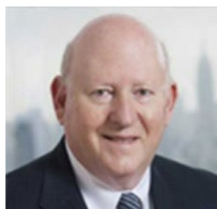
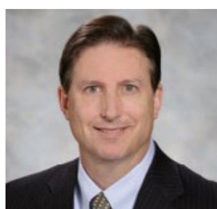
DEMYSTIFYING THE 20 PERCENT DEDUCTION FOR QUALIFIED BUSINESS INCOME UNDER SECTION 199A (PART 2)



JERALD DAVID AUGUST is a chair of Fox Rothschild, LLP in Philadelphia, Pennsylvania, and is a nationally recognized tax lawyer who advises clients on income tax matters, including foreign taxation of U.S. businesses and U.S. taxation of foreign businesses and investors. Jerry is a Life Sustaining Member of the prestigious American Law Institute (ALI) and regularly serves as a program chair and speaker for ALI CLE federal tax webcasts on various topics involving federal taxation and is chair of the Advisory Board of the ALI's long-standing tax law journal, The Practical Tax Lawyer. He has been recently selected to the Editor-in-Chief of the Journal of Corporate Taxation. He is a graduate of the Wharton School of the University of Pennsylvania (B.S. & B.A.), the University of Pittsburgh School of Law (J.D.) and New York University School of Law (L.L.M. in Taxation). He is a member of the Florida, New York, and Pennsylvania Bar Associations.

RONALD A. LEVITT is a shareholder in Dentons Sirote PC, a law firm based in Birmingham, Alabama. Mr. Levitt advises clients in tax and business planning and estate and succession planning, as well as federal and state controversy matters. Mr. Levitt has served as a Council Director of the ABA Tax Section, as chair of the ABA Tax Section's S Corporation Committee, as a Fellow (and former Regent) in the American College of Tax Counsel, and as former chair of the Alabama Bar Association's Tax Section. Mr. Levitt taught Partnership Taxation for Cumberland School of Law and for the University of Alabama School of Law's LLM in Taxation Program.



STEPHEN R. LOONEY is a shareholder in the law firm Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A., in Orlando, Florida. He received his B.A., magna cum laude, in Accounting and Business Administration from Drury College in 1981 and earned his J.D., cum laude, from the University of Missouri-Columbia in 1984, where he was also a member of the Order of the Coif and the Notes and Comment Editor for the Missouri Law Review. He received his Master's in Taxation from the University of Florida in 1985, where he graduated first in his class. Mr. Looney practices in the areas of tax, corporate, partnership, business, and health care law. Mr. Looney is a past-chair of the S Corporations Committee of the American Bar Association Tax Section. Additionally, Mr. Looney is on the Board of Advisors and Department Heads for the Corporate Taxation journal where he also serves as Co-Editor for the Recent Developments column. He is also a Fellow and Regent of the American College of Tax Counsel and is a prior member of the Board of Trustees of the Southern Federal Tax Institute. He is co-author of the two-volume treatise Tax Planning for S Corporations published by Lexis-Nexis.

Part 1 of this article, which appeared in the May issue of The Practical Tax Lawyer, *broadly covered the Code section 199A final regulations and operational rules and definitions. This Part will address aggregation rules and final regulations under section 1.199A-4, computation rules for relevant passthrough entities (RPEs), publicly traded partnerships (PTPs), trusts and estates, and Treasury Regulation section 1.199A-6.*

AGGREGATION RULES AND FINAL REGULATIONS: SECTION 1.199A-4

The Preamble to the Final Regulations noted how important the aggregation rules are. A large number of businesses may be viewed as a single trade or business when, in reality, they may be divided across multiple entities for legal or economic reasons. The aggregation rules address this issue and allow individual owners and entities to aggregate qualified trades or businesses for purposes

of section 199A without changing market-driven ownership and management structure benefits and incentives. Without an aggregation rule, some taxpayers would be forced into restructuring their business operations solely for tax purposes, with the resulting structures leading to inefficient economic outcomes. While comments were received on the regulations, the IRS rejected a Code section 469 (passive activity) "grouping of activities" approach.

General aggregation rules

An RPE may engage in more than one trade or business which may be a qualified trade or business (QTB). Except as provided in Treasury Regulation section 1.199A-4, each trade or business is a separate trade or business for purposes of applying the section 199A limitations set forth in Treasury Regulation section 1.199A-1(d)(2)(iv). Therefore, the Final Regulations warn that "[t]rades or businesses may be aggregated only to the extent provided in this section, but aggregation by taxpayers or by an RPE is not required." In particular, Treasury Regulation section 1.199A-4(b)(1) provides that trades or businesses may be aggregated only if an individual or RPE can demonstrate that:

- The same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of stock of the corporation, or, in the case of such trades or businesses operated by a partnership, 50 percent or more of the capital or profits in the partnership. The ownership rule does not require that every person involved in the ownership determination own an interest in every trade or business, but rather, the rule is satisfied so long as one person or group of persons holds a 50 percent or more common ownership interest in each trade or business;
- The ownership described above exists for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income. The Final Regulations clarify that the "majority of the taxable year" must include the last day of the taxable year);
- All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;
- None of the trades or businesses to be aggregated are a specified service trade or business (SSTB); and
- The trades or businesses to be aggregated satisfy at least two of the following factors: (i) the trades or businesses provide products and services that are the same or customarily offered together; (ii) the trades or businesses share facilities or centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or (iii) the trades or businesses are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies). The Final Regulations clarify that with respect to the first of the three factors (of which two factors must be met in order to aggregate), the trades or businesses need only to provide products, property, or services that are the same or customarily offered together.

Operating rules for aggregation of QBIs

An individual may aggregate trades or businesses operated directly, or indirectly through ownership in an RPE for such individual's share of qualified business income (QBI), W-2 wages, and unadjusted basis immediately after acquisition (UBIA) of qualified property from trades or businesses operated through RPEs. For those trades or businesses directly operated by the individual, the individual computes QBI, W-2 wages, and UBIA of qualified property for each trade or business before applying the aggregation rules. If an individual aggregates multiple trades or businesses, the individual must combine the QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses for purposes

of applying the W-2 wage and UBIA of qualified property limitations.[1]

With respect to RPEs, the Final Regulations permit an RPE to aggregate trades or businesses it operates directly or through lower-tier RPEs. The resulting aggregation must be reported by the RPE and by all owners of the RPE. In other words, the owners of an RPE are bound by the aggregation election made by the RPE. If an RPE itself does not aggregate, multiple owners of an RPE need not aggregate in the same manner. If an RPE aggregates multiple trades or businesses under Treasury Regulation section 199A-(4)(b)(1), the RPE must compute and report QBI, W-2 wages, and UBIA of qualified property for the aggregated trade or business under the rules described in Treasury Regulation section 1.199A-6(b). An RPE may not subtract from the trades or businesses aggregated by a lower-tier RPE but may aggregate additional trades or businesses with a lower-tier RPE's aggregation if the applicable rules under the regulations are otherwise satisfied.

Ownership attribution rules

Under the Proposed Regulations, for purposes of determining ownership, an individual was considered as owning the interest in each trade or business owned, directly or indirectly, by or for the individual's spouse, and the individual's children, grandchildren, and parents (but not by the taxpayer's siblings).[2] The Final Regulations replaced these limited family attribution rules with the broader attribution rules of Code sections 267(b) and 707(b).

Aggregation reporting and consistency rule

Once an individual (or RPE) elects to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. An individual may, however, add a newly created or newly acquired trade or business to an existing aggregated trade or business if the aggregation rules are otherwise satisfied. If, in a subsequent year, there is a change in facts or circumstances, such that an individual's prior aggregation of trades or businesses no longer qualifies for aggregation, then the trades or businesses will no longer be aggregated, and the individual must reapply the aggregation rules to determine a new permissible aggregation (if any).[3] For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated under Treasury Regulation section 1.199A-4, and the statement must contain:

- A description of each trade or business;
- The name and EIN of each entity in which a trade or business is operated;
- Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year; and
- Such other information as the IRS may require on forms, instructions, or other published guidance.

When an individual fails to attach the required statement, the IRS may disaggregate the individual's trades or businesses.[4] The Final Regulations clarify that the disaggregation is not permanent by providing that trades or businesses that are disaggregated by the IRS may not be re-aggregated for three subsequent taxable years, similar to the typical period during which a tax return may be audited.

Failure to aggregate

The Final Regulations provide that a taxpayer's failure to aggregate trades or businesses will not be considered to be an aggregation under the aggregation rules, so that the taxpayer is not precluded from making an aggregation election later. Although the Final Regulations generally do not allow an initial aggregation election to be made on an amended return, because many individuals and RPEs were unaware of the aggregation rules when filing returns for the 2018 taxable year, the IRS had previously announced it will allow initial aggregations to be made on amended returns for the 2018 taxable year.

Application of aggregation consistency rules to RPEs

When an RPE elects to aggregate two or more trades or businesses, the RPE must consistently report the aggregated trades or businesses in succeeding taxable years. A failure to aggregate will not be considered to be an aggregation for purposes of this rule. An RPE that fails to aggregate may not aggregate trades or businesses on an amended return (other than an amended return for the 2018 taxable year). An RPE may, however, add a newly created or acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business (other than the aggregated trade or business of a lower-tier RPE) if the requirements of Treasury Regulation section 199A-(4)(b)(1) are satisfied. In a subsequent year, if there is a significant change in facts and circumstances such that an RPE's prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be aggregated within the meaning of this section, and the RPE must reapply the rules in Treasury Regulation section 199A-(4)(b)(1)[5] to determine a new permissible aggregation (if any). An RPE also must report aggregated trades or businesses of a lower-tier RPE in which the RPE holds a direct or indirect interest.

Required annual disclosure

For each taxable year, RPEs (including each RPE in a tiered structure) must attach a statement to each owner's Schedule K-1 identifying each trade or business aggregated under Treasury Regulation section 1.199A-(4)(b)(1). The same type of information required to be filed for other taxpayers as to an aggregation election must be complied with. If an RPE fails to attach the required statement, the IRS may disaggregate the RPE's trades or businesses. The RPE may not aggregate trades or businesses that are disaggregated by the IRS for the subsequent three taxable years.

SECTION 199A COMPUTATION RULES FOR RPES, PTPS, AND TRUSTS AND ESTATES: REGULATION SECTION 1.199A-6

The section 199A Final Regulations provide special rules for RPEs, PTPs, and trusts and estates necessary for the computation of the section 199A deduction of their owners or beneficiaries.

General rules for RPEs

In general, an RPE must determine and report information attributable to any trades or businesses it is engaged in that is necessary for the owners to determine their section 199A deduction. Specifically, under Treasury Regulation section 1.199A-6(b)(2), an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their section 199A deduction as follows:

- The RPE must determine if it is engaged in one or more trades or businesses and the RPE must also determine whether any of its trades or businesses is an SSTB;
- The RPE must apply the rules in Treasury Regulation section 1.199A-3 to determine the QBI for each trade or business engaged in directly;
- The RPE must apply the rules in section 199A-2 to determine the W-2 wages and UBIA of qualified property for each trade or business engaged in directly;
- The RPE must determine whether it has any qualified REIT dividends earned directly or through another RPE. The RPE must also determine the net amount of qualified PTP income earned directly or indirectly through investments in PTPs; and
- The RPE must satisfy all reporting requirements, including identifying on schedule K-1: (i) each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property attributable to each such trade or business; and (ii) whether any trades or businesses constitute an SSTB.

Additionally, an RPE must also report on an attachment to the Schedule K-1 any QBI, W-2 wages,

UBIA of qualified property, or SSTB determinations reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocable share of any qualified REIT dividends or qualified PTP income or loss received by the RPE (including through another RPE). If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to any owner any items described above, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will presumed to be zero.[6] The Final Regulations generally retain the rules relating to reporting of QBI, W-2 wages, and UBIA of qualified property to the owners of an RPE, but modify the rule which provided that all of an RPE's items related to section 199A are presumed to be zero because of a failure to report one item. Specifically, the Final Regulations revise the presumption to provide that if an RPE fails to separately identity and report an item of QBI, W-2 wages, or UBIA of qualified property, the owner's share of each such unreported item of positive QBI, W-2 wages, or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero (rather than presuming all of these items to be zero).

Computational and reporting rules for PTPs

Each PTP must determine its QBI under the rules of Treasury Regulation section 1.199A-3 for each trade or business in which the PTP is engaged directly. The PTP must also determine whether any of the trades or businesses it is engaged in directly is an SSTB. Additionally, each PTP is required to separately identify and report the information on Schedules K-1 issued to its partners. Each PTP must also determine and report any qualified REIT dividends or qualified PTP income or loss received by the PTP including through an RPE, a REIT, or another PTP. A PTP is not required to determine or report W-2 wages or the UBIA of qualified property attributable to trades or businesses it is engaged in directly.[7]

General rules for trusts, estates, and beneficiaries

A trust or estate computes its section 199A deduction based on the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary's section 199A deduction in the same manner as though the items had been allocated from an RPE. A trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.[8]

Grantor and non-grantor trusts

To the extent that the grantor or other person is treated as owning all or a part of a trust under sections 671 through 679, such person computes the section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or another person.[9] For non-grantor trusts and estates, each trust or estate must calculate its QBI, W-2 wages, UBIA, qualified REIT dividends, and qualified PTP income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in section 199A(c)(3) in accordance with the classification of those deductions under Treasury Regulation section 1.652(b)-3(a), and deductions not directly attributable within the meaning of Treasury Regulation section 1.652(b)-3(b) are allocated in a manner consistent with the rules of section 1.652(b)-3(b). Any depletion and depreciation deductions described in Code section 642(e) and any amortization deductions described in Code section 642(f) that are otherwise properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.[10]

Allocation of section 199A characteristics among trust or estate and beneficiaries

Qualified REIT dividends and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust or estate's distributable net income (DNI) for the taxable year that it is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. The trust or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to section 199A. If the trust or estate has no DNI for the taxable year, any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.[11]

Threshold amount

The threshold amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. Thereafter, the threshold amount is $157,500 increased by the cost of living adjustment provided in Treasury Regulation section 1.199A-1(b)(12). In a change from the Proposed Regulations, the Final Regulations specifically provide that for purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under Code sections 651 or 661.[12]

Subchapter S electing small business trusts

Treasury Regulation section 1.199A-6(d)(3)(vi) provides that an electing small business trust (ESBT) is entitled to the deduction under section 199A. The S portion of the ESBT must consider the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets owned by a grantor or another person of a trust under Code sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. The Final Regulations clarify that the S portion and non-S portion of an ESBT are treated as a single trust for determining applicable threshold amounts.[13]

Anti-abuse rule for creation of a trust to avoid exceeding the threshold amount

Under Treasury Regulation section 1.199A-6(d)(3)(vii), a trust formed or funded with a principal purpose of avoiding, or using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be recognized as a separate trust entity for purposes of determining the threshold amount under section 199A. The Final Regulations clarify that the anti-abuse rule is designed to thwart the creation of even one single trust with a significant purpose of avoiding, or using more than one, threshold amount. This should be contrasted with the anti-abuse rules set forth in Treasury Regulation section 1.643(f)-1(a), which only apply to multiple trusts.

Anti-abuse rules for multiple trusts

Treasury Regulation section 1.643(f)-1(a) provides that for purposes of Subchapter J, two or more trusts will be aggregated and treated as a single trust if: (i) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (ii) if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of federal income tax. Spouses are treated as one person for this rule. In the Final Regulations, (section 643(f)), the IRS removed the definition of "principal purpose" and the examples illustrating this rule that had been included in the Proposed Regulations. The Preamble to the Final Regulations also provides that the IRS believes that the anti-abuse rules contained in section 643(f) apply to any arrangement involving multiple trusts entered into or modified before the effective date of the Final Regulations.

Potential legislation under the Biden administration

During the 2020 election campaign, it was generally thought that were Biden to become President, many of the tax reforms introduced by President Trump in the Tax Cuts and Jobs Act (TCJA) would be repealed.[14] Tax rates, particularly the C corporation

rate of a flat 21 percent, would be increased to 28 percent. Individual tax rates would increase to 39.6 percent or possibly higher for taxpayers having $1 million or more in taxable income and capital gains for high-income taxpayers would be taxed at regular rates. What would happen, therefore, to section 199A, which is due to expire at the end of 2025?

The "Main Street Tax Certainty Act," S. 480, H.R. 1381, legislation introduced in both chambers of Congress with bipartisan support, would make section 199A permanent. The Republican-led bill was introduced February 25, 2021 in the Senate by Finance Committee member Steve Daines (R-Mont.) and in the House by Ways and Means Committee member Jason Smith (R-Mo.). The bills are cosponsored by Finance Committee members Bill Cassidy (R-La.), Tim Scott (R-S.C.), and Rob Portman (R-Ohio), along with six Republicans on the Ways and Means Committee. In her testimony before Senate Finance Committee Chair Chuck Grassley (R-Iowa), the Biden Secretary of Treasury nominee, Janet Yellen, was questioned about section 199A. She responded: "[a]s section 199A is a relatively new provision, I commit to studying its impact on small businesses since its inception to determine the extent to which it is helping to improve the prospects of America's small business owners."

She did defend Biden's proposal for a 15 percent corporate minimum on global book income on large corporations.

It is unclear whether section 199A will survive the Biden administration's "chopping block" to remove parts of the TJCA. It is possible that section 199A will remain in effect for those individuals making less than $400,000 or some other "ceiling" amount. Moreover, instead of eliminating section 199A or allowing it to phase out, the artificial limitation of denying the SSTB income tax deduction to its owners should be re-examined as it suffers from a severe case of horizontal equity unfairness.[15] The C corporate income tax rate cannot be pegged much lower than the maximum individual income tax rate. That is why section 199A was enacted, and allegedly by an effective group of lobbyists who were only focused on high payroll, high capital-intensive organizations, and those in which such income was not attributable to personal services. Section 199A was therefore enacted, but still penalized owners of closely held passthrough entities engaged in one or more SSTBs. Congress should retain section 199A not only in order to avoid giving C corporations too much of a tax competitive advantage, but also to correct the horizontal fairness issue from a tax policy perspective.

CONCLUSION

As discussed above, the rules applicable to the 20 percent of QBI deduction for passthroughs and sole proprietorships are complex and should be carefully considered in the selection of the type of entity to use. Because of the anomalies of section 199A, the use of different types of passthrough entities or sole proprietorships may result in different deductions under section 199A even under identical facts.

A great deal of thought should be given before a business decides to convert from a passthrough entity to a C corporation. This is due to the difficulty in getting out of C corporation status and the "toll charges" imposed on converting from C corporation status, especially the built-in gains tax imposed under section 1374 discussed in Part 1.

Unless the taxpayer or tax practitioner has a crystal ball predicting future changes in tax laws, revenues, payroll, equipment purchases, and the timing of the sale of the business, it remains problematic to recommend that a business convert to C corporation status. However, there will certainly be some situations in which a C corporation will make sense.

Obviously, the biggest factors as to whether a C corporation is the preferred choice of entity is how much of the earnings are expected to be distributed to the shareholders and whether the assets of the business are expected to be sold in the foreseeable future. If the owner or owners frequently take profits out of the business and/or the business will be sold in the foreseeable future, it makes the most sense to remain a passthrough entity or sole proprietorship. Conversely, if the owners are reinvesting most of the

earnings of the business back into non-deductible expenditures, they cannot take advantage of the section 199A deduction. If they are not planning on selling the business in the foreseeable future, a C corporation may be the better vehicle to conduct the business.

The eligibility of the shareholders of a C corporation to utilize the gain exclusion provisions of Code section 1202 (for certain small business stock) is also an important factor to take into consideration.

Finally, concepts of the time value of money clearly come into play in making this determination—as they do in all aspects of tax planning.

Notes

1. Treas. Reg. § 1.199A-4(b)(2).
2. Prop. Reg. § 1.199A-4(b)(3).
3. Treas. Reg. §§ 1.199A-4(c)(1), -4(c)(2) (individual), -4(c)(3), -4(c)(4)(RPE).
4. Treas. Reg. § 1.199A-4(c)(2).
5. See also Treas. Reg. § 199A-4(c)(3).
6. Treas. Reg. § 1.199A-6(b)(3).
7. Treas. Reg. § 1.199A-6(c).
8. Treas. Reg. § 1.199A-6(d)(1).
9. Treas. Reg. § 1.199A-6(d)(2).
10. Treas. Reg. § 1.199A-6(d)(3)(i).
11. Treas. Reg. § 1.199A-6(d)(3)(ii).
12. Treas. Reg. §1.199A-6(d)(3)(iv).
13. Treas. Reg. §1.199A-6(e)(3)(vi).
14. See Joint Committee on Taxation, Present Law and Background on the Taxation of High Income and High Wealth Taxpayers, JCX-24-21 (5/10/2021) (republished in Tax Notes (5/10/2021)). See also Andrew L. Snyder, The Lawyer, the Engineer, and the Gigger: §199A Framed as an Equitable Deduction for Middle-Class Business Owners and GIG Economy Works, 25 Fordham J. Corp. & Fin. L. 15 (2020).
15. For an explanation, see "What is Horizontal Equity?", Corporate Finance Institute, available at https://corporatefinanceinstitute.com/resources/knowledge/finance/horizontal-equity/.