AN ALERT FROM BDO'S NATIONAL TAX OFFICE

BDO KNOWS: TAX REFORM

JANUARY 2019 / www.bdo.com

Final regulations regarding the determination of the Section 199A deduction have been issued

On January 18, 2019, the Department of the Treasury (Treasury) and Internal Revenue Service (IRS) issued widely-anticipated final regulations concerning the deduction for qualified business income under Section 199A (the QBI Deduction). The final regulations were posted on the IRS website. Because of the partial shutdown of the federal government, it is uncertain when these final regulations will be published in the Federal Register. The final regulations follow proposed regulations originally published on August 8, 2018 (REG-107892-18) (proposed regulations), and provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of Section 199A. The final regulations clarify several aspects and make a number of changes to the rules contained in the proposed regulations.

BACKGROUND

For tax years beginning after December 31, 2017, taxpayers (other than C corporations) with taxable income (before computing the QBI Deduction) at or below the Threshold Amount[1], are entitled to a Section 199A deduction equal to the lesser of:

1. The combined qualified business income amount of the taxpayer, or
2. An amount equal to 20 percent of the excess, if any, of the taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for such taxable year.

The combined qualified business income amount is generally equal to the sum of (A) 20 percent of the taxpayer's qualified business income (QBI) with respect to each qualified trade or business plus (B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

QBI with respect to each qualified trade or business is generally defined to mean any item of domestic income, gain, loss, and deduction attributable to a qualified trade or business.

1 The Threshold Amount is equal to $315,000 for joint filing taxpayers and $157,500 for all other taxpayers. The limitations and exclusions subject to these Threshold Amounts are subject to a phase-in over the $100,000 and $50,000 of taxable income generated by joint filing and other taxpayers earned above the Threshold Amounts. Therefore, for joint filing taxpayers, the phase-in occurs between $315,000 – $415,000 and for other taxpayers the phase-in occurs between $157,500 – 207,500. Note that the Threshold Amounts are subject to indexing for inflation.

Read more ▶

A qualified trade or business is further defined to include any trade or business except for a specified service trade or business (SSTB). The statute, as enacted, doesn't define the meaning of the term SSTB.

Additionally, taxpayers with taxable income (calculated before the QBI Deduction) in excess of the Threshold Amount may be subject to a limitation based on the amount W-2 wages or W-2 wages and the unadjusted basis immediately after acquisition (UBIA) of qualified property (Wages & Capital Limitation) attributable to the QBI generated from each qualified trade or business. Taxpayers with taxable income exceeding the Threshold Amount may also be subject to an exclusion for QBI generated from an SSTB.

Calculating the QBI Deduction and applying the Wages & Capital Limitation and SSTB exclusion are deceptively simple. In practice, however, an accurate calculation of the QBI Deduction has been virtually impossible without additional guidance. The final regulations are intended to provide this necessary guidance.

BDO INSIGHTS & OBSERVATIONS

The final regulations clarify a number of rules contained within the proposed regulations. Additionally, the final regulations make several important changes to the rules originally included in the proposed regulations. Broadly, several key areas of consideration addressed in the final regulations include:

- Determination of a trade or business for purposes of Section 199A
- Calculation of QBI
- Clarification of the meaning of certain SSTBs
- Modification of the SSTB anti-abuse rules
- Application of the W-2 Wages and UBIA of qualified property limitations
- Application of the trade or business aggregation rules

Given the complexity of determining the QBI Deduction, taxpayers should carefully consider the rules contained within the final regulations. As noted in the preamble to the final regulations, there are still a number of areas where detailed guidance has not been provided. As a result, taxpayers and their advisors will need to evaluate other sources of guidance in reaching final conclusions.

Determination of a Trade or Business for Purposes of Section 199A

Many of the comments received by the IRS regarding the Section 199A proposed regulations revolved around whether the IRS could clarify the definition of "trade or business." Since the QBI Deduction only materializes if the QBI relates to a trade or business of the taxpayer, this determination is of paramount importance. After more than four months of consideration by the IRS after the proposed Section 199A proposed regulations were issued, little clarification was provided to help taxpayers determine the existence of one or more trades or businesses. For purposes of determining whether a trade or business exists, the IRS refers to two Supreme Court cases[2] in the final regulations preamble and notes that whether an activity rises to the level of a Section 162 trade or business is inherently a factual question.

First, in *Higgins*, the Supreme Court noted that courts have established certain elements and two definitional requirements to determine the existence of a trade or business. ONE, in relation to profit motive, is said to require the taxpayer to enter into and carry on the activity with a good faith intention to make a profit or with the belief that a profit can be made from the activity, and TWO, is in relation to the scope of the activities and is said to require considerable, regular, and continuous activity.

Next, in *Groetzinger*, the Supreme Court stated, "[w]e do not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the statutes with which we are here concerned."

In addition to the foregoing general rules, Treasury and the IRS sought to provide additional guidance in a number of specific areas related to the meaning of the term trade or business for purposes of Section 199A:

Rental Real Estate Activities: A subset of the definition of trade or business is determining whether a *rental real estate activity* is a Section 162 trade or business. Treasury and the IRS cite in the final regulations preamble that relevant factors in this determination might include, but are not limited to:

- the type of rented property (commercial real property versus residential property)
- the number of properties rented
- the owner's or the owner's agents day-to-day involvement

2 See *Higgins v. Commissioner*, 312 U.S. 212 (1941) and *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

Read more ▶

- the types and significance of any ancillary services provided under the lease
- the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease)

In recognition of the inherent difficulty in determining whether a rental real estate activity constitutes a Section 162 trade or business, the IRS issued **Notice 2019-07** which provides notice of a proposed revenue procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of Section 199A.

- **Planning Note:** Application of the safe harbor provided for in Notice 2019-07 and the proposed revenue procedure will provide taxpayers with certainty regarding qualification of the rental real estate activity as a trade or business. However, it is important to note that failure to qualify for this safe harbor does not necessarily mean that the rental real estate activity is not a trade or business for purposes of Section 199A.

Special Rule for Renting Property to a Related Person: In one instance, the proposed and final regulations extend the definition of trade or business for purposes of Section 199A beyond Section 162. Solely for purposes of Section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing activity and the other trade or business are commonly controlled. This rule also allows taxpayers to aggregate their trades or businesses with the leasing or licensing of the associated rental or intangible property if certain requirements are met. The final regulations clarify these rules by limiting this special rule to situations in which the related party is an individual or a relevant pass-through entity.[3] Further, the final regulations provide that the related party rules under Sections 267(b) or 707(b) will be used to determine relatedness for this special rule.

Multiple Trades or Businesses within an Entity: The Treasury Department and the IRS acknowledge that an entity can conduct more than one Section 162 trade or business. However, the Treasury Department and the IRS also believe that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under Treas. Reg. §1.446-1(d). Treas. Reg. §1.446-1(d) explains that no trade or business is considered separate and distinct unless a complete and separable set of books and records is kept for that trade or business. Further, trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected. This guidance is of particular importance to taxpayers seeking to identify and support the existence of multiple trades or businesses, especially where at least one may be considered an SSTB. Care should be taken in evaluating the multiple trades or businesses consistent with existing authorities and contemporaneous documentation is certainly advisable.

- **Planning Note:** Where a taxpayer may otherwise be subject to the 5 percent / 10 percent SSTB de minimis rule, identification and documentation of multiple trades or businesses may create an opportunity to increase the overall QBI Deduction. However, given Treasury's comments contained within the preamble to the final regulations, including those with regard to Treas. Reg. §1.446-1(d), careful consideration is warranted in evaluating and documenting the existence of multiple trades or businesses within a single entity.

Taxpayer Consistency: In cases in which other Code provisions use a trade or business standard that is the same or substantially similar to the Section 162 standard adopted in the final regulations, taxpayers should generally report such items consistently. For example, taxpayers should consider the appropriateness of treating a rental activity as a trade or business for purposes of Section 199A where the taxpayer does not comply with the information return filing requirements under Section 6041.

Trade or Business of Performing Services as an Employee: The proposed regulations contain a presumption that an individual who was previously treated as an employee and is subsequently treated as other than an employee while performing substantially the same services to the same person or a related person, is in the trade or business of performing services of an employee for purposes of Section 199A. The final regulations provide a three-year look-back rule for purposes of determining this presumption. An individual may rebut the presumption by providing records sufficient to corroborate the individual's status as a non-employee for three years from the date a person ceases to treat the individual as an employee

3 Treas. Reg. §1.199A-1(b)(10) defines an RPE to mean a partnership (other than a publicly traded partnership) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. Other passthrough entities including common trust funds and religious or apostolic organizations described in section 501(d) are treated as RPEs if they file Form 1065 and are owned, directly, or indirectly, by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income.

Read more ▶

for Federal employment taxes.[4] The final regulations also provide an example demonstrating the successful rebuttal of the presumption by an employee that materially modified his relationship with his employer.

Calculation of QBI

Under Section 199A, QBI is generally defined to include the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. The proposed regulations provide guidance in order to accurately determine the appropriate items to be included in QBI. The final regulations contain a number of important modifications intended to further assist taxpayers with the ultimate calculation of QBI:

Previously Disallowed Losses: The proposed regulations provide that previously disallowed losses, e.g., losses limited under Sections 465, 469, 704(d), and 1366(d), are taken into account for purposes of computing QBI so long as the losses were incurred in a taxable year beginning after January 1, 2018. The final regulations provide that any losses disallowed, suspended, or limited under the provisions of Section 465, 469, 704(d), and 1366(d), or any similar provisions, shall be used, for purposes of Section 199A, in order from the oldest to the most recent on a FIFO basis.[5] Additionally, the Treasury Department and the IRS published amended proposed regulations under Section 199A (REG-134652-18) that treat previously suspended losses as losses from a separate trade or business for purposes of Section 199A.

- **Planning Note:** It is important to note that the Code sections enumerated in the final regulations may not be comprehensive. For example, losses under Section 179 appear to be similarly subject to this rule. Care should be taken in ensuring compliance with the rules regarding application of previously disallowed losses.

Other Deductions: Section 199A(c)(1) provides that QBI includes the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business. The final regulations provide that for purposes of Section 199A, deductions such as the deductible portion of the tax on self-employment income under Section 164(f), the self-employed health insurance deduction under Section 162(l), and the deduction for contributions to qualified retirement plans under Section 404 are considered attributable to a trade or business to the extent that the gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis.[6] To the extent that the deductions are attributable to a trade or business, reduction of QBI is appropriate.

- **Planning Note:** The Treasury Department and the IRS declined to address whether deductions for unreimbursed partnership expenses, the interest expense to acquire partnership and S corporation interests, and state and local taxes are attributable to a trade or business, citing a scope limitation. Consequently, uncertainty in this area continues.

Items Treated as Capital Gain or Loss: The proposed regulations provide that any item of long or short-term capital gain or loss, including gains or losses under Section 1231 that are treated as capital gains or losses, are not taken into account as a qualified item of income, gain, deduction, or loss in computing QBI.

Under the final regulations, taxpayers must first net their Section 1231 gains and losses in order to determine whether the amounts will be treated as a capital gain or ordinary loss. If the net result is an excess gain, the character of the gain is capital and is excluded from QBI. If the net result is an excess loss, the character of the loss is ordinary and reduces QBI.

Additionally, Section 1231(c) requires taxpayers to recapture Section 1231 capital loss taken in the previous five-year period to the extent that the taxpayer has a current year Section 1231 capital gain. The recapture provision converts the current year 1231 capital gain to ordinary gain to the extent of previously claimed 1231 capital losses within the look-back period. Based on the preamble to the final regulations Section 1231(c) rules should be applied for purposes of determining a taxpayer's QBI.[7]

Finally, while the proposed regulations did not provide a definition of net capital gain for purposes of Section 199A, the final regulations define net capital gain as net capital gain within the meaning of Section 1222(11) plus any qualified dividend income (as defined in Section 1(h)(11)(B)) for the taxable year.[8]

- **Planning Note:** The final regulations provide clarity around what many tax advisors and taxpayers had already suspected. While the rules appear technically accurate, the

4 See Treas. Reg. §1.199A-5(d)(3).

5 Treas. Reg. §1.199A-3(b)(1)(iv).

6 Treas. Reg. §1.199A-3(b)(1)(vi).

7 Preamble to the final regulations, IV.A.10.

8 See Treas. Reg. §1.199A-1(b)(3).

Read more ▶

implementation may be challenging for taxpayers. In order to properly apply these rules, individual taxpayers will need RPEs to provide specific Section 1231 gain and loss information separate from the RPEs calculation of QBI. This will place an additional reporting burden on RPEs.

Clarification of the Meaning of Certain SSTBs

The final regulations clarify several definitions of the services listed in Section 199A(d)(2) and provide additional examples to aid in SSTB determination. The final regulations also add two rules for general application. The first rule specifies that the rules for determining whether a business is an SSTB within the meaning of Section 199A(d)(2) apply solely for purposes of Section 199A. Second is a hedging rule that is applicable to any trade or business conducted by an individual or an RPE. The rule provides that income, deduction, gain, or loss from a hedging transaction entered into in the normal course of a trade or business is included as income, deduction, gain, or loss from that trade or business. Items to note within the final regulations with respect to SSTBs include:

Healthcare Services: The field of healthcare services is vast and at times multi-faceted, as in the case of an assisted-living or skilled-nursing facility, making the analysis of the existence of separate trades or businesses imperative. The preamble to the final regulations reiterates that each trade or business must be analyzed based on the facts and circumstances unique to such trade or business.

The final regulations remove the requirement from the proposed regulations that health services be provided directly to patients.[9] This is likely to increase the number of businesses considered to be conducting a trade or business in the field of health, as it broadens the definition to include ancillary or indirect services to patients. The final regulations also provide several examples of services that would not be considered services in the field of health. Careful consideration will need to be made for each trade or business that could possibly be subject to the SSTB designation.

- **Planning Note:** Removal of the requirement for services in the field of health to be provided directly to patients is likely to capture a number of services providers that do not work directly with patients. For example, medical practices where providing detailed lab reports is likely considered an SSTB in the field of health. Taxpayers who had made a preliminary determination under the proposed regulations relying on a lack of proximity to the patient should re-consider their analysis.
- **Planning Note:** As stated in the preamble to the final regulations, the Treasury Department and the IRS agree that skilled nursing, assisted living, and similar facilities provide multi-faceted services to their residents. Further, as discussed earlier, it is possible for an RPE to operate multiple trades or business. Taxpayers operating in this industry will need to ensure a detailed analysis of their activities is well-documented to either demonstrate the existence of multiple trades or businesses or to document the amount of gross receipts, if any, generated in the field of health.
- **Planning Note:** The final regulations now include an example of an outpatient surgical center demonstrating a fact pattern that the Treasury Department and the IRS believe is a trade or business operating in the field of health. While this example is helpful, there are a number of factors not addressed and its practical application may be limited. Consistent with other aspects of the QBI Deduction, a careful analysis of the facts and circumstances will be necessary.

Consulting Services: The proposed regulations define the field of consulting as the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Examples are then provided to assist taxpayers in analyzing facts and circumstances for application of the provision. While comments received by the Treasury Department stated that the definition was overly broad, the final regulations maintain the general definition of consulting and the requirement to assess whether a trade or business is an SSTB based on the relevant factors particular to that trade or business.

- **Staffing Services:** In response to a number of comments with suggestions and requests for clarification, the final regulations incorporate a number of modifications, including an additional example. The implications of these modifications appears to confirm that the provision of staffing services does not fall within the purview of consulting.
- **Architecture & Engineering Services:** The final regulations provide that architecture and engineering services are not treated as consulting services for purposes of Section 199A. This is potentially significant as many architecture and engineering services businesses provide services that could be considered "consulting" under the general definition of this term.

9 See Preamble to the final regulations VI.A.2.

Read more ▶

Financial Services: The final regulations clarify that the provision of financial services does not include taking deposits or making loans. Consequently, financial institutions operating trades or businesses in this area will not be considered as operating an SSTB. Also, for purposes of Section 199A, the performance of services to originate a loan is not treated as the purchase of a security from the borrower.[10]

The preamble to the final regulations contemplates the exclusion of services provided by insurance agents from the definition of financial services, but ultimately did not categorically exclude these services from the definition due to the fact that insurance agents may provide wealth management, financial advisory and other services that may be financial services. To the extent that these services are ancillary to the commission-based sale of an insurance policy, however, the services will generally not be considered the provision of financial services for purposes of Section 199A.

- **Planning Note:** If an entity is performing financial services that are excluded from the definition of an SSTB and also services that are an SSTB, an analysis should be done to see if they can be treated as multiple trades or businesses contained in a single entity. There may be reasons to consider segregating the SSTB from the non-SSTB in different entities through a restructuring.

Brokerage Services: The final regulations clarify that although the performance of services in the field of financial services does not include taking deposits or making loans, it does include arranging lending transactions between a lender and borrower.[11]

Dealing in Securities: The final regulations clarify that for purposes of Section 199A and the definition of performing services that consist of dealing in securities, the performance of services to originate a loan is not treated as the purchase of a security from the borrower. The final regulations also remove the reference to the negligible sales exception under Treas. Reg. §1.475(c)-1(c)(2) and (4) from the definition of dealing in securities.

Dealing in Commodities: The Treasury Department and the IRS limited the definition of dealing in commodities for purposes of Section 199A to a trade or business that is dealing with financial instruments or otherwise does not engage in substantial activities with respect to physical commodities.

The final regulations adopt rules similar to the rules that apply to qualified active sales of commodities under Treas. Reg. §1.954-2(f)(2)(iii), which require a person to be engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities and to perform certain activities with respect to those commodities.[12]

Gains and losses from the sale of commodities in the active conduct of a commodities business as a producer, processor, or handler of commodities will be qualified active sales. Gains and losses from qualified active sales are not taken into account to determine whether a person is engaged in the trade or business of dealing in commodities for purposes of Section 199A.

Qualified active sales generally require a taxpayer to hold commodities as inventory or similar property and to satisfy specified conditions regarding substantial and significant activities described in the final regulations. A sale by a trade or business of commodities held for speculation is not a qualified active sale.[13] Income, deduction, gain, or loss from a hedging transaction (as defined in Treas. Reg. §1.1221-2(b)) entered into in the normal course of a commodities business conducted by a producer, processor, merchant, or handler of commodities will be treated as gains and losses from qualified active sales that are part of that trade or business.

Athletics: Treasury and the IRS received a number of comments around the meaning of the term athletics specifically in the context of professional sports teams. In the preamble to the proposed regulations, Treasury commented "While sports club and team owners are not performing athletic services directly, that is not a requirement of Section 199A, which looks to whether there is income attributable to a trade or business involving the performance of services in a specified activity, not who performed the services." As such, no changes were made in the final regulations to the meaning of the term athletics for purposes of Section 199A.

- **Planning Note:** The final regulations retain the treatment of professional sports clubs and team owners as trades or businesses within the field of athletics. While ultimately a factual determination, affected taxpayers will likely need to consider whether they conduct multiple trades or businesses and whether any such business falls outside of the meaning of athletics. It may be possible that the facts and circumstances support identification of multiple trades or businesses.

10 See Treas. Reg. §1.199A-5(b)(2)(ix).

11 See Treas. Reg. §1.199A-5(b)(2)(x).

12 See Treas. Reg. §1.199A-5(b)(2)(xiii)(B).

13 See Treas. Reg. §1.199A-5(b)(2)(xiii)(B)(1).

Read more ▶

Modification of the SSTB "Special Rules"

SSTB De Minimis Rule: The final regulations confirm that a trade or business with gross receipts in excess of $25 million and generating at least 5 percent of its gross receipts from an SSTB will be treated entirely as an SSTB for purposes of Section 199A.[14] However, the preamble to the final regulations acknowledges that a single entity may conduct more than one trade or business. The final regulations also contain an example demonstrating application of the de minimis rule. The de minimis threshold is applied to each trade or business of an RPE separately, not in the aggregate to all of the trades or businesses of the RPE.

- **Planning Note:** Given the potentially draconian result under the de minimis rule, careful consideration should be given to the identification of each trade or business conducted within a single entity. To the extent multiple trades or businesses are identified, taxpayers should contemporaneously document the basis for this conclusion.

Services or Property Provided to an SSTB: The proposed regulations state that a trade or business that provides more than 80 percent of its property or services to an SSTB is treated as an SSTB if there is 50 percent or more common ownership of the trades or businesses. In cases in which a trade or business provides less than 80 percent of its property or services to a commonly owned SSTB, the portion of the trade or business providing the property to the commonly owned SSTB is treated as part of the SSTB with respect to the related parties.

The final regulations remove the 80 percent rule and provide that if a trade or business provides property or services to an SSTB and there is 50 percent or more common ownership of the trade or business, the portion of the trade or business providing property or services to the 50 percent or more commonly owned SSTB will be treated as a separate SSTB with respect to related parties. The final regulations also clarify through an example that the rule applies only to those who make up the 50 percent test.

- **Planning Note:** As a result of the change in the final regulations, owners of the trade or business providing services or property to the SSTB who are not part of the common ownership calculation will not be subject to the SSTB taint on the QBI generated from the separate trade or business. While this may create planning opportunities, care should be taken to ensure compliance with the often complex common ownership rules.

- **Removal of the Incidental Rule:** The proposed regulations include an anti-abuse rule intended to limit the ability of taxpayers to separate their SSTB and non-SSTB income into two trades or businesses to benefit from the Section 199A deduction with respect to the non-SSTB activity. The rule provided that if a trade or business has both 50 percent or more common ownership with an SSTB and shared expenses with an SSTB, then the trade or business is treated as incidental to, and part of the SSTB, if the gross receipts of the trade or business are 5 percent or less of the total combined gross receipts of the trade or business and the SSTB in a taxable year. The final regulations remove this anti-abuse rule primarily due to administrative difficulty and potential over-inclusiveness. **Planning Note:** This taxpayer-favorable change has a positive impact on start-up companies which might have been tainted by SSTB receipts from a related company.

Application of the W-2 Wages and UBIA of Qualified Property Limitations

For taxpayers whose taxable income exceeds the Threshold Amount, Section 199A may limit the taxpayer's QBI Deduction based on (i) the type of trade or business engaged in by the taxpayer (SSTB limitation) or (ii) the amount of W-2 wages paid with respect to the trade or business (W-2 wages), and/or the UBIA of qualified property held for use in the trade or business (W-2 Wages/UBIA limitation).

UBIA of Qualified Property - Allocation: In general, each owner's share of the UBIA of qualified property is equal to the owner's share of tax depreciation for the year. However, where qualified property held by a partnership does not produce tax depreciation during the year, each partner's share of the UBIA of qualified property is based on a hypothetical allocation of depreciation under Section 704(b).

- **Planning Note:** The final regulations removed a requirement in the proposed regulations that required the hypothetical Section 704(c) gain allocation be considered in the allocation of UBIA. This modification greatly simplifies the allocation and may be more favorable to newer partners in partnerships whose assets have experienced significant appreciation.

UBIA of Qualified Property – Non-Recognition Transactions: Under the proposed regulations, the UBIA of qualified property contributed to a partnership in a Section 721 transaction would generally equals the partnership's tax basis under Section 723. Similarly, the UBIA of qualified property contributed to an S corporation in a Section 351 transaction

14 The threshold is 10 percent in the case of a trade or business with $25 million or less gross receipts.

Read more ▶

would be determined by reference to Section 362.[15] The final regulations modify this rule to provide that, solely for the purposes of Section 199A, if qualified property is acquired in a transaction described in Section 168(i)(7)(B), the transferee's UBIA in the qualified property is the same as the transferor's UBIA in the property, decreased by the amount of money received by the transferee in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction.[16]

- **Planning Note:** Allowing for the use of tax basis at the time the property was placed in-service by the contributing partner or shareholder as opposed to the adjusted tax basis at the time of the contribution allows contributors to avoid a "penalty" in the form of lower UBIA of qualified property as a result of the contribution.

UBIA of Qualified Property – Like-Kind Exchange & Involuntary Conversion: The final regulations provide that the UBIA of qualified like-kind property that a taxpayer receives in a Section 1031 like-kind exchange is the UBIA of the relinquished property, adjusted downward by the excess of any money or the fair market value of other property received by the taxpayer in the exchange over the taxpayer's appreciation in the relinquished property, or upward by the amount of money paid or the fair market value of other property transferred to reflect additional taxpayer investment in the acquisition. The rules are similar for qualified property acquired pursuant to an involuntary conversion under Section 1033, except that appreciation for this purpose is the difference between the fair market value of the converted property on the date of the conversion over the fair market value of the converted property on the date of acquisition by the taxpayer.[17]

- **Planning Note:** Allowing for the use of the basis at the time the property was placed in-service by the taxpayer as opposed to the adjusted basis at the time of the exchange allows taxpayers to avoid a "penalty" in the form of lower UBIA of qualified property as a result of the like-kind exchange or involuntary conversion. This is a welcome change from the proposed regulations.

UBIA of Qualified Property – Section 743(b) Basis Adjustments: The final regulations allow a Section 743(b) basis adjustment to be treated as qualified property to the extent the Section 743(b) basis adjustment reflects an increase in the fair market value of the underlying qualified property over the original UBIA of such property. This modification to the proposed regulation allows purchasers of partnership interests to benefit to the extent the purchase price allocable to appreciated assets exceeds the original UBIA of the property while safeguarding against duplication of UBIA.

Determination of W-2 Wages: The Treasury Department and the IRS have issued Revenue Procedure 2019-11 concurrently with the final regulations to provide additional guidance on the definition of W-2 wages, including amounts treated as elective deferrals. The computation of W-2 wages for purposes of Section 199A requires thoughtful consideration of W-2 wages paid and reported on forms W-2. Special attention should be given to the Revenue Procedure and the final regulations.

Application of the Trade or Business Aggregation Rules

Under the proposed regulations, individuals may aggregate QBI, W-2 wages, and UBIA of qualified property from multiple trades or businesses that satisfy five criteria. Significantly, the final regulations allow for aggregation by RPEs, in addition to individuals. Under the final regulations, aggregation is allowed providing the following requirements are satisfied:

i. The same person or group of persons, directly or by attribution under Sections 267(b) or 707(b), 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 the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership.

ii. The ownership described above exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income.

iii. 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.

iv. None of the trades or businesses to be aggregated is a specified service trade or business (SSTB).

v. The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):

   a. The trades or businesses provide products, property, or services that are the same or customarily offered together.

15 Preamble to the final regulations, III.B.2.

16 Treas. Reg. §1.199A-2(c)(3)(iv).

17 Preamble to the final regulations, III.B.3.

Read more ▶

b. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

c. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

General Requirements to Aggregate: The final regulations provide that both direct ownership and ownership by attribution through Sections 267(b) or 707(b) count for this purpose. Further, the final regulations clarify that a C corporation may constitute part of the ownership group for this test.[18] Additionally, the requirement that the 50 percent ownership test, mentioned above, must be for a majority of the taxable year, has been modified. It now requires that the majority of the taxable year must also include the last day of the taxable year.[19]

Aggregation at the RPE level is binding on all owners of the RPE. An individual or RPE that receives information on aggregated trades or businesses from an RPE can aggregate additional trades or businesses with that group, assuming all the criteria in Treas. Reg. §1.199A-4(b) are met. However, an individual or RPE may not separate the aggregated trades or businesses that have been reported to them by an RPE.[20]

The final regulations clarified that it is possible for real estate trades or businesses to meet criteria (v) above, by adding the term property in addition to products or services. In addition, the final regulations also provide an example clarifying when a real estate trade or business satisfies the aggregation rules.[21]

Aggregation Reporting Rules: The final regulations provide detailed rules regarding reporting and consistency of aggregation by both individuals and RPEs. These rules include the requirement that once two or more trades or businesses are aggregated, they must be aggregated in all subsequent taxable years, unless there is a significant change in facts and circumstances.

If there is a significant change in facts and circumstances such that the previously aggregated group no longer qualifies for aggregation, then the trades or businesses must reapply the aggregation rules to determine a new permissible aggregation, if applicable.

Additionally, the final regulations provide that failure to aggregate trades or businesses will not be considered an aggregation and thus aggregation in a later year is not precluded. Generally taxpayers may not aggregate trades or businesses on amended returns but an exception is provided for taxable year 2018. Individuals or RPEs may add newly created or newly acquired trades or businesses to an existing aggregated group if the other conditions of aggregation are met. Individuals and RPEs must report all aggregations they make directly on their returns as well as aggregations reported to them by RPEs.[22]

The final regulations retain the requirement that aggregations be reported annually. This is required for both individuals and RPEs even if there are no newly acquired or disposed trades or businesses within the aggregated group. The annual required disclosures that must be attached to taxpayers' returns must include the following information:

1. A description of each trade or business.
2. The name and EIN of each entity in which a trade or business is operated.
3. Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year.
4. Information identifying any aggregated trade or business of an RPE in which the RPE holds an ownership interest.
5. Such other information as the Commissioner may require in forms, instructions, or other published guidance.[23]

Failure to disclose an aggregation on the required annual attachment may result in disaggregation by the IRS. If the IRS exercises this right, the taxpayer is prohibited from aggregating those trades or businesses for the subsequent three taxable years.[24]

18 Treas. Reg. §1.199A-4(b)(1)(i).

19 Treas. Reg. §1.199A-4(b)(1)(ii).

20 Treas. Reg. §1.199A-4(b)(2)(ii).

21 See Treas. Reg. §1.199A-4(d), Example 18.

22 Treas. Reg. §1.199A-4(c)(1) for individuals and Treas. Reg. §1.199A-4(c)(3) for RPEs.

23 Treas. Reg. §1.199A-4(c)(2)(i) for individuals and Treas. Reg. §1.199A-4(c)(4)(i) for RPEs.

24 Treas. Reg. §1.199A-4(c)(2)(ii) for individuals and Treas. Reg. §1.199A-4(c)(4)(ii) for RPEs.

Read more ▶

- **Planning Note:** The decision to aggregate has grown increasingly complex with the issuance of the final regulations. The ability of RPEs to aggregate should lessen the administrative burden for individual taxpayers. Further, the actual tax return reporting requirements on RPEs is likely going to be reduced. However, now that RPEs, in addition to individual taxpayers, may aggregate this decision requires a more complex and detailed analysis. While RPE-level aggregation may be beneficial for some individual taxpayers, it also has the potential to be detrimental for others. Additionally, since an aggregation is binding on future years, individuals and RPEs must carefully consider whether an aggregation that is beneficial in the current year is likely to be so in the future.
- **Planning Note:** Under the final regulations, the RPE is required to separately identify each trade or business, determine whether such trades or businesses are qualified trades or businesses or SSTBs and then determine QBI, W-2 wages, and UBIA of qualified property with respect to each trade or business. Failure to accurately apply the rules of Section 199A could result in a loss of some or all of the potential benefit. Consequently, the ability to aggregate at the RPE level does not relieve these taxpayers from their obligations to satisfy the requirements of Section 199A and the final regulations.
- **Planning Note:** For taxpayers that expect aggregation to be beneficial in future years but have no net benefit in taxable year 2018 (for example, all owners are below the taxable income threshold), consider postponing aggregation until necessary to avoid any potential downside. For 2018, the ability to aggregate on an amended return mitigates the risk of an unforeseen amendment bringing owners' taxable income over the applicable threshold. This mitigation strategy will not be available for taxable years after 2018.

CONCLUSION

The final regulations, promulgated within five months of the issuance of the proposed regulations represents a number of taxpayer-favorable provisions including the elimination of the incidental rule, the new safe harbor for rental real estate activities, and the ability to aggregate multiple trades or businesses at the entity level. There are still a number of areas that will require in-depth analysis including the determination of whether a trade or business exists and whether there are multiple trades or businesses contained within a single entity.

CONTACT

JEFFREY N. BILSKY
National Tax Office Partner
Technical Practice Leader, Partnerships
404- 979-7193 / jbilsky@bdo.com

JULIE ROBINS
National Tax Office Managing Director
512-391-3534 / jrobins@bdo.com

NEAL WEBER
National Tax Office Managing Director
404-942-2959 / nweber@bdo.com

REBECCA LODOVICO
National Tax Office Managing Director
412-315-2484 / rlodovico@bdo.com

TOMMY ORR
National Tax Office Senior Manager
202-644-5434 / torr@bdo.com

ANDY KRAMER
National Tax Office Senior Manager
248-688-3405 / akramer@bdo.com

KATIE PENDZICH
National Tax Office Senior Manager
414-615-6782 / kpendzich@bdo.com