Section 162, which as been interpreted by courts as requiring a profit motive and activities that are considerable, regular, and continuous. A qualified trade or business is business other than (i) an SSTB ("Specified Service Trade or Business") or (ii) the trade or business of performing services as an employee. Drawing upon a familiar international tax concept, qualified business income must also be "effectively connected" with the active conduct of a qualified U.S. trade or business. Code Sec. 864(c) applies in determining whether income is effectively connected.

The Alternative Limitation acts as a counterbalance to QBI. The QBI Component is (in most cases) the lesser of 20 percent of QBI and the Alternative limitation. Therefore, ideally it is best to maximize the Alternative Limitation — to a point, but only if the taxpayer is in Tier 2 or Tier 3. The Alternative Limitation has no applicability to taxpayers in Tier 1. For them, there will be no adverse QBI affects from having W-2 wages or UBIA.

For taxpayers in Tier 2 or Tier 3, maximizing the Alternative Limitation will help, but no further benefit will accrue once the Alternative Limitation equals QBI. Once the Alternative Limitation exceeds QBI, the QBI Component will be determined by QBI and not by the (lower) Alternative Limitation.

Although it might seem unfair for a taxpayer in Tier 2 whose income is $1 above the Threshold Amount to be subject to the Alternative Limitation, while a taxpayer in Tier 1 whose income is $1 less will not be subject to the Alternative Limitation, it must be remembered that while the W-2 wages and UBIA for the taxpayer in Tier 1 will be ignored and will not be subject to the Alternative Limitation, that same wage income and UBIA will result in a higher Alternative Limitation, and thus potentially a higher QBI Component for the taxpayer in Tier 2. The same holds true for phaseout of SSTB allocations for taxpayers in Tier 2 versus taxpayers in Tier 3, who derive no benefit whatsoever from allocations of QBI from SSTBs.

[There is one "cliff," however, and that will be discussed later. That cliff exists for taxpayers with QBI from SSTBs who seek protection under a de minimis safe harbor. In that case, missing the safe harbor by even a tiny amount will result in drastic tax consequences.]

As noted, performing services as an employee is not a qualified trade or business, and income earned by an employee will never constitute QBI. The final regulations address the issue of an owner of a passthrough entity who was previously treated as an employee, but is subsequently treated as an independent contractor while performing substantially the same services for the same employer or a related person. That taxpayer will be presumed, but not conclusively so, to still be in the trade or business of performing services as an employee for purposes of Section 199A. However, the final regulations include a three-year lookback rule for this rebuttable presumption, which can also be refuted by the taxpayer showing records that corroborate status as a non-employee. Reg. §1.199A-5(d)(3).

Illustration III-A

Taxpayer X is unincorporated and operates as a sole proprietor through a single member LLC, Y Company. Y Company is employed by ABC Corp. to perform janitorial services. At some point, X requests that ABC Corp. enter into an independent contracting agreement in lieu of the employment agreement. ABC Corp. agrees, and the employment agreement is rescinded. X seeks to take a Section 199A deduction. Under the final regulations, a rebuttable presumption will arise that X is engaged in the trade or business of providing services as an employee of ABC Corp. Since a qualified trade or business for purposes of Section 199A can never include the trade or business of providing services as an employee, X will be denied the deduction. The presumption against X will continue for three years, after which time X could claim the Section 199A deduction, since the trade or business of providing janitorial services does not involve special expertise and therefore would not constitute an SSTB. (see *infra, Section X*).

The final regulations expand the definition of a qualified trade or business for Section 199A purposes to include certain rental activity that would not otherwise qualify under Section 162. Thus, the trade or business requirement is satisfied if tangible personal property is rented or licensed to a trade or business conducted by a taxpayer or relevant passthrough entity (RPE) under common control, as defined in Regs. Sec. 1.199A-4(b)(1)(i). The final regulations employ Sections 267(b) and 707(b) in determining common control. Notice 2019-07 proposed a safe harbor under which rental real estate activities may qualify under Section 199A. Triple net lease arrangements may not qualify under Section 199A.

An important distinction exists between a taxpayer who seeks a Section 199A deduction and the same taxpayer who seeks to comply with Section 162: While under Section 162, a taxpayer must actively participate in the trade or business, <u>a taxpayer is not required to actively participate in the trade or business of the RPE</u>. The active participation requirement applies at the RPE level. If the RPE is a single disregarded entity of which the owner is sole proprietor, the taxpayer would be required to actively participate, but not by reason of Section 199A per se, but because <u>someone</u> must meet the active participation requirement for the trade or business.

Income or loss can be passive with respect to the taxpayer under Section 469, although QBI is calculated only after the passive loss limitations of Section 469 have been applied. Other loss provisions, such as the at-risk limitations of

Section 465, partnership basis limitations, and S corporation basis limitations, are also applied before calculating the Section 199A deduction. However, deferred losses occurring before January 1, 2018 will not affect QBI when they are later allowed.

IV. QBI and Limitations as a Function of Taxable Income

The Threshold Amount of taxable incomed in 2019 is $160,700 for single filers and $321,400 for joint filers. The Phase-in Amount is $50,000 for single filers and $100,000 for joint filers. The Phase-in Range is that amount of taxable income between $160,700 and $210,700 for single filers, and between $321,400 and $421,400 for joint filers. The Phase-in Limit is that amount exceeding $210,700 for single filers and $421,400 for joint filers.

Whether the taxpayer is in Tier 1, 2, or 3 is determined solely by taxable income. The forces imposed by the statute limiting the Section 199A deduction begin as the taxpayer enters Tier 2, but increase throughout the range of Tier 2 until the taxpayer crosses into Tier 3. The limitations and phaseouts are linear and proportionate to taxable income once taxable income exceeds the threshold amount, with the proviso that the phaseout of QBI allocations for SSTBs is linear through Tier 2, but completes its phaseout when the taxpayer reaches the cusp of the upper end of Tier 2.

Entrance into Tier 3 signals the point where all allocations of tentative QBI from the SSTB are ignored, since the phaseout has become complete. The Alternative Limitation continues its work through Tier 3. Calculations for taxpayers in Tier 2 are involved, as some, but not all, tentative allocations of QBI from SSTBs are disallowed, and the Reduction Amount makes its appearance. Like the SSTB phaseout which operates only in Tier 2, the Reduction Amount, though not dependent on the existence of an SSTB, also begins and ends its operation in Tier 2. Once the taxpayer is beyond the phase-in range and enters into Tier 3, the only limitation that will apply is the Alternative Limitation, and that will apply as taxable income increases, regardless of the increase.

Tier 1
TI ≤ Threshold Amount

If taxable income is equal to or below the threshold amount, the taxpayer is in Tier 1. The Combined QBI Amount equals the sum of the QBI Components for all qualified trades or businesses (including SSTBs) plus 20 percent of the sum of the taxpayer's aggregate qualified REIT dividends and aggregate qualified PTP income. The Alternative Limitation is ignored, meaning that qualified W-2 wages and UBIA of qualified property are both ignored. The

Section 199A deduction equals the lesser of the Combined QBI Amount and 20 percent of the difference between taxable income and net capital gain. (Formulas 3A, 2 & 1).

Tier 3
TI > Phase-in Limit

If taxable income exceeds the Threshold Limit, the taxpayer will be in Tier 3. All allocations of QBI from businesses that are SSTBs are ignored. The silver lining — if there is one — is that the calculations for Tier 3 taxpayers are less complicated than those for taxpayers in Tier 2. The Alternative Limitation applies to Tier 3 taxpayers, but not the phase-out for QBI allocations from SSTBs, since those allocations are entirely phased-out. The Alternative Limitation calculation is also less involved for Tier 3 taxpayers than for Tier 2 taxpayers with allocations of QBI from an SSTB, since the Reduction Amount is inapplicable.

Tier 2
Combined QBI Amount

Thrshld Amt < TI ≤ Phase-in Limit

Taxpayers whose taxable income exceeds the threshold amount but is less than or equal to the phase-in limit will be in Tier 2. To calculate the QBI Component, one must first know whether the business is an SSTB. If Tier 2 taxpayers have allocations of QBI from an SSTB, then the Applicable Percentage must first be applied. The Applicable Percentage will reduce not only QBI, but also qualified W-2 wages, UBIA of qualified property, and PTP income. After applying the Applicable Percentage, the Alternative Limitation must be applied and, if 20 percent of QBI is greater than the Alternative Limitation, the Reduction Amount must be calculated, which will reduce QBI further.

If an SSTB is not involved, then Alternative Limitation must be applied and, if 20 percent of QBI is greater than the Alternative Limitation, the Reduction Amount must be calculated, which will reduce QBI further. These procedures will be discussed in greater depth, infra.

V. Combining QBI Components and Calculating the Deduction

Formula 1
Calculation of § 199A Deduction
(All Tiers)

The Section 199A deduction equals <u>the lesser of</u>

(1) The Combined QBI Amount, and

(2) 20 percent of (taxable income less net capital gain.)

Formulas 3A, 2, and 1 are the only formulas required in order to calculate the Section 199A deduction for taxpayers whose taxable income is less than or equal to the Threshold Amount. Formula 1 is also the final step in calculating the Section 199A deduction for taxpayers in all Tiers. Taxable income for purposes of Formula 1 is computed under Section 63 without regard to Section 199A itself. The final regulations define net capital gain as net capital gain within the meaning of Section 1222(11), increased by qualified dividend income under Section 1(h)(11)(B).

Regardless of whether a taxpayer is in Tier 1, 2, or 3, taxable income minus net capital gain may limit or prevent the Section 199A deduction entirely. Increasing taxable income and reducing net capital gain may increase the deduction since it will increase the second term in Formula 1. However, increased taxable income may also propel the taxpayer farther into the phase-in range and, if taxable income is high enough, past the phase-in limit to Tier 3. This will result in more phase-outs and greater limitations.

Empirically it is observed that the deduction is highest when the Combined QBI Amount is high and the difference between taxable income and net capital gain is low. Since it seems fair to assume that a high Combined QBI Amount would also tend to correlate with high taxable income, net capital gain may be a substantial limiting factor for high income taxpayers. Therefore, deferral of capital gain may help increase the Section 199A deduction.

Illustration V-A

Taxpayer A has the following tax attributes:

CQBI Amount: $10,000
Taxable income: $150,000
Net Capital Gain: $100,000

Taxable income minus net capital gain is $50,000, 20 percent of which is $10,000. A's Section 199A deduction is $10,000.

Illustration V-B

The same facts as in Illustration 1, except A has CQBI of $100,000. Although A's CQBI Amount is now $100,000, the Section 199A deduction is still limited to $10,000.

Illustration V-C

The same facts as in Illustration A, except A has net capital gain of $150,000. Since the second component is zero, A has no Section 199A deduction.

Illustration V-D

The facts are the same as in Illustration A, except A has CQBI Amount of $5,000. Here, A's deduction is limited to $5,000.

Observation: Comparing Illustration B to A, even though taxpayer A's CQBI amount increased tenfold, the Section 199A deduction was unchanged, reflecting the limitation imposed by taxable income and net capital gain. Increasing net capital gain by $50,000, in Illustration C operated to completely eliminate the deduction. Finally, decreasing the CQBI Amount to $5,000, in Illustration D caused the CQBI Amount, now representing only 3.33 percent of taxable income, to become the limiting factor, which makes sense: The deduction should not exceed the CQBI Amount.

Formula 2
All Tiers
Combining QBI Components
With Aggregate Qualified
REIT Dividends & PTP Income
(Applies to All Tiers)

The Combined QBI amount = the sum of QBI Components plus 20 percent of the sum of aggregate qualified REIT dividends and aggregate qualified PTP income.

The Combined QBI Amount equals the sum of the QBI Components for each qualified trade or business and 20 percent of the sum of aggregate qualified REIT dividends and qualified PTP (publicly traded partnership) income. The QBI Component is defined in Formula 3. If the QBI Component is zero, a

Section 199A deduction may still arise from aggregate qualified REIT dividends and aggregate qualified PTP income, which can create a positive Combined QBI Amount.

As noted, if the net Combined QBI Amount is negative for all qualified trades or businesses, the negative number is carried forward and available for use in the following year to offset positive QBI. Note that the net Combined QBI may be positive, even though some qualified trades or businesses generate negative QBI. In that case, the negative QBI is allocated proportionately among all trades or businesses with positive QBI. *This allocation is made before applying the Alternative Limitation.*

Illustration V-E

Facts: Y has four qualified trades or businesses, M, N, O, and P. Their respective QBI Components are ($20,000), ($20,000), $10,000, and $10,000. Y has no qualified REIT dividends and no UBIA of qualified property. However, Y has aggregate qualified W-2 wages of $10,000 and aggregate qualified UBIA $10,000. Y has $100,000 in taxable income and $20,000 in net capital gain.

Analysis: The Combined QBI amount is the net of the four QBI Components, or negative $20,000. Since QBI cannot be less than zero, $20,000 is carried forward to the following year. Although Y has qualified W-2 wages and UBIA of qualified property, those amounts are not carried over to subsequent years. Y will apparently derive no tax benefit from these items. Regs. 1.199A-1(d)(2)(iii)(A).

VI. Aggregate Qualified REIT Dividends and Aggregate Publicly Traded Partnership (PTP) Income

The second component of Formula 2 is 20 percent of the sum of aggregate qualified REIT dividends and aggregate qualified Publicly Traded Partnership (PTP) income. The taxpayer may have qualified REIT dividends and qualified PTP income from many businesses. The term *aggregate* means the sum of these items from all qualifying trades or businesses. The "aggregate" function is analogous to the "Combined" QBI Amount, in the sense that Combined QBI Amount reflects the sum of all QBI Components (if the taxpayer has more than one qualified trade or business and those businesses are not aggregated).

To be qualified for purposes of Section 199A, a REIT dividend must emanate from a REIT having been held for 45 days or more, and not be a capital gain dividend under Section 857(b)(3), or a qualified dividend under Section 1(h)(11). The reason for this exclusion is that capital gain dividends and qualified dividends already enjoy preferential tax treatment for noncorporate taxpayers. Allowing a deduction under Section 199A would result in a perceived windfall.

Qualified PTP income is the sum of the net amount of the taxpayer's share of income, gain, deduction, and loss from a publicly traded partnership, as defined in Section 7704(b), and not taxed as a corporation under Section 7704(a). PTP income also includes ordinary income attributable to gain or loss on a sale relating to unrealized receivables or inventory of a partnership under Section 751(a) or (b).

For purposes of combining aggregate qualified PTP income and aggregate qualified REIT dividends, those components are fungible: If either qualified PTP income or qualified REIT dividends are negative, they are netted against any positive REIT dividends or PTP income. If netting results in a negative number, that number is carried forward and netted against aggregate qualified REIT dividends and aggregate qualified PTP income in the following year. Regs. 1.199A-1(c)(2)(ii), (d)(3).

Example VI-A
[Tier 1]

Facts: Taxpayer A is married and files jointly. A receives a K-1 showing QBI from a qualified trade or business of $200,000. For tax year 2019, A has taxable income of $250,000 and $5,000 of net capital gain. A has no qualified REIT dividends or PTP income.

Analysis: Since A is below the threshold amount of $321,400, A is affected by neither the Alternative Limitation nor SSTB disallowance rules. A's QBI Component is 20 percent of QBI, or $40,000. Since aggregate REIT dividends and PTP income is zero, the Combined QBI Amount of A is also $40,000. (Formula 2). The Section 199A deduction is the lesser of $40,000, or 20 percent of A's taxable income, $250,000, less net capital gain of $5,000. (Formula 1). Taxable income less net capital gain for A is $245,000, twenty percent of which is $49,000. Since $40,000 is less than $49,000, A has a Section 199A deduction of $40,000.

Example VI-B

Facts: The same facts as in Example 1, except the K-1 reveals that the trade or business is an SSTB.

Analysis: Since SSTB status is ignored for Tier 1 taxpayers, the result is the same.

Example VI-C

Facts: The facts are the same as in Example 2, except Y has aggregate qualified REIT dividends of $50,000.

Analysis: Since the Combined QBI Amount includes 20 percent of aggregate qualified REIT dividends, Y now has a Combined QBI Amount of $50,000. Y's Section 199A deduction is now the lesser of $50,000 and $49,000. Y's Section 199A deduction is $49,000.

Illustration VI-D

Taxpayer A files jointly, has taxable income of $300,000, net capital gain of $50,000, and has three qualifying trades or businesses, none of which are SSTBs. A has qualified REIT Dividends of $50,000 and no Qualified PTP Income. Allocable QBI of each of the trades or businesses is as follows:

Business 1: $50,000
Business 2: $25,000
Business 3: $25,000

The QBI Component for each qualified trade or business is 20 percent of the allocated QBI from each business, or $10,000, $5,000, and $5,000, respectively for Businesses 1, 2 and 3. (Formula 3, first component).

The Combined QBI Amount is the sum of the QBI Components, or $20,000, plus 20 percent of aggregate qualified REIT dividends, $10,000, for a total of $30,000.

A is below the Threshold Amount. The Section 199A deduction is the lesser of the Combined QBI Amount and 20 percent of what remains after subtracting net capital gain from taxable income. The deduction is the lesser of (i) $30,000 or (ii) 20 percent of $250,000, or $50,000. A's Section 199A deduction is $30,000.

VII. The Alternative Limitation

The Alternative Limitation is also known as the Wage/Property Limitation. The Alternative Limitation applies only to taxpayers in Tiers 2 and 3. Qualified W-2 wages and UBIA of qualified property are the two items that determine the limitation. It is best examined under the lens of a Tier 3 taxpayer, because Tier 3 taxpayers are not affected by the Reduction Amount, which burdens only Tier 2 taxpayers, and are also not affected by the "haircut" exacted by the Applicable Percentage that affects only Tier 2 taxpayers with QBI allocations from SSTBs.

However, the relative ease of calculating the Section 199A deduction for taxpayers in Tier 3 by no means implies that it is preferable to be in Tier 3 than in Tier 2. It simply means that allocations of QBI, W-2 wages, UBIA and PTP income are ignored entirely, which is by no means beneficial. Tier 2 taxpayers must contend with a bevy of limitations, but they are not subject to a blanket disallowance of these items, as are Tier 2 taxpayers. Tier 2 taxpayers are also unique in possibly being subject to the Reduction Amount. Both Tier 2 and Tier 3 taxpayers are subject to the Alternative Limitation. Therefore, calculations for Tier 3 taxpayers are somewhat more involved than those for Tier 1 taxpayers, but considerably less onerous than for Tier 2 taxpayers.

The Alternative Limitation is integrally related to the QBI Component. To determine the QBI Component for Tier 2 and Tier 3 taxpayers, one compares 20 percent of QBI with the Alternative Limitation. The QBI Component is the lesser of the two. The Alternative Limitation itself is the greater of (i) 50 percent of qualified W-2 wages and (ii) 25 percent of the sum of qualified W-2 wages and UBIA of qualified property. Knowing both the Alternative Limitation and 20 percent of QBI, the QBI Component is simply the lesser of those two amounts. There is, however, an exception.

In the case of a Tier 2 taxpayer with QBI allocations from an SSTB, after calculating the Applicable Percentage, it may be necessary to calculate the Reduction Amount. Such calculation is required if QBI is <u>greater than</u> the Alternative Limitation. If that is the case, QBI is then reduced further (having already been reduced by the Applicable Percentage) by the Reduction Amount, in order to arrive at the QBI Component. (See Table 5).

The term "Limitation" in Alternative Limitation is slightly misleading, since on the one hand if less than 20 percent of QBI, it will replace 20 percent of QBI as the figure that determines the QBI Component; but on the other hand, that being the case, increased qualified W-2 wages and increased UBIA of qualified property will increase the Alternative Limitation which, if still less than 20 percent of QBI, will work to marginally increase the QBI Component. The benefit of a higher Alternative Limitation ends when it equals 20 percent of QBI. If it is any higher, the QBI Component will again be determined by 20 percent of QBI.

To recapitulate, the QBI Component (for each qualified trade or business) of Tier 2 and Tier 3 taxpayers equals the lesser of 20 percent of QBI and the Alternative Limitation, except in two instances:

First, allocations of QBI to Tier 3 taxpayers <u>where the only business</u> is an SSTB are entirely ignored. The Alternative Limitation need not be computed for such a business since there will be no QBI. However, the Tier 3 taxpayer may have other businesses which will require computation of the Alternative Limitation, and there may be qualified REIT dividends. (Qualified PTP income is disallowed if the business is an SSTB).

Second, in the case of Tier 2 taxpayers, if 20 percent of allocated QBI *exceeds* the Alternative Limitation, calculation of the Reduction Amount is required, regardless of SSTB status. The Reduction Amount will reduce QBI. The QBI Component will be that reduced amount. The otherwise operative rule prevails if 20 percent of QBI is less than the Alternative Limitation: In that case, QBI Component is simply the lesser of 20 percent of QBI and the Alternative Limitation.

If the allocation is from an SSTB and the taxpayer is in Tier 2, before testing for the Alternative Limitation, the Applicable Percentage must be applied to reduce the QBI allocation. The Applicable Percentage operates to reduce not only QBI, but also qualified W-2 wages, UBIA of qualified property, and qualified PTP income. If 20 percent of the reduced QBI is less than the reduced Alternative Limitation, the QBI Component is that amount.

However, if 20 percent of the (reduced) QBI exceeds the (reduced) Alternative Limitation, then calculation of the Reduction Amount is required. The Reduction Amount will *further reduce* QBI (but only QBI). The QBI Component will then equal 20 percent of that twice-reduced QBI. Note that in calculating the Reduction Amount, the Excess Amount, being a term in the calculation for the Reduction Amount, must be determined first.

Illustration VII-A

Z has $600,000 of taxable income and of QBI of $300,000 from a non-SSTB business, and $160,000 of aggregate qualified W-2 wages. The QBI Component is the lesser of $60,000 and $80,000 (i.e., 50 percent of $180,000), or $60,000. (Formula 3A).

Illustration VII-B

Facts: Assume Taxpayer X is in Tier 2, and Y is in Tier 3. They both have $100,000 of QBI allocated from a single, non-SSTB qualified trade or business. X and Y also have qualified W-2 wages of $5,000.

Analysis: The Alternative Limitation applies to both since Taxpayers X and Y both are above the threshold amount. Twenty percent of QBI is $20,000 for both. With respect to X, since 20 percent of QBI exceeds the Alternative Limitation ($2,500), X must calculate the Reduction Amount. The QBI Component for X will equal the 20 percent of allocated QBI reduced by the Reduction Amount. Since the Reduction Amount does not apply to Tier 3 taxpayers, and Y is in Tier 3, the QBI Component for Y equals the lesser of $20,000 and $2,500, or $2,500.

Illustration VII-C

Facts: The same as in VII-B, except that the trade or business is an SSTB.

Analysis: Since X is in Tier 2, and the business is an SSTB, the Applicable Percentage must be calculated first, and it must be calculated before the (potential) necessary of determining the Reduction Amount. Once determined, the Applicable Percentage will reduce the QBI allocation, as well as other items (discussed infra). If 20 percent of QBI is less than the Alternative Limitation, the QBI Component is that amount. However, if 20 percent of the (already reduced) QBI allocation is greater than the Alternative Limitation, the Reduction Amount must be calculated.

Since Y is in Tier 3, the SSTB is not a qualified business, and every allocation of QBI (and other items) is disregarded. Y is still subject to the Alternative Limitation, if Y has other non-SSTB QBI allocations.

Illustration VII-D

Assume taxpayer is in Tier 1, 20 percent of QBI is $10,000; and the Alternative Limitation is $2,500, reflecting qualified W-2 wages. Since the Alternative Limitation is inapplicable to taxpayers in Tier 1, the taxpayers' QBI Component is $10,000. The QBI Component equals $10,000. Since SSTBs are qualified businesses for taxpayers in Tier 1, its hypothetical classification as such would be inconsequential.

If the taxpayer were in Tier 2, he or she would be required to determine SSTB status. Assuming the business were an SSTB, the Applicable Percentage would need to be calculated, and would reduce the tentative QBI allocation. Calculation of the Reduction Amount would be required if the (reduced) 20 percent of QBI exceeded the Alternative Limitation. If the business were not an SSTB, the Applicable Percentage would not be required, although the Reduction Amount might still apply, depending on whether it was less than 20 percent of allocated QBI. These concepts will be discussed infra.

If the taxpayer were in Tier 3, SSTB status would become irrelevant, since the business would not be qualified. All allocations of QBI (and other items to be discussed infra) would be disregarded. If 20 percent of QBI were greater than the Alternative Limitation, the Reduction Amount would be required.

VIII. UBIA of Qualified Property

Also known as the "Property Limitation," the "Capital Limitation," or the "real estate exception," UBIA or "unadjusted basis immediately after acquisition," is the second component of the Alternative Limitation. UBIA is the unadjusted cost basis under Section 1012, immediately after acquisition of tangible personal property subject to depreciation. UBIA also reflects the basis of property acquired at death under Section 1014. Adjustments for depreciation, Section 179 deductions, or for tax credits or bonus depreciation, are ignored for UBIA purposes. UBIA does not include the percentage of property not used in the qualifying trade or business.

Only "qualified" property for which the "depreciable period" has not ended before the close of the taxable year will produce a Section 199A deduction. Qualified property is any tangible property (personal or real) subject to depreciation under Section 167(a), (not land or intangible property) held by, and available for use in a qualified trade or business at the close of the taxable year. The property must be available for use during the taxable year in the production of QBI.

The depreciable period begins on the date when the passthrough entity first places the property in service, and ends on the date which is the later of (i) 10 years after the property was placed in service and (ii) the last day of the last full year of the class life of the property based on the applicable recovery period under ACRS. Once the Modified Accelerated Cost Recovery System (MACRS) period ends, the property is no longer qualified. In some cases it may be possible to "restart" the depreciable period. Reg. 1.199A-2(c)(2). However, the regulations contain anti-abuse provisions designed to prevent taxpayers from engaging in transactions between related parties in an attempt to restart the depreciable period. Reg. 1.199A-2(c)(2)(iv), (3).

Additional first year depreciation for other purposes is disregarded for purposes of Section 199A. Because of this and other variations, separate tracking is necessary. Note that because of the requirement that the depreciable period not have ended before the close of the taxable year, no property disposed of before December 31 will qualify for UBIA.

The regulations impose a holding period to prevent taxpayers from fleetingly increasing the Alternative Limitation by purchasing property near the end of the year and disposing of it early in the following year. Thus, property will not qualify for inclusion in the Alternative Limitation 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 qualifying trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates a purpose other than increasing the Section 199A deduction.

Since UBIA is constant and never changes, depreciation deductions taken over the life of the property itself will have no effect on UBIA. However, the "depreciable period" of the property is critical, and will affect the status of property as qualified property. The actual date property is placed in service is important both for determining UBIA, and for determining whether the property is qualified property. Improvements to property are treated, for purposes of Section 199, as separate property and accordingly, separate UBIA considerations apply to such property.

If qualified property provides a tax depreciation, each shareholder or partner's share of UBIA is generally equal to the taxpayer's share of tax depreciation.

The final regulations modify the proposed regulations in calculating the UBIA of qualified property that <u>does not produce tax depreciation during the year</u>: Each partner's share of the UBIA of qualified property is determined in accordance with the manner in which depreciation <u>would be</u> allocated for Section 704(b) book purposes on the last day of the taxable year. With respect to S corporations, the final regulations provide that each S corporation shareholder's share of UBIA of qualified property is proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the tax year over the total issued and outstanding shares of the S corporation.

The final regulations provide that (i) with respect to property contributed to a partnership in a Section 721 transaction, or property contributed to an S corporation in a Section 351 transaction (*i.e.,* transactions described in Section 168(i)(7)(B)), (ii) for purposes of Section 199A only, the transferor's UBIA will be the UBIA of the contributed property (not reduced by depreciation deductions taken before the date of contribution) decreased by the amount of money received and increased by the amount of money paid by the transferee to acquire the property. Reg. 1.199A-2(c)(4)(viii)-(ix) (Examples 8-9). This rule allows UBIA to reflect basis at the time the property was placed in service by the partner or shareholder, rather than the lower adjusted basis at the time the property was contributed.

Reflecting another change in the final regulations with respect to basis adjustments under Sections 734(b) and 743(b) with Section 754 elections in effect, the preamble to the final regulations states that "[t]he Treasury Department and the IRS agree that Section 743(b) basis adjustments should be treated as qualified property to the extent [they] represent an increase in the fair market value of underlying property." Preamble to Final Regulations at 36.

UBIA of property received in a Section 1031 like-kind exchange is the UBIA of the relinquished property, adjusted upward for money paid or the fair market value of property transferred, and downward by money received and the fair market value of non-like kind property received. The date the replacement property is placed in service will be the original date the property was placed in service by the transferor. The transferee will not get a new placed in service date.

On the other hand, the UBIA will not have been reduced by depreciation taken by the transferor before it was exchanged. Also, that part of the replacement property having UBIA greater than the relinquished property (i.e., any "excess" consideration paid by the transferor) will be treated as separate property placed in service on the date the replacement property was placed in service. Reg. 1.199A-2(c)(3)(iii). Separate tracking will therefore be necessary.

Illustration VIII-A

Facts: Taxpayer A purchases a building, but not the associated land, for $1 million in Long Island City and places it in service on January 5, 2012. On January 15, 2019, the property, now with an adjusted basis of $820,482, is worth $1.3 million. A engages in a like-kind exchange, acquiring property worth $1.5 million, transferring cash of $200,000 in the exchange. A has no qualified W-2 wages, no qualified PTP income, and no qualified REIT income.

Analysis: Since UBIA in a Section 1031 exchange reflects the unadjusted basis at the time the property was first acquired, plus any money paid in the exchange, total UBIA will equal $1.2 million. However, since UBIA cannot exceed UBIA in the transferred property, UBIA of the replacement property is capped at $1 million. The consideration paid by A in the exchange is treated as having been paid for new property with UBIA of $200,000 on January 15, 2019, the date the replacement property was placed in service.

Caution: Had the exchange occurred on December 25, 2018 rather than on January 15, 2019, A would not have been able to claim any UBIA for the relinquished property in 2018, since the statute requires that the property be *held by, and be available for use in a qualified trade or business at the close of the taxable year*.

Note: Here A did not purchase the land associated with the building. Had A also purchased the land, income generated therefrom would not have been eligible for the Section 199A deduction.

Note: Although Section 1031 is mandatory if its requirements are satisfied, it appears that the IRS will not challenge the deliberate avoidance of the statute by failing to identify replacement property within the 45 day identification period.

Illustration VIII-B

Facts: The building in Long Island City in Illustration VIIIA generates QBI of $150,000 in 2019. The property has engaged a management company and therefore has no W-2 wages. A has a total UBIA of $1.2 million (i.e., $1 million plus $200,000). Determine the Section 199A deduction to which A, in Tier 3, is entitled.

Analysis: The QBI Component is the lesser of $30,000 and the Alternative Limitation. The Alternative Limitation equals 2.5 percent of $1.2 million, or $30,000. Since UBIA covers 20 percent of QBI, A will have a QBI Component of $30,000.

Note: Since A engaged a management company, prior to the final regulations, it would appear that A would receive no benefit of W-2 wages paid by the Management Company to its own employees. However, the final regulations authorize A to include in UBIA wages paid to employees of a real estate Management Company under certain conditions. (See infra, Section IX.)

In the illustration, the ability of A to include W-2 wages paid by the Management Company would not change the QBI Component.

IX. Qualified W-2 Wages

Qualified W-2 wages are defined in Section 3401(a) as wages subject to withholding, and include all amounts paid during the calendar year, including elective deferrals if subject to withholding, deferred compensation, and Roth contributions. For wages to be allocable to QBI, they must be reported to the Social Security Administration on or before the 60th day after the due date of the return, including extensions. The failure to do so will result in a presumption that qualified W-2 wages are zero. The regulations presume that W-2 wages allocable to QBI should have been deducted in arriving at QBI. Reg. 1.199A-2(b)(4). Wages are determined before applying the aggregation rules. W-2 wages are allocated to a QBI activity in the same manner as wage deductions are allocated in computing QBI.

A partner can never be an employee of a partnership. Therefore, guaranteed payments, although compensation, cannot constitute W-2 wages. Since guaranteed payments are deductible by the partnership and will reduce QBI, they are disadvantageous, as they will receive no Alternative Limitation benefit (in the form of W-2 wages) to offset the reduction in QBI. One possible solution would be for an S corporation to which the partnership interest has been contributed, instead pay the wages. Although wages reduce QBI, as would guaranteed payments, they also work to increase the Alternative Limitation, which will in turn increase the QBI Component.

Compensation paid to shareholders of S corporations will constitute W-2 wages and will be reflected in an increased Alternative Limitation. Note that if the business is an SSTB, and the taxpayer is in Tier 3, the issue may be moot, unless the taxpayer has other non-SSTB businesses, since all QBI allocations, including W-2 wages and UBIA, are disregarded. For taxpayers in Tier 2, QBI allocations from an SSTB will be subject to phaseout, but will not be entirely excluded. Increasing UBIA and W-2 wages work to increase the Alternative Limitation. Rev. Proc. 2019-11 contains additional guidance concerning the computation of W-2 wages. 6051(a).

If the RPE conducts more than one trade or business, wages must be allocated to the trade or business that generated the W-2 wages. If a trade or business is acquired or disposed of during the year, W-2 wages must be allocated based upon the amount of time of employment under each employer. In a manner similar to that used to allocate W-2 wages among multiple trades or businesses, the RPE must also identify W-2 wages that are properly allocable to QBI for each trade or business. W-2 wages are properly allocable to QBI if the wage expense was also used to compute QBI.

Rev. Proc. 2019-11 provides three methods of computing W-2 wages: The first method is the "Unmodified Box Method," which is the simplest. The second method is the "Modified Box 1 Method." This method is more detailed, but may provide a benefit if a substantial amount of wage income includes elective deferrals under Sections 401(k), 403(b), 408(k)(6), 457(b), or 408(p). The third method, the "Tracking-Wages Method," involves as it implies, tracking total wages actually or constructively paid. Owners who require employees to keep detailed time records may find this method advantageous.

The regulations provide a relief provision for real estate investors who engage separate management companies to manage properties. Since the fees paid to the management companies would not produce W-2 income for Section 199 purposes, the regulations provide that a taxpayer may take into account W-2 wages paid by another person provided the wages are paid to a "common law employee." Reg. 1.199A-2(b)(iii).

X. Specified Service Trades or Businesses (SSTBs) Defined

Overview of SSTBs Rules

A "Specified Service Trade or Business" or SSTB, is like a chameleon, it may or may not be a qualified trade or business, depending on taxable income.

Section 199A largely defers to Section 1202 in defining trades or businesses that will result in SSTB classification. This generally includes any trade or business whose "principal asset is the reputation or skill of one or more of its employees or owners." Thus, the performance of services in health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and management, trading, dealing in securities, partnership interests, or commodities, will result in SSTB classification. Curiously, the fields of engineering and architecture are excluded.

The preamble to the final regulations emphasizes the importance of applying a facts and circumstances approach to the determination of whether a trade or business is an SSTB. The final regulations also expand the breadth of services in the health field that will not constitute an SSTB.

Regs. 1.199A-5(c) provides additional guidance as to what trades or businesses constitute SSTBs. SSTB limitations are intended to decrease the motivation of taxpayers to transform high compensation income of skilled employees into QBI. The regulations provide specific examples. The field of "health" includes many health professionals, including physicians, pharmacists, nurses, dentists, etc., but do not include those "who provide medical services directly to a patient." Reg. 1.199A-5(b)(2)(ii). The term "law" includes lawyers, paralegals, legal arbitrators, and other similar professions, but do not include services not requiring skills unique to the legal profession, such as printers, delivery services, or stenographic services. Reg. 1.199A-5(b)(2)(iii).

Businesses which depend on the reputation or skill of an employee as a "principal asset" will also be classified as an SSTB. The regulations narrowly define this restriction, and reserve its application to businesses that receive income from endorsing products or services, using a taxpayer's likeness, name, etc., or appearing at an event or on radio, television, or other media format. Reg. 1.199A-5(b)(2)(xiv).

The final regulations provide that SSTB limitations apply to qualified PTP income. If the taxpayer has multiple businesses, some of which are SSTBs and some of which are not, then separate calculations will be necessary, unless the taxpayer aggregates the businesses, which may or may not be possible, and even if possible, may or may not be desirable for purposes of Section 199A.

SSTB: Tier 1 Taxpayers

Except for taxpayers in Tier 1 — for them it makes no difference — the classification of a trade or business as an SSTB has profound implications in determining the Section 199A deduction. For Tier 1 taxpayers, the taint of being an SSTB is inconsequential because Section 199A provides an "exception to the exception" for those taxpayers: The exception preventing an SSTB from qualifying as a trade or business is itself inapplicable to taxpayers in Tier 1. Therefore, if taxable income is below the threshold amount ($321,400 for joint filers in 2019; and $160,700 for single filers; Tier 1), an SSTB will (by definition) be a qualified trade or business, and all allocations of QBI will "count" toward determining the QBI Component for that business.

Illustration X-A

Facts: X is married, files jointly, and has taxable income of $300,000 from two businesses. Business A has QBI from an SSTB of $290,000. The QBI

Component of Business B is $20,000. X has no allocations of either qualified W-2 wages or qualified UBIA, and has no net capital gain, but has qualified PTP income of $10,000.

Analysis: Since X is below the Threshold Amount, both SSTB considerations and the Alternative Limitation are ignored for Business A. The QBI Component for Business A equals 20 percent of QBI, or $58,000. (F.3, first component). The Combined QBI Amount equals the sum of the QBI Components, $78,000, and qualified PTP Income, $10,000, or $88,000. The Section 199A deduction is the lesser of (i) $88,000 and (ii) 20 percent of $300,000, or $60,000. The Section 199A deduction for X is $60,000.

SSTB: Tier 2 Taxpayers

Once taxable income exceeds the threshold amount, which is $160,700 for single filers, and $321,400 for joint filers, the classification of a trade or business as an SSTB becomes problematic. Where taxable income exceeds the threshold amount but not the phase-in limit, the taxpayer, now in the "phase-in range," will experience an erosion of the deduction, as QBI, W-2 wages, UBIA of qualified property, and PTP income allocated to the SSTB are reduced by several phaseout mechanisms.

However, Tier 2 taxpayers are not completely denied the benefit of QBI allocations from an SSTB. Rather, the disallowance increases through Tier 2. To be exact, the disallowance is proportional to the distance the taxable income has advanced through Tier 2. For example, if taxable income is midway through the phase-in range of Tier 2, then half of the QBI allocations from the SSTB will be disallowed, and so forth. When taxable income reaches the phase-in limit, the disallowance is complete.

Accordingly, a Tier 2 taxpayer whose business is an SSTB and who derives QBI from that business must reduce QBI, W-2 wages, UBIA of qualified property, and PTP income by the Applicable Percentage. The Applicable Percentage applies only to Tier 2 taxpayers, and only to those Tier 2 taxpayers who are allocated QBI from an SSTB. This "haircut" or disallowance will be a direct function of taxable income.

After applying the Applicable Percentage to reduce the above items, the procedure grows a bit more complex: If 20 percent of (reduced) QBI is less than the Alternative Limitation (whose Wage and UBIA components have been reduced), the QBI Component is that amount. However, if 20 percent of QBI exceeds the Alternative Limitation, the Reduction Amount must be calculated. Since the Excess Amount is a term in the formula for the Reduction Amount, its calculation will always be required when determining the Reduction Amount but will otherwise never be required.

After calculating the Reduction Amount, the QBI Component will equal the (already reduced) QBI, reduced again by the Reduction Amount.

Note that calculation of the Reduction Amount may be required for taxpayers in Tier 2 with allocations from an SSTB, and may also be required for taxpayers in Tier 2 whose QBI allocation does not emanate from an SSTB.

Note also that whereas the Applicable Percentage operates to reduce QBI, W-2 wages, UBIA of qualified property, and PTP income, the Reduction Amount reduces only QBI. It bears repeating that if SSTB items are allocated to a taxpayer in Tier 2, the Applicable Percentage is always calculated before testing for the Alternative Limitation. The final regulations also stipulate that QBI from an SSTB is reduced by the Applicable Percentage before applying the netting and carryover rules.

SSTB: Tier 3 Taxpayers

Once taxable income exceeds the threshold amount, an SSTB is no longer a qualified trade or business. Accordingly, no allocations of QBI, W-2 wages, UBIA, or PTP income will be qualified. The QBI Component will be zero. The existence of a Section 199A deduction will depend entirely on the taxpayer having qualified REIT income, and taxable income that exceeds net capital gain. It is axiomatic that if the taxpayer has no QBI, determination of the Applicable Percentage, Alternative Limitation, or Reduction Amount is unnecessary.

If a taxpayer has multiple businesses, one or more of which is an SSTB and one or more of which is not, then these calculations will be required for those qualified trades or businesses that are not SSTBs.

SSTB: Exceptions

Taxpayers in Tier 2 and in Tier 3 with allocations of QBI from an SSTB classification can avoid its harsh consequences by falling within one of two de minimis exceptions. The first exception provides that if an SSTB constitutes only a relatively small fraction of the trade or business, then the burden of SSTB classification will not be imposed. Thus, if the trade or business has gross receipts of $25 million or less, and less than 10 percent of gross receipts are attributable to SSTB. The second exception provides that if the trade or business has gross receipts of $25 million or more, and less than 5 percent of gross receipts are attributable to an SSTB, then this small SSTB portion of the trade or business will not result in the business being classified as an SSTB.

Interestingly, the statute does not look kindly upon a taxpayer who misses falling within the safe harbor — even by only a very small amount. The final regulations warn (despite recommendations from various groups that the test was flawed) that if the de minimis test is not met, the entire business will be classified as an SSTB. However, the final regulations also allow that a single entity may operate many separate trades and businesses. In such a case, the de minimis rule would be applied separately to each trade or business.

SSTB: Anti-Abuse Rules

Taxpayers may be inclined to compartmentalize SSTBs in order to avoid the harshness of the disallowance rules. Anti-abuse mechanisms, in the form of strict attribution rules, operate to prevent segregating businesses to avoid application of the SSTB rules. The final regulations provide that if non-SSTB and SSTB activities are in separate trades or businesses, the fact that the businesses are commonly controlled and share expenses will not cause the non-SSTB business to be treated as an SSTB. However, if the SSTB and non-SSTB activities are part of the same business, and are commonly controlled, the de minimis rules will apply. Common ownership is determined by applying the attribution rules of Sections 267(b) or 707(b). Avoidance of common control test may therefore be important.

Reg. 1.446-1(d) generally requires that separate books and records be maintained for a separate business. A taxpayer who wishes to segregate an SSTB from other trades or businesses should be aware of this rule.

Illustration X-BH

Lawn Company, an LLC, sells lawn care and landscaping equipment, and also provides landscape design consulting services. Lawn Company keeps one set of books and treats the sales and design services as a single trade or business for purposes of Sections 162 and 199A. Revenues from the design service are $250,000, and total revenues for the company are $1 million. Since the design services provide more than 10 percent of gross revenues, the entire business is considered an SSTB. Reg. 1.199A-5(c)(1)(iii)(A) Ex 1. (See supra, Section X, "SSTB: Exceptions.)

Illustration X-C

Bark, LLC provides veterinary services (an SSTB in the health field) and its own line of non-GMO organic dog food. Bark keeps separate books and records for the veterinarian and dog food businesses, has separate employees, separately invoices customers, and treats the two divisions as separate trades or businesses for purposes of Sections 162 and 199A. The veterinary practice generates one-third of total revenues of Bark. In contrast to the facts in the previous illustration involving Lawn Company, the dog food business is not considered an SSTB because the veterinary practice and the dog food development and sales are separate trades or businesses under Section 162. Reg. 1.199A-5(c)(1)(iii)(B) Ex. 2.

XI. Aggregation of Multiple Trades or Businesses

The preamble to the final regulations provides that aggregation is intended to assist taxpayers in applying the Alternative Limitation across multiple entities. In some cases, but not all, aggregating businesses may yield a higher deduction than if the Alternative Limitation were calculated separately. A taxpayer may elect to aggregate multiple qualified trades or businesses and treat them as a single trade or business in applying the Alternative Limitation. Aggregation is unnecessary for taxpayers whose taxable income is below the threshold amount, since they are not subject to the Alternative Limitation and aggregation will produce no tax benefit. Those taxpayers simply determine 20 percent of QBI for each trade or business. If an election to aggregate is made, the QBI, W-2 wages, and UBIA of qualified property in all trades and businesses are combined before applying the Alternative Limitation.

Trade or Business Requirement

As a prerequisite to aggregation, the qualified trade or business requirement must be satisfied.

Aggregation Criteria

The final regulations impose five criteria each of which must be satisfied in order for trades or businesses to be aggregated:

1. Ownership Requirement

The same person or group of persons, directly or by attribution under Sections 267(b) or 707(b), must own 50 percent or more of each trade or business. In the case of S corporations, this means 50 percent or more of stock; and in the case of partnerships, 50 percent or more of the capital or profits interest in the partnership. The preamble to the final regulations provides that a C corporation may comprise part of the ownership group. Note that the common ownership test applies to owners (as a group) of the entity. It is immaterial whether the taxpayer seeking to make the election meets these requirements. Regs. 1.199A-4(b)(1)(i),(ii).

2. Temporal Requirement

The ownership requirement must be satisfied for a majority of the tax year, including the last day of the tax year in which the items attributable to each trade or business to be aggregated are included in income.

3. Same Tax Year

All items attributable to each trade or business must be reported in the same tax year. Therefore, trades or businesses sought to be aggregated must all report either on the calendar year, or on the fiscal year.

4. No SSTBs Can Be Aggregated

Trades or businesses sought to be aggregated cannot be Specified Service Trades or Businesses.

5. At Least 2 of 3 Factors Satisfied

A taxpayer wishing to aggregate must satisfy at least two of the following factors based on all of the facts and circumstances: (i) the trades or businesses provide products, property, or services that are customarily offered together; (ii) the trades or businesses share facilities or share centralized business elements, such as personnel, accounting, legal, manufacturing, etc., and (iii) the trades or businesses are operated in coordination with, or reliance on, one or more of the businesses (*e.g.,* supply chain interdependencies).

Aggregation: Annual Election

An annual election is required disclosing the entities being aggregated. Despite the annual reporting requirement, the election is irrevocable. The election cannot be changed from year to year unless there is a material change in circumstances. However, new entities can be added to the existing group if they meet the qualification requirements. Conversely, if the trade or business no longer qualifies for aggregation, it must be removed from the aggregated group.

Aggregation of multiple trades or businesses was not in the original statute. Instead, aggregation was added via regulations to make it easier for both the IRS and taxpayers to administer Section 199A. Aggregation is intended when a single business is operated across multiple entities for various legal, economic, or other non-tax reasons. Irrespective of the rationale for its inclusion in the regulations, aggregation can offer substantial tax benefits

Relevant Passthrough Entities (RPEs) May Aggregate

The final regulations clarify that the aggregation rules are applied at the trade or business level, meaning relevant pass-through entities (RPEs) can also make the aggregation election (proposed regulations only allowed taxpayers to make the election). The final regulations permit an RPE to aggregate trades or businesses it operates directly or through lower-tier RPEs. If an RPE makes the election, the RPE is subject to the same disclosure requirements. The taxpayer must follow the aggregation of the RPE (i.e., taxpayers cannot decide to group the RPE items differently). Aggregation made at the RPE level is binding on all owners of the RPE.

The final regulations permit taxpayers who have not previously reported businesses as aggregated on filed returns may report those businesses as aggregated on a future return. However, taxpayers may not report new aggregation of trades or businesses on amended returns since this would give taxpayers the benefit of hindsight. Since many taxpayers were not previously aware of the rules permitting aggregation, 2018 returns that are amended may report aggregation.

Aggregation: Reporting and Compliance

The final regulations expanded the aggregation rules to permit aggregation by RPEs in addition to individual. Individuals may aggregate any businesses in which they have an ownership interest, whether operated directly or through an RPE. RPEs may also aggregate businesses conducted directly or through lower-tier RPEs.

Upper-tier RPEs or individuals with an interest in the RPE must maintain the aggregation made by a lower-tier RPE. Although an upper-tier RPE or individual owner must maintain the aggregation of a lower-tier RPE, the individual or higher-tier RPE may itself add additional trades or businesses to the aggregated group at their level, provided the rules of Regs. Sec. 1.199-4(b)(ii) are otherwise satisfied.

Aggregation at the RPE level provides some reporting simplification, since the RPE reporting aggregated trades or businesses are required to report QBI, W-2 wages, and UBIA to the owners for the aggregated group. If trades or businesses are not aggregated, each owner's share of those items from each trade or business must be reported. While aggregating at the RPE level will result in simplified reporting, it removes the ability of individual owners to themselves decide whether to aggregate.

Fortunately, since the final regulations allow taxpayers to aggregate where lower-tier RPEs have not done so, there is a reduced likelihood that a failure to aggregate by a lower-tier RPE will be met with disapproval by higher-tier owners. Neither must all owners make the same election where RPEs have not aggregated.

Aggregation must be disclosed every tax year, even if there is no change in those trades or businesses that are aggregated. Failure to report aggregation may result in disaggregation by the IRS. If the IRS disaggregates, aggregation will then be prohibited for the following three tax years.

If the reporting is by a taxpayer, a statement indicating aggregation must be included. If aggregation is by an RPE, a Schedule K-1 must be included with the return. Required information includes (i) a description of each trade or business; (ii) the name and EIN of the business; (iii) Information identifying any aggregated trade or business of an RPE in which either the taxpayer or upper-tier RPE holds an ownership interest; and (iv) any other information the IRS may require in published guidance. Regs. 1.199A-(c)(4)(i), (ii).

Deciding Whether to Aggregate

The decision on whether to aggregate involves an initial determination as to whether the trade or business qualifies for aggregation. SSTBs do not qualify for aggregation. Then the taxpayer must determine whether aggregation is beneficial. This will require calculations and perhaps even a bit of clairvoyance, since the election is irrevocable. Aggregation may or may not provide a tax benefit.

For example, if one trade or business has no W-2 wage income or UBIA of qualified property, but a second business has a large amount of either of these, then aggregating the two may increase the Alternative Limitation, and consequently the QBI component, and ultimately the Section 199A deduction. One situation that could either militate against aggregating or counsel in favor of it is where one of the trades or businesses has negative QBI. Again, to determine whether aggregation makes sense, one must perform the necessary calculations and make assumptions as to future tax years.

Since the election to aggregate is irrevocable barring a material change in circumstances, taxpayers must exercise caution and be willing to assume the risk that aggregating will continue to provide a tax benefit in future tax years. An RPE with many owners must be careful to when aggregating, since a decision to aggregate made by lower-tier RPE binds all upper-tier RPEs.

XII. Compliance

Understatement Penalty

The penalty for a substantial understatement of tax under Section 6662(b)(2) has been made more stringent if a Section 199A deduction is claimed on a return. The substantial understatement penalty of 20 percent will be triggered if the understatement exceeds the greater of 5 percent (rather than 10 percent) or $5,000, regardless of whether the understatement is attributable to QBI.

Self-Employment Taxes

The regulations provide that the Section 199A deduction will not reduce net earnings from self employment under Section 1402 or net investment income under Section 1411. Nor will Section 199A affect the application of the AMT tax. The QBI deduction calculated under Section 199A will also be allowed for AMT purposes.

Reporting Requirements for RPEs

The regulations require that the RPE (Relevant Passthrough Entity) maintain records and report relevant information to owners on Schedule K-1, whether or not the owner is eligible for the deduction. The RPE must (i) determine whether it is engaged in one or multiple businesses; (ii) determine whether any business is an SSTB; (iii) determine QBI for each business in which it is engaged; (iv) calculate W-2 wages and qualified UBIA for each business in which it is engaged; (v) determine W-2 wages and UBIA for each trade or business in which the RPE is directly engaged; (vi) determine the total amount of qualified REIT dividends it earns directly or indirectly; and (vii) determine net qualified income through publicly traded partnerships (PTPs) in which it invests directly or indirectly.

Once the foregoing data is compiled, it must be reported to owners. The RPE must report on a separate Schedule K-1 each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property. The Schedule K-1 must also disclose whether any of the trades or businesses are SSTBs. On a separate schedule attached to the K-1, the RPE must report items reported to it by another RPE as well as the owner's share of REIT dividends and PTP income whether received from the RPE directly or indirectly through another RPE. The penalty for noncompliance with the above rules are draconian: The final regulations provide that failure to report an item of QBI, wages, or UBIA will result in that item presumed to be zero. (The proposed regulations were harsh, in concluding that the omission of any one of these items would result in all three being presumed to be zero.) The final regulations provide that an item may be reported on an amended or late filed return provided the period of limitations is open.

Reporting Requirements for PTPs

Publicly traded partnerships have reporting requirements as well. They must report to owners QBI for each traded or business in which the PTP is engaged in directly or indirectly. It must, like RPEs, also disclose whether any are SSTBs. Each PTP must also determine any qualified REIT dividends and qualified PTP income that it receives from another RPE, REIT, or PTP. The foregoing information must be reported on Schedule K-1 to each partner. Since PTPs are not subject to W-2 wage limitation or qualified UBIA limitations, they are not required to report these items.

XIII. Examples and Illustrations

Illustration XIV-A

Facts: Taxpayer A in Tier 3 has a single trade or business which is an SSTB, with allocations of $25,000 in qualified W-2 wages, $25,000 in qualified UBIA, QBI allocations of $10,000.

Analysis: Since Business C is an SSTB, the allocation of QBI income, as well as the allocation of qualified W-2 wages and qualified UBIA of qualified property are ignored. Taxpayer A has no QBI Component, no Combined QBI Amount, and consequently, no Section 199A deduction.

Illustration XIV-B

Facts: The same as in Illustration XI-A, except taxpayer A is in Tier 1.

Analysis: Since Tier 1 taxpayers are not subject to either SSTB restrictions involving the Applicable Percentage or the Alternative Limitation, all QBI items allocated to the taxpayer "count" toward calculating the QBI Component and the Section 199A deduction.

Illustration XIV-C

Facts: Taxpayer A in Tier 3 has a single trade or business which is not an SSTB. A receives allocations of QBI of 10,000. The Alternative Limitation is $7,500.

Analysis: The QBI Component is the lesser of 20 percent of QBI and the Alternative Limitation of $7,500. Since $2,000 is less than $7,500, the QBI Component is $2,000.

Illustration XIV-D

Facts: The taxpayer is in Tier 2, the business is not an SSTB, allocated QBI is $10,000, and W-2 Wages are $10,000.

Analysis: Since 20 percent of QBI, $10,000, exceeds the Alternative Limitation, $5,000, calculation of the Reduction Amount is required. Once calculated, the Reduction Amount will reduce QBI. The QBI Component will equal the QBI reduced by the Reduction Amount.

Illustration XIV-E

Facts: Z is single and has $215,000 of taxable income Z has QBI of $100,000, all of which is allocated from an SSTB. Z has $10,000 of QBI from another business which is not an SSTB.

Analysis: The phase-in range for Z is the Threshold Amount plus the Phase-in Amount, or $160,700 plus $50,000, or $210,700. Z's taxable income of $215,000 places Z above the phase-in limit of $210,700, and places him in Tier 3. Therefore, the $100,000 in QBI allocated to Z from the SSTB will be disregarded. Z's other, non-SSTB income, will be subject to the Alternative Limitation, but not the Reduction Amount, since that limitation applies only to taxpayers in Tier 2.

Illustration XIV-F

Facts: Y files jointly, has allocated QBI from an SSTB of $50,000, and has taxable income of $371,400. What is the procedure for calculating the Section 199A deduction?

Analysis: The phase-in range for Y is that amount between the Threshold Amount and the Threshold Amount plus the Phase-in Amount, (i.e., $100,000); or put another way, the range of taxable income between $321,400 and $421,400.

Y is in Tier 2. Since $371,400 is midway through the phase-in range, the SSTB income gets a "haircut" of 50 percent. (Formula 6). The resulting $25,000 of QBI from the SSTB will be subject to the Alternative Limitation and, if applicable, the Reduction Amount. The Applicable Percentage limitation is always applied before the Alternative Limitation. If 20 percent of QBI exceeds the Alternative Limitation, the Reduction Amount must be calculated. Twenty percent of (already reduced) QBI less the Reduction Amount will yield the QBI Component, from which the Section 199A deduction may be calculated, after taking into account the possibility of qualified REIT Dividends and qualified PTP income from the business, as well as the possibility that Y may have other QBI Components (and REIT Dividends and PTP income from other businesses.

Note: Since the taxpayer is in Tier 2, had there been qualified W-2 wages UBIA of qualified property, or qualified PTP Income, those items would have been subject to being reduced by the Applicable Percentage as well.

Observation: If Y's taxable income had been $421,000, all SSTB allocations except $400 would have been phased-out, leaving only $400 of QBI in which to apply first the Applicable Percentage, and if 20 percent of QBI exceeded the Alternative Limitation, the Reduction Amount.

Observation: Since Section 199A is not elective, these calculations would be mandatory, even though they would likely produce virtually no tax benefit. Since Y would be required to report a Section 199A deduction, the threshold for the imposition of 20 percent penalty for an understatement of income would be triggered if an understatement exceeded the greater of 5 percent (rather than 10 percent) or $5,000, regardless of whether the understatement were attributable to QBI.

Example XIV-G

Facts: Taxpayer X is an architect and consults as a physician on a part time basis. X is single and has taxable income of $600,000 from three trades or businesses, A, B, and C. Taxpayer X has net capital losses of $20,000, and qualified REIT dividends of $10,000 as well as qualified PTP income of $10,000. X is in Tier 3.

X has $300,000 of QBI from his architectural practice, business A. X's allocated share of W-2 wages is $100,000, and his allocated share of UBIA of qualified property is $10,000.

X is allocated QBI of $200,000 from business B, his consulting practice as a physician, with W-2 wages of $20,000, and UBIA of qualified property of $1,000.

X is allocated a QBI loss of $10,000 from business C, which is a qualified trade or business as to X. X is not allocated any W-2 wages or UBIA of qualified property from business C.

Analysis:

Business A: The architectural practice of X is a qualified trade or business, since it is expressly excluded from the list of businesses that are SSTBs. The QBI Component is the lesser of (i) 20 percent of $300,000, and (ii) the greater of (a) 50% of W-2 wages and (b) 25% of the sum of W-2 wages and 2.5% of UBIA of qualified property. The Alternative Limitation is calculated to be $50,000. The QBI Component is the lesser of $60,000 and $50,000, or $50,000.

Business B: X's consulting practice as a physician is, based on the information provided, likely an SSTB. Since X is in Tier 3, allocations of QBI, qualified W-2 wages, UBIA of qualified property, and qualified PTP income are all disregarded.

Observation: The trade or business of X, though clearly qualified Under Section 162, fails to qualify under Section 199A.

Business C: Although QBI cannot be less than zero, X may offset the negative QBI Component of $10,000 with other positive QBI allocations.

Netting: The QBI Components from businesses A and business C are netted, resulting in Combined QBI Components totaling $40,000 ($50,000 minus $10,000).

Computing Combined
QBI Amount:

The Combined QBI Amount is the sum of the QBI Components, plus 20 percent of the sum of aggregate qualified REIT dividends and aggregate qualified PTP income. 20 percent of aggregate qualified REIT dividends and qualified PTP income equals $4,000. Therefore, the Combined QBI Amount is $44,000. (Formula 2).

Taxable Income
& Net Capital Gain

The Section 199A deduction is the lesser of the Combined QBI Amount, $44,000, and 20 percent of the difference between taxable income of $600,000 and zero. Twenty percent of $600,000 is $200,000. Since $44,000 is less than $200,000, X has a Section 199A deduction of $44,000.

Observation: Although X has capital losses of $20,000, X has no net capital gain. X's net capital loss for other would be subject to the usual rule limiting capital losses. In this case, $3,000 of capital losses would offset income, and $17,000 of capital losses would carry forward.

Illustration XIV-H

Facts: Assume that single taxpayer X with taxable income of $200,000 has QBI from a non-SSTB qualified trade or business of $100,000, qualified W-2 wages of $4,000 and UBIA of qualified property of $1,000.

Analysis: Taxpayer X is in Tier 2. The first step is to compare 20 percent of QBI to the Alternative Limitation. If 20 percent of QBI is less than the Alternative Limitation, then that is the QBI Component. If 20 percent of QBI is more than the Alternative Limitation, calculation of the Reduction Amount is required.

Here, 20 percent of QBI is $20,000, is clearly greater than the Alternative Limitation. That being the case, calculation of the Reduction Amount is necessary.

Since the Excess Amount is a factor in the equation for the Reduction Amount, it must be determined in order to calculate the Reduction Amount. The Excess Amount equals 20 percent of QBI $20,000 minus the Alternative Limitation of $2,000, or $18,000.

The Reduction Amount equals the Excess Amount times taxable income minus the threshold amount over the phase-in amount. Taxable income of $200,000 minus $160,700 divided by $50,000 equals .786. The Reduction Amount equals .786.

The QBI Component equals 20 percent of QBI, $20,000 reduced by the Reduction Amount. The Reduction Amount equals .786 ($20,000), or $15,720. The QBI Component equals $4,280.

Observation: The Reduction Amount reflects the amount which 20 percent of QBI must be reduced to reflect the fact that X has traveled 78.6 percent of the way through the phase-in range, i.e., ($200,000 ─ 160,700)/$50,000.

Check: Had X traveled to the cusp of Tier 3, the Phase-in Limit of $210,700, the fraction would equal 1, reflecting the fact that X had traveled the length of the Tier 2.

Example XIV-J
[Tier 2]

Facts: Taxpayer Y is single, has taxable income of $170,000, and $25,000 of net capital gain. Since the Threshold Amount is $160,700, Y is in Tier 2. Y is allocated QBI of $100,000 from Business A, which is not an SSTB. Y has no qualified REIT dividends or qualified PTP income. Y's allocated share of W-2 wages is $10,000, and Y's allocated share of UBIA of qualified property is $500,000.

Analysis:

If 20 percent of QBI is less than the Alternative Limitation (*i.e.,* the "greater than" calculation in Formula 3), then the QBI Component is that amount. However, since the taxpayer is in Tier 2, if 20 percent of QBI is greater than the Alternative Limitation, then the QBI must be reduced by the Reduction Amount. To calculate the Reduction Amount, the Excess Amount must be known.

Here, the QBI Component must be reduced by the Reduction Amount, since 20 percent of $100,000, $20,000, is greater than Alternative Limitation of $15,000. [50% of W-2 wages is $5,000; 25% of (W-2 wages + UBIA) is $15,000].

The Excess Amount (Formula 5) is $20,000 minus $15,000, or $5,000. The Reduction Amount (Formula 4) is the Excess Amount ($5,000) times taxable income less the Threshold Amount, over the phase-in Amount. (Formula 5).

Stated Algebraically:

Reduction Amount = Excess amount times [(Taxable Income − Threshold Amount) ÷ Phase-in Amount]

Taxable Income ($170,000) less the Threshold Amount ($160,700) over the phase-in Amount ($50,000) equals .186. The Reduction Amount equals $5,000 times 0.186, or $930. The QBI Component for Y is $20,000 minus $930, or $19,070. (Formula 3).

Twenty percent of the difference between Y's taxable income and net capital gain is ($145,000) x .2, or $29,000. Since $19,070 is less than $29,000, Y's

Section 199A deduction is $19,070.

Example XIV-K
[Tier 2]

Facts: Taxpayer Z is single, has taxable income of $170,000 and $25,000 of net capital gain. Since the Threshold Amount is $160,700, Y is in Tier 2. Y is allocated QBI of $10,000 from Business B, which is an SSTB. Y has no qualified REIT dividends or qualified PTP income. Z's allocated share of A's W-2 wages is $70,000, and Z's allocated share of UBIA of qualified property is $500,000.

Analysis: Since the business is an SSTB, the Applicable Percentage must be determined before applying the Alternative Limitation and, if necessary, the Reduction Amount. The Applicable Percentage equals 1 minus taxable income less the threshold amount over the phase-in amount.

Expressed Algebraically:

Applicable Percentage =
1 ─ (Taxable Income ─
Threshold Amount)
Phase-in Amount

Step 1: Determine the Applicable Percentage. The Applicable Percentage is 1 minus [170,000 - 160,700/$50,000] x 100, or (1 - .186) x 100, or .818 x 100, or 81.8 percent. QBI, W-2 wages, and QBIA of qualified property must each be multiplied by the applicable percentage. After applying the Applicable Percentage, QBI is $16,360, W-2 wages are $57,260, and UBIA of qualified property is $409,000. (Formulas 6 and 7).

[Note: If Z had qualified PTP income, that would also have had to been reduced in the same manner as QBI, W-2 wages, and UBIA.]

Step 2: Determine if Calculation of the Reduction Amount is Necessary. A. 20% of QBI is **$16,360.**
B. 50% of W-2 wages
is $28,630
C. 25% of the sum of W-2 wages
and 2.5% of UBIA of
qualified property is
$10,225 + $14,315, **or $24,540.**
B ($28,630) is greater than
C ($24,540).

Step 3. Since A is less than C, calculation of the Reduction Amount is unnecessary. **The QBI Component is $16,360.**

Step 4. Since Taxpayer Y has no qualified REIT dividends or qualified PTP income, Y's Combined QBI Amount is $16,360. (Formula 2).

Step 5. Y's Section 199A deduction is the lesser of (i) $16,360 and (ii) $29,000 (i.e., 20% of $145,000). Y's Section 199A deduction is $16,360.

Example XIV-L
[Tier 2]

Facts: The same as in the previous example, except Taxpayer Y has no W-2 wages and no UBIA of qualified property.

Step 1: Determine the Applicable Percentage. The Applicable Percentage is 1 minus [170,000 - 160,700/$50,000] x 100, or (1 - .186) x 100, or .818 x 100, or 81.8 percent. QBI must be multiplied by the applicable percentage. After applying the Applicable Percentage, QBI is $16,360.

Step 1. Calculation of the Reduction Amount is now necessary, since 20 percent of QBI is greater than 0. In order to calculate the Reduction Amount, one must first know the Excess Amount.

Step 2. The Excess Amount equals the 20 percent of QBI less the Alternative Limitation. 20 percent of QBI (having been reduced by the Applicable Percentage first) is $16,300. The Alternative Limitation is 0.

Step 3. The Reduction Amount equals the Excess Amount times taxable income minus the Threshold Amount over the Phase-in Amount. The Reduction Amount equals $3,272 x ($170,000 ─ $160,700) ÷ $50,000) or $16,300 x .186, or **$3,032.**

Step 4. The QBI Component is $16,360 less $3,032, or $13,328. (i.e., QBI less the Excess Amount, or $16,360, then less the Reduction Amount, of $3,032, or $13,328. (Formula 3).

Step 5. Combined QBI equals $13,328 + 0, or $13,328. (Formula 2).

Step 6. The Section 199A deduction is the lesser of (i) $13,328 and (ii) $29,000. Y's Section 199A deduction is $13,328. ■