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QUALIFIED BUSINESS INCOME DEDUCTION: NON–SPECIFIED SERVICE TRADES OR BUSINESSES

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LEARNING OBJECTIVES

After completing this session, participants will be able to do the following:

- ✔ Determine what constitutes qualified business income (QBI)
- ✔ Calculate the QBI deduction
- ✔ Apply the taxable income limit and the W-2 wage and capital limit
- ✔ Understand when trades or businesses can be aggregated
- ✔ Understand how QBI losses are applied and carried over
- ✔ Calculate the real estate investment trust and publicly traded partnership component of the QBI deduction
- ✔ Allocate QBI items to owners of a pass-through entity
- ✔ Understand how the understatement penalty applies to the QBI deduction
- ✔ Determine whether a real estate rental activity is eligible for the QBI deduction

INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, enacted I.R.C. § 199A, which applies to sole proprietorships, partnerships, S corporations,

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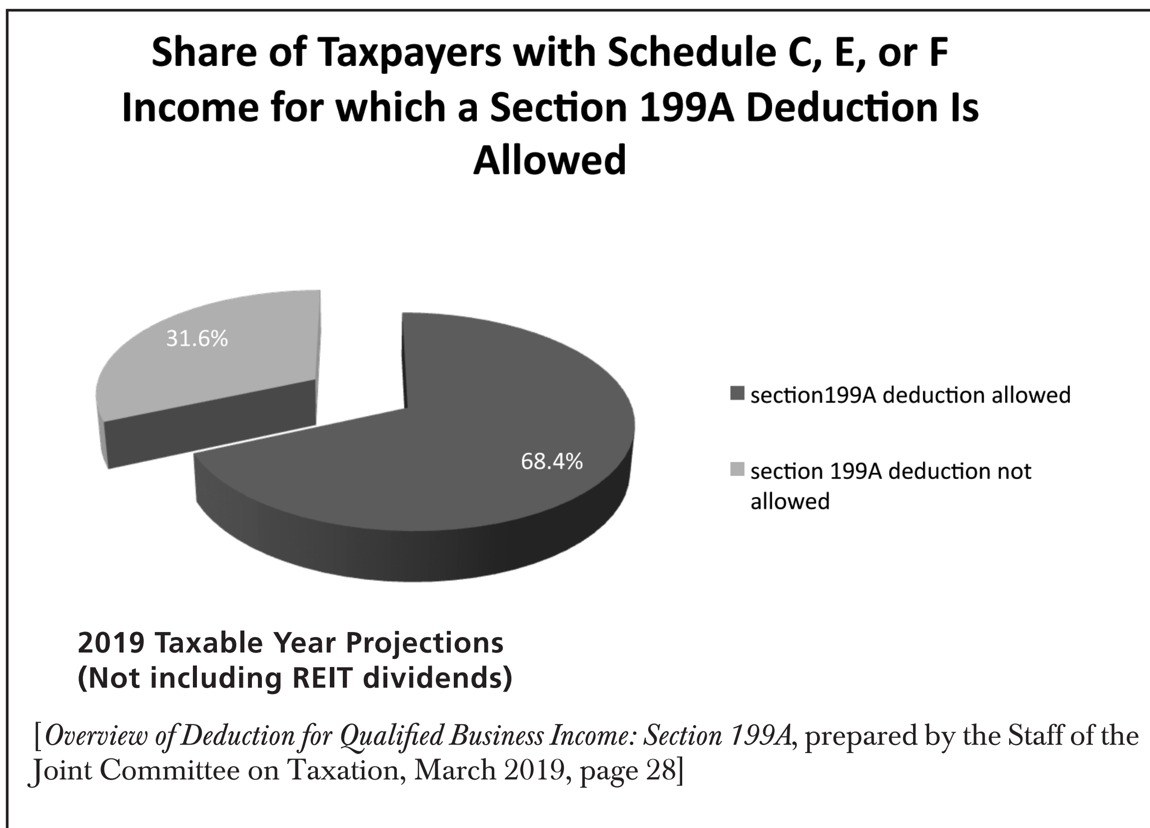
trusts, and estates. It also applies to dividends from real estate investment trusts (REITs), income from publicly traded partnerships (PTPs), and certain payments from cooperatives to their patrons. Section 199A allows a deduction for up to 20% of qualified business income (QBI). The QBI deduction applies to tax years after 2017 and before 2026.

The QBI deduction will offset income tax liability and the alternative minimum tax (AMT). However, it will not reduce self-employment income or net investment income. The deduction is after AGI, and it is available to taxpayers who either itemize or claim the standard deduction.

The Joint Committee on Taxation projects that for the 2019 tax year, 39,200,000 returns will include business income from Form 1040 Schedules C, E, or F. On 26,800,000 of these returns, taxpayers will take the QBI deduction. **Figure 1.1** shows that 68.4% of taxpayers with Schedule C, E, or F income are projected to claim the QBI deduction. **Figure 1.2** shows the projection that 91.5% of that Schedule C, E, or F income will be eligible for the QBI deduction.

This chapter discusses how to calculate the QBI deduction for proprietorships, partners in partnerships, and S corporation shareholders. This chapter contains comprehensive examples of the income that qualifies for the deduction, and two limitations on the deduction. A third limitation on the deduction, the specified service trade or business (SSTB) limitation, is discussed in the "Qualified Business Income Deduction: Specified Service Trades or Businesses" chapter.

FIGURE 1.1 Share of Schedule C, E, or F Taxpayers Who Can Claim the QBI Deduction



[*Overview of Deduction for Qualified Business Income: Section 199A*, prepared by the Staff of the Joint Committee on Taxation, March 2019, page 28]

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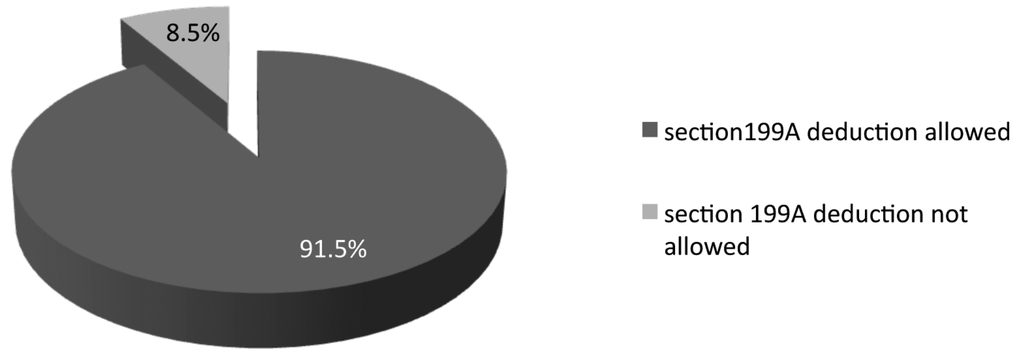
FIGURE 1.2 Share of Income That Is Eligible for the QBI Deduction

Share of Schedule C, E, or F Income for which a Section 199A Deduction Is Allowed



2019 Taxable Year Projections
(Not including REIT dividends)

[*Overview of Deduction for Qualified Business Income: Section 199A*, prepared by the Staff of the Joint Committee on Taxation, March 2019, page 29]

This chapter also explains when trades or businesses can be aggregated, how to net and carry over QBI losses, and how pass-through entities allocate and report certain QBI items that the owner uses to calculate the QBI deduction. Finally, this chapter discusses whether real estate rental income qualifies for the QBI deduction.

Cross-Reference

Cooperatives and Patrons

See the "Agricultural and Natural Resource Issues" chapter in the *2019 National Income Tax Workbook* for a complete discussion of the application of section 199A to cooperatives and their patrons.

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CALCULATING THE QBI DEDUCTION

This section explains how to calculate the QBI deduction.

In general, the QBI deduction is the lesser of 20% of QBI or 20% of the taxpayer's taxable income before the QBI deduction (the taxable income limit). The deduction may be further limited by the W-2 wage and unadjusted basis of qualified property immediately after acquisition limitations (collectively called the W-2 wage and capital limit). This section first discusses what constitutes QBI. It then explains the taxable income limit and how the W-2 wage and capital limit may reduce the deduction.

Example 1.1 Calculating the QBI Deduction

Miguel Hernandez is an architect. He conducts his business as a sole proprietorship. The business maintains a complete and separate set of books and records. In 2019, the business had $100,000 of net business income, which is all QBI. Miguel's taxable income was $150,000. Miguel's section 199A deduction is $20,000 [$100,000 × 20%].

Definition of QBI

In general, QBI is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. A trade or business is defined with reference to I.R.C. § 162, including certain self-rentals [Treas. Reg. § 1.199A-1(b)(14)].

CROSS-REFERENCE

Services as an Employee

Under Treas. Reg. § 1.199A-5(d), the trade or business of performing services as an employee is not a trade or business for purposes of section 199A and the section 199A regulations. Thus, no items of income, gain, deduction, or loss from the trade or business of performing services as an employee constitute QBI. See the "Qualified Business Income Deduction: Specified Service Trades or Businesses" chapter for a discussion of wage income and when a worker may be presumed to be an employee.

QBI items must be effectively connected with a US trade or business (discussed later) and must be included or allowed in determining taxable income for the tax year.

QBI excludes the following:

- Dividends, including qualified dividends
- Interest, unless it is allocable to a trade or business
- Capital gains and losses (short-term or long-term)
- Gains and losses from transactions of foreign personal holding companies
- Income from annuities, unless received in connection with a trade or business

[I.R.C. § 199A(c)(3)(B)]

PRACTITIONER NOTE

Combined QBI Amount

QBI does not include any qualified REIT dividends or qualified PTP income [I.R.C. § 199A(c)(1)]. However, the QBI deduction is calculated based on the combined QBI amount [I.R.C. § 199A(b)(1)]. This includes the deductible amount for each trade or business (the QBI component). It also includes 20% of the taxpayer's qualified REIT dividends and qualified PTP income (the REIT/PTP component) [Treas. Reg. § 1.199A-1(d)(3)]. The deduction for the REIT/PTP component is limited only by taxable income. It is not subject to the W-2 wage and capital limit. See the "REIT/PTP Component" section later in this chapter.

QBI also does not include wages, salaries, and guaranteed payments for services [I.R.C. § 199A(c)(4)]. While reasonable compensation of an S corporation shareholder and I.R.C. §§ 707(a) and 707(c) payments are not included in the owner's QBI, they are an item of QBI and will reduce QBI if they are properly allocable to the trade or business and are otherwise deductible for federal income tax purposes [Treas. Reg. §§ 1.199A-3(b)(2)(ii)(H), (I), and (J)].

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PRACTITIONER NOTE

Reasonable Compensation

An S corporation must pay its shareholders reasonable compensation. If the salary paid to an S corporation shareholder is not reasonable, the IRS can recharacterize a shareholder distribution as wages that are subject to self-employment tax. Therefore, reasonable compensation of an S corporation shareholder includes any amounts (including distributions) paid by the S corporation to the shareholder, up to the amount that would constitute reasonable compensation.

The section 199A regulations provide special rules for I.R.C. § 751 gain; guaranteed payments; I.R.C. § 481 adjustments; previously disallowed losses; net operating losses (NOLs); other deductions, such as the self-employed health care deduction; and capital gains and losses. These rules are discussed later in this chapter.

US Trade or Business

QBI must be effectively connected with the conduct of a trade or business in the United States [I.R.C. § 199A(c)(3)(A)(i)], as defined in I.R.C. § 864(c). Section 864(c) broadly includes businesses with offices in the United States, and certain rents and royalties received from US properties. Income is effectively connected with a US trade or business if

1. the business has an office or other fixed place of business in the United States;
2. the office or other fixed place of business is a material factor in the realization of the income, gain, or loss; and
3. the activities at that office or other fixed place of business substantially contribute to the realization of the income, gain, or loss.

[Treas. Reg. § 1.864-6(b)(1)]

Any business conducted in Puerto Rico is treated as a US trade or business if the business income is taxable income in the United States [I.R.C. § 199A(f)(1)(C)(i)].

I.R.C. § 751 Gain

One commenter to the proposed section 199A regulations noted that if guaranteed payments are treated like interest income for purposes of section 199A, and if such payments are properly allocated to a qualified trade or business of the recipient, they should constitute QBI. The Treasury Department and the IRS agreed with this comment, and the final section 199A regulations provide that, with respect to a partnership, if I.R.C. § 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and such gain or loss is included in the computation of QBI [Treas. Reg. § 1.199A-3(b)(1)(i)].

Guaranteed Payments to Partners

QBI does not include (1) any guaranteed payment described in I.R.C. § 707(c) paid to a partner for services rendered with respect to the trade or business or (2) any payment described in I.R.C. § 707(a) to a partner who is not acting in his or her capacity as a partner for services rendered with respect to the trade or business.

Example 1.2 Guaranteed Payments

Dan Donaldson and Dave Denman are equal partners in Henley Cycles, a partnership that conducts a qualified trade or business. In 2019, Henley Cycles had $1,050,000 of QBI before deducting $250,000 in guaranteed payments made to Dan and Dave for their services ($125,000 each). Henley Cycles had $800,000 ($1,050,000 – $250,000) of QBI after deducting the guaranteed payments.

The partnership allocates $400,000 ($800,000 × 50%) of QBI to each partner. The guaranteed payments to Dan and Dave are not QBI. Dan and Dave each calculate the QBI deduction on their $400,000 share of QBI (subject to the W-2 wage and capital limit and the taxable income limit).

PLANNING POINTER

Reducing Guaranteed Payments

Guaranteed payments to partners lower the QBI allocated to each partner, resulting in a lower QBI deduction. If instead a partnership made no guaranteed payments, and treated payments to its partners as a distribution of partnership income, the partnership will have more QBI that it can allocate to its partners.

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Income attributable to a guaranteed payment for the use of capital is generally not included in QBI. However, this income may be included in QBI if it is properly allocable to a trade or business of the recipient. The partnership's deduction for the guaranteed payment is included in the QBI calculation if the deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes [Treas. Reg. § 1.199A-3(b)(1)(ii)].

Section 481 Adjustments

I.R.C. § 481 adjustments (whether positive or negative) may be included in the computation of QBI only if the adjustment arises in tax years ending after December 31, 2017 [Treas. Reg. § 1.199A-3(b)(1)(iii)].

Previously Disallowed Losses

The proposed section 199A regulations provided that previously disallowed losses or deductions [including under I.R.C. §§ 465, 469, 704(d), and 1366(d)] allowed in the tax year may be included in the calculation of QBI if the losses were incurred in a tax year beginning after January 1, 2018. Because previously disallowed losses incurred for tax years beginning before January 1, 2018, are not included, several commenters on the proposed regulations recommended that final regulations provide an ordering rule for the use of such losses.

The Treasury Department and the IRS agreed that taxpayers with previously disallowed losses for tax years beginning both before and after January 1, 2018, require an ordering rule to determine which portion of a previously disallowed loss is included for purposes of section 199A. The final section 199A regulations provide that any losses disallowed, suspended, or limited under the provisions of sections 465, 469, 704(d), and 1366(d), or any other similar provisions, must be used, for purposes of section 199A and the 199A regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis [Treas. Reg. § 1.199A-3(b)(1)(iv)].

A taxpayer's I.R.C. § 469 groupings may differ from the taxpayer's section 199A aggregations. Thus, a previously disallowed section 469 loss carryforward would have to be allocated to those groupings when it is later used. Also, a previously disallowed loss may relate to a trade or business that is no longer in existence. To address these issues, proposed regulations would amend Treas. Reg. § 1.199A-3(b)(1)(iv) to provide that previously disallowed losses are treated as a loss from a separate trade or business. To the extent that losses relate to a PTP, they must be treated as losses from a separate PTP.

Prop. Treas. Reg. § 1.199A-3(b)(1)(iv)(B) provides that whether the disallowed loss or deduction is attributable to a trade or business and otherwise meets the requirements of section 199A is determined in the year the loss is incurred. Also, whether a disallowed loss or deduction is attributable to an SSTB (including whether an individual has taxable income under the threshold amount, within the phasein range, or in excess of the phasein range) is determined in the year the loss is incurred. To the extent a loss is partially disallowed, QBI in the year of disallowance must be reduced proportionately [REG-134652-18]. QBI losses are discussed in the "Qualified Business Loss" section later in this chapter.

Net Operating Losses

Generally, a net operating loss (NOL) deduction under I.R.C. § 172 is not included in calculating QBI. However, an excess business loss under I.R.C. § 461(l) is treated as an NOL carryover to the following tax year and is taken into account for purposes of computing QBI in the subsequent tax year in which it is deducted [Treas. Reg. § 1.199A-3(b)(1)(v)]. See the later discussion and examples of QBI losses.

Other Deductions

As discussed earlier, QBI includes qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Thus, deductions that are included in calculating QBI must be with respect to a qualified trade or business.

PRACTITIONER NOTE

Effectively Connected Income

I.R.C. § 873(b) allows a deduction for theft losses of US property and charitable contribution deductions, regardless of whether they are effectively connected income from the conduct of a US trade or business. These items are not QBI items if they are not incurred with respect to a trade or business.

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For purposes of section 199A only, deductions such as the deductible portion of the tax on self-employment (SE) income under I.R.C. § 164(f), the self-employed health insurance deduction under I.R.C. § 162(l), and the deduction for contributions to qualified retirement plans under I.R.C. § 404 are considered attributable to a trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction [Treas. Reg. § 1.199A-3(b)(1)(vi)].

PRACTITIONER NOTE

Proposed Regulations

The proposed section 199A regulations did not address whether these other deductions are QBI items. For 2018, a taxpayer may rely on the 2018 proposed regulations or the 2019 final regulations (but not both). For 2018 only, some practitioners believe that, in reliance on the proposed regulations, they do not have to include these other deductions when computing the QBI deduction. IRS QBI Deduction FAQ 32 states that these deductions must be included in the 2018 QBI calculation.

Example 1.3 Effect of Self-Employment Tax Deduction on QBI

Lester Rhoades owns a music store, which he operates as a sole proprietorship. He is single. **Figure 1.3** shows Lester's 2019 taxable income.

FIGURE 1.3 Lester's 2019 Taxable Income

Income from music store	$140,000
Ordinary income, not from a trade or business or subject to SE tax	40,000
SE tax deduction*	(9,891)
SE health insurance deduction	(5,000)
AGI	$165,109
Standard deduction	(12,200)
Taxable income before 199A deduction	$152,909

*$140,000 × 0.9235 = $129,290 × 0.153 = $19,781 × 50%

Lester's taxable income is less than the 2019 threshold and he is not subject to the W-2 wage and capital limit. He calculates his QBI deduction as shown in **Figure 1.4.**

FIGURE 1.4 Lester's 2019 QBI Deduction

Income from music store	$140,000
Less SE tax deduction	(9,891)
Less SE health insurance deduction	(5,000)
Net QBI	$125,109
Tentative QBI deduction ($125,109 × 20%)	$ 25,022
Taxable income limitation [$152,909 (Figure 1.3) × 20%]	$ 30,582
QBI deduction (lesser of tentative deduction or taxable income limitation)	$ 25,022

If the taxpayer has more than one trade or business, he or she may need to allocate the deductions among the businesses. If, for example, income from two or more businesses is taken into account in calculating the SE tax and the self-employed health insurance deduction, the taxpayer must allocate these deductions to each business in proportion to gross income received from the trade or business [Treas. Reg. § 1.199A-3(b)(1)(vi)].

PRACTITIONER NOTE

S Corporation Shareholders

An S corporation shareholder-employee is not a self-employed person. However, the S corporation shareholder may claim the self-employed health insurance deduction for premiums paid by the S corporation and reported as W-2 wages. IRS QBI Deduction FAQ 33 states that generally, the self-employed health insurance deduction under section 162(l) is considered attributable to a trade or business for purposes of section 199A and will be a deduction in determining QBI. This may result in QBI being reduced at both the entity and the shareholder level.

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Capital Gains and Losses

The proposed section 199A regulations provided that any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of these items (such as gains or losses under I.R.C. § 1231 that are treated as capital gains or losses), are not included in the calculation of QBI. The final section 199A regulations remove the specific reference to section 1231 and provide that any item of short or long-term capital gain, or short or long-term capital loss, including any item treated as one of these items, is not included in the calculation of QBI.

Netting Section 1231 Gains and Losses

Commenters to the proposed section 199A regulations noted that whether a taxpayer has long-term capital gain or loss under section 1231 is determined at the taxpayer level, and not at the level of the trades or businesses for which QBI is being determined. For example, if a taxpayer has two businesses, the taxpayer may have section 1231 gains in one trade or business and section 1231 losses in the other trade or business. The taxpayer nets all his or her section 1231 gains and losses from multiple trades or businesses to determine their ultimate character. The preamble to the final regulations states that this does not change in the context of section 199A.

For purposes of calculating QBI, taxpayers must net their section 1231 gains and losses from their multiple trades or businesses to determine whether they have excess gain (which characterizes all the gain or loss as capital and is excluded from QBI) or excess loss (which characterizes all the gain or loss as ordinary and is included in QBI). The character determined at the individual level is applied to the trade or business that disposed of the asset.

Figure 1.5 summarizes the tax treatment of section 1231 gains and losses.

FIGURE 1.5 Treatment of Section 1231 Gains and Losses

Net gains from casualties, thefts, and involuntary conversions combined with gains or losses from sales and exchanges	Result is net gain	Capital gain (unless recaptured); not QBI
	Result is net loss	Ordinary deduction; may be QBI*
Net losses from casualties, thefts, and involuntary conversions		Ordinary deduction; may be QBI*

* The item must be with respect to a qualified US trade or business.

Recapture

Under the I.R.C. § 1231(c) recapture rule, a taxpayer that has a section 1231 capital gain in the current year must look back to any section 1231 ordinary loss taken in the previous 5 years and convert a portion of the current-year section 1231 capital gain to ordinary gain, based on the previous losses taken. The preamble to the final section 199A regulations states that for purposes of determining whether ordinary income is included in QBI, taxpayers must apply the section 1231(c) recapture rules in the same manner as they would otherwise. Amounts recaptured as ordinary gain may be included in QBI.

PRACTITIONER NOTE

Other Ordinary Income

Items treated as ordinary income, such as gain under I.R.C. §§ 475, 1245, and 1250, may be included in QBI.

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LIMITATIONS ON THE QBI DEDUCTION The taxable income limit and the W-2 wage and capital limit may reduce the QBI deduction.

The following three limitations may reduce the QBI deduction:

1. Taxable income limit [I.R.C. § 199A(a)(2)]
2. W-2 wage and capital limit [I.R.C. § 199A (b)(2)(B)]
3. Specified service trade or business (SSTB) limit [I.R.C. § 199A(d)(2)]

This section discusses the taxable income limit and the W-2 wage and capital limit. See the "Qualified Business Income Deduction: Specified Service Trades or Businesses" chapter for a detailed discussion of the SSTB limit.

Taxable Income Limit

The QBI deduction is limited to the lesser of 20% of QBI or 20% of the taxpayer's taxable income before the QBI deduction. Taxable income excludes any net capital gain. Net capital gain is any long-term capital gain, unrecaptured I.R.C. § 1250 gain, collectibles gain, I.R.C. § 1202 gain, and qualified dividends [Treas. Reg. § 1.199A(b)(3)].

Example 1.4 Effect of Capital Gains on QBI Deduction

The facts are the same as in Example 1.3, except that Lester's $40,000 of other income consisted entirely of capital gains and qualified dividends. **Figure 1.6** shows Lester's 2019 taxable income.

FIGURE 1.6 Lester's 2019 Taxable Income

Income from music store	$140,000
Capital gains and qualified dividends	40,000
SE tax deduction*	(9,891)
SE health insurance deduction	(5,000)
AGI	$165,109
Standard deduction	(12,200)
Taxable income before QBI deduction	$152,909

* $140,000 × 0.9235 = $129,290 × 0.153 = $19,781 × 50%

Lester's taxable income is less than the 2019 threshold, and he is not subject to the W-2 wage and capital limit. He calculates his QBI deduction as shown in **Figure 1.7.**

FIGURE 1.7 Lester's 2019 QBI Deduction

Income from music store	$140,000
Less SE tax deduction	(9,891)
Less SE health insurance deduction	(5,000)
Net QBI	$125,109
Tentative QBI deduction ($125,109 × 20%)	$ 25,022
Taxable income limitation ($112,909* × 20%)	$ 22,582
QBI deduction (lesser of tentative deduction or taxable income limitation)	$ 22,582

* $152,909 (Figure 1.6 taxable income) – $40,000 capital gains and qualified dividends

Lester's $25,022 tentative QBI deduction exceeds $22,582, which is 20% of his taxable income, less net capital gains. Lester's QBI deduction is limited to $22,582.

PRACTITIONER NOTE

Net Capital Gains

For purposes of calculating the taxable income limit, taxable income does not include net capital gains. However, for purposes of calculating taxable income to determine whether income exceeds the threshold or the phasein range (discussed below), taxable income includes net capital gains.

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W-2 Wage and Capital Limit

The QBI deduction is limited to the greater of

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

[I.R.C. § 199A(b)(2)]

This W-2 wage and capital limit fully applies to taxpayers above the phasein range. It does not apply to taxpayers whose income is below the phasein range, and it partially applies to taxpayers within the phasein range [I.R.C. § 199A(b)(3)]. **Figure 1.8** shows the phasein ranges for 2018.

FIGURE 1.8 QBI Phasein Ranges for 2018

	All Except MFJ	MFJ
Threshold	$157,500	$315,000
Phasein range	$157,501–$207,500	$315,001–$415,000
Fully phased in	> $207,500	> $415,000

In tax years beginning after 2018, the threshold amounts are indexed for inflation [I.R.C. § 199A(e)(2)(B)]. **Figure 1.9** shows the 2019 phasein ranges.

FIGURE 1.9 QBI Phasein Ranges for 2019

	Single, HoH	MFJ	MFS
Threshold	$160,700	$321,400	$160,725
Phasein range	$160,701–$210,700	$321,401–$421,400	$160,726–$210,725
Fully phased in	> $210,700	> $421,400	> $210,725

[Rev. Proc. 2018-57, 2018-49 I.R.B. 827]

OBSERVATION

Taxable Income

The taxpayer's taxable income determines whether the taxpayer exceeds the threshold. Taxable income includes income and deductions of the taxpayer and his or her spouse (if filing a joint return). In some cases, business income may exceed the threshold, but the taxpayer's other deductions can reduce taxable income below the threshold.

Figure 1.10 shows the Joint Committee on Taxation's projection that 95.1% of taxpayers who will claim the QBI deduction in 2019 have taxable income that is below the threshold.

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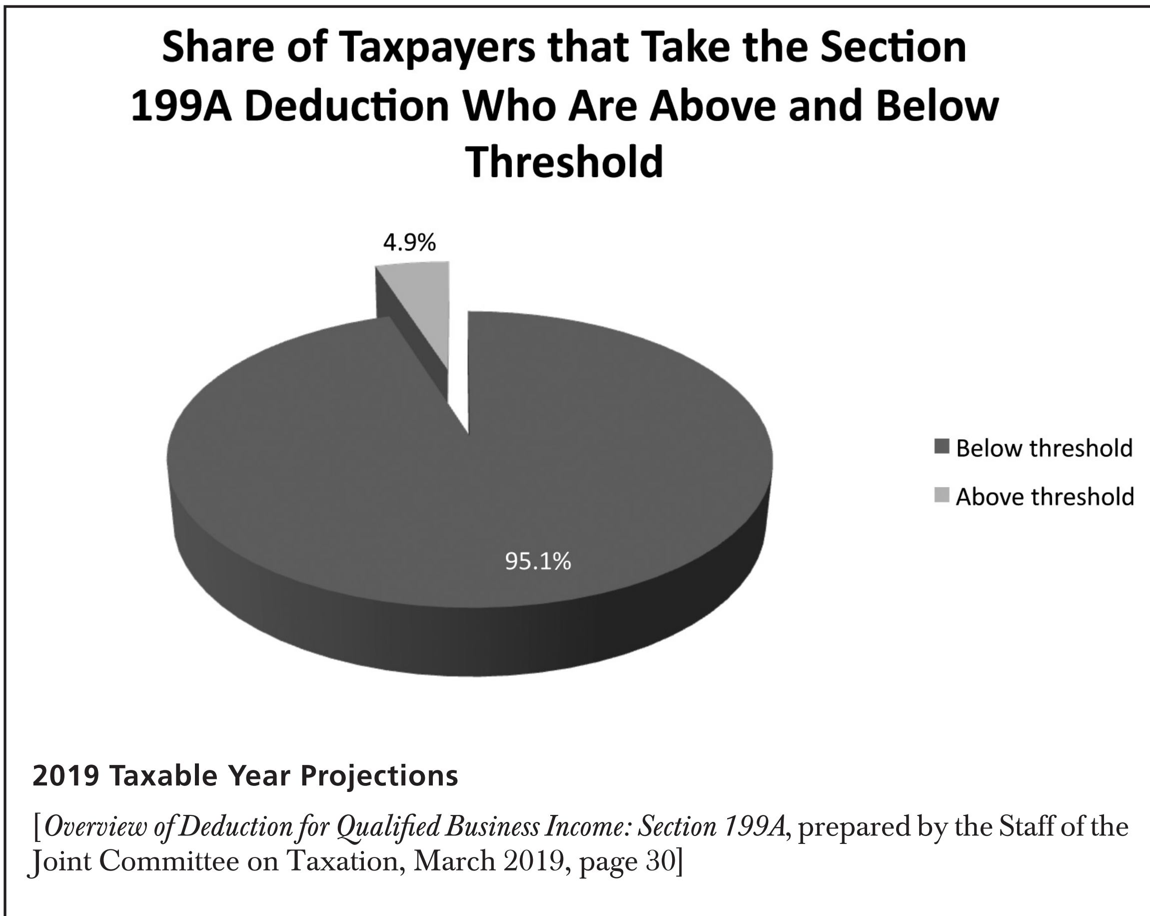
FIGURE 1.10 Taxpayers with Income above and below the Threshold



2019 Taxable Year Projections

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Taxable Income below the Phasein Range

When a taxpayer's taxable income is below the phasein range, the W-2 wage and capital limit does not apply.

Example 1.5 Taxable Income below the Phasein Range

Milton and Athena Freewater filed a joint return for 2019. They each own a business that is not an SSTB. Milton's business reported $140,000 net income and paid $20,000 in W-2 wages for 2019. Athena's business had $160,000 net income, and her business paid $60,000 in W-2 wages. Milton's business had UBIA of $220,000 at the end of the year, and Athena's business had $400,000 of UBIA. Neither spouse is subject to SE tax. Their only other income is $80,000 wages. Their itemized deductions for the year are $60,000.

Milton and Athena's 2019 taxable income is shown in **Figure 1.11**.

FIGURE 1.11 Milton and Athena's 2019 Taxable Income—without the QBI Deduction

Wage and salary income	$ 80,000
QBI ($140,000 + $160,000)	300,000
AGI	$380,000
Itemized deductions	(60,000)
Taxable income before the QBI deduction	$320,000

Milton's QBI deduction is $28,000 (20% × $140,000). Athena's QBI deduction is $32,000 (20% × $160,000). The W-2 wage and capital limit does not apply because their taxable income is below the phasein range. Their combined QBI deduction is $60,000 ($28,000 + $32,000), which does not exceed the $64,000 taxable income limit ($320,000 × 20%).

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Milton and Athena's taxable income is calculated in **Figure 1.12**.

FIGURE 1.12 Milton and Athena's 2019 Taxable Income—with the QBI Deduction

AGI	$380,000
Itemized deductions	(60,000)
Taxable income before QBI deduction	$320,000
QBI deduction	(60,000)
Taxable income	$260,000

Figure 1.13 shows Milton and Athena's 2019 Form 8995, Qualified Business Income Deduction Simplified Computation.

FIGURE 1.13 Form 8995 for Milton and Athena Freewater

Form **8995**

Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction Simplified Computation

▶ Attach to your tax return.

▶ Go to *www.irs.gov/Form8995* for instructions and the latest information.

OMB No. XXXX-XXXX

2019

Attachment Sequence No. XX

DRAFT AS OF February 13, 2019 DO NOT FILE

Name(s) shown on return	Your taxpayer identification number
Milton and Athena Freewater	aaa-bb-cccc

1	(a) Trade or business name	(b) Taxpayer identification number	(c) Qualified business income or (loss)
i	Milton's Business	xx-xxxxxx	$140,000
ii	Athena's Business	yy-yyyyyyy	160,000
iii			
iv			
v			

Line	Description				
2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2	300,000		
3	Qualified business net (loss) carryforward from the prior year	3	(0)		
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4	300,000		
5	Qualified business income component. Multiply line 4 by 20% (0.20)			5	60,000
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6	0		
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7	(0)		
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8	0		
9	REIT and PTP component. Multiply line 8 by 20% (0.20)			9	0
10	Qualified business income deduction before the income limitation. Add lines 5 and 9			10	60,000
11	Taxable income before qualified business income deduction	11	320,000		
12	Net capital gain (see instructions)	12	0		
13	Subtract line 12 from line 11. If zero or less, enter -0-	13	320,000		
14	Income limitation. Multiply line 13 by 20% (0.20)			14	64,000
15	Qualified business income deduction. Enter the lesser of line 10 or line 14. Also enter this amount on the applicable line of your return ▶			15	60,000
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-			16	(0)
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-			17	(0)

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Taxable Income above the Phasein Range

When a taxpayer's taxable income is above the phasein range, the W-2 wage and capital limit applies in full.

Planning Pointer

Grouping Activities

The W-2 wage limit applies to each separate trade or business. In certain circumstances, taxpayers may want to combine activities into a single trade or business if one of the activities has W-2 wages or qualified property and the other does not. The rules for aggregation of businesses are discussed later.

Example 1.6 Above the Phasein Range—Wages

Marta Almas does business as a sole proprietorship. She conducts a dress-making business using rented equipment. The business had two employees in 2019 and paid $100,000 in wages. In 2019, the business had $400,000 net income after the addition of one-half SE tax. Marta's taxable income was above the phasein range, and the W-2 wage and capital limit applies in full. Marta's tentative QBI deduction is $80,000 ($400,000 × 20%). However, the deduction is limited to $50,000, which is the greater of

1. $50,000 [$100,000 W-2 wages × 50%], or
2. $25,000 [($100,000 W-2 wages × 25%) + ($0 UBIA of qualified property × 2.5%)].

Example 1.7 Above the Phasein Range—Wages and UBIA

The facts are the same as in Example 1.6, except that Marta's business bought dress-making equipment for $1,500,000 and placed it in service in 2019. Marta's QBI deduction is limited to $62,500, which is the greater of

1. $50,000 [$100,000 W-2 wages × 50%], or
2. $62,500 [($100,000 W-2 wages × 25%) + ($1,500,000 UBIA of qualified property × 2.5%)].

Example 1.8 Above the Phasein Range—Joint Filers

The facts are the same as in Example 1.5, except that Milton and Athena's wage income is $190,000. Milton and Athena's 2019 taxable income is shown in **Figure 1.14**.

FIGURE 1.14 Milton and Athena's 2019 Taxable Income—without the QBI Deduction

Wage and salary income	$190,000
QBI ($140,000 + $160,000)	300,000
AGI	$490,000
Itemized deductions	(60,000)
Taxable income before the QBI deduction	$430,000

Milton's tentative QBI deduction is $28,000 ($140,000 × 20%). His deduction is limited to $10,500, which is the greater of

1. $10,000 [$20,000 W-2 wages × 50%], or
2. $10,500 [($20,000 W-2 wages × 25%) + ($220,000 UBIA × 2.5%)].

Athena's tentative QBI deduction is $32,000 ($160,000 × 20%). Her deduction is limited to $30,000, which is the greater of

1. $30,000 [$60,000 W-2 wages × 50%], or
2. $25,500 [($62,000 W-2 wages × 25%) + ($400,000 UBIA × 2.5%)].

Their $40,500 ($10,500 + $30,000) combined QBI deduction does not exceed the $86,000 ($430,000 × 20%) taxable income limit. Milton and Athena's taxable income is calculated in **Figure 1.15**.

FIGURE 1.15 Milton and Athena's 2019 Taxable Income—with the QBI Deduction

AGI	$490,000
Itemized deductions	(60,000)
Taxable income before the QBI deduction	$430,000
QBI deduction	(40,500)
Taxable income	$389,500

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Taxable Income within the Phasein Range

When taxable income exceeds the threshold but is still within the phasein range, the W-2 wage and capital limit applies proportionately [I.R.C. § 199A(b)(3)(B)(i) and (ii)]. If income is within the phasein range, taxpayers must calculate the disallowance percentage using the following calculations:

- MFJ [(taxable income – $321,400 threshold for 2019) ÷ $100,000]
- MFS [(taxable income – $160,725 threshold for 2019) ÷ $50,000]
- Single/HoH [(taxable income – $160,700 threshold for 2019) ÷ $50,000]

To determine the reduction in the QBI deduction, the disallowance percentage is applied to the difference between the deduction without the W-2 wage and capital limit and the deduction with the limit.

Example 1.9 Taxable Income in the Phasein Range

The facts are the same as in Example 1.8 except that Milton and Athena's combined wage income is $144,400. **Figure 1.16** shows their 2019 taxable income before the QBI deduction.

FIGURE 1.16 Milton and Athena's 2019 Taxable Income—without the QBI Deduction

Wage and salary income	$144,400
QBI ($140,000 + $160,000)	300,000
AGI	$444,400
Itemized deductions	(60,000)
Taxable income before the QBI deduction	$384,400

Their taxable income (before the QBI deduction) is within the phasein range. Accordingly, the W-2 wage and capital limit is proportionately phased in. Milton and Athena calculate the disallowance percentage as 63% [($384,400 – $321,400) ÷ $100,000]. Stated differently, Milton and Athena are 63% through the $100,000 phasein range because their taxable income exceeds the threshold amount by $63,000.

As in Example 1.8, Milton's tentative QBI deduction is $28,000 and the W-2 wage and capital limit limits his deduction to $10,500. His deduction without the limit exceeds his deduction with the limit by $17,500 ($28,000 – $10,500), which is the excess amount. The reduction amount is $11,025 (63% of the $17,500 excess amount). Milton can deduct $6,475 ($17,500 – $11,025) of the excess amount. Milton can claim the $10,500 deduction (as limited by the wage and capital limit). His total deduction is $16,975 ($6,475 + $10,500).

As in Example 1.8, Athena's tentative QBI deduction is $32,000, and the W-2 wage and capital limit limits her deduction to $30,000. Her deduction without the limit exceeds her deduction with the limit by $2,000 ($32,000 – $30,000), which is the excess amount. The reduction amount is $1,260 (63% of the $2,000 excess amount). Athena can deduct $740 ($2,000 – $1,260) of the excess amount. Athena can claim the $30,000 deduction (as limited by the wage and capital limit). Her total deduction is $30,740 ($740 + $30,000).

Milton and Athena have a $47,715 ($16,975 + $30,740) combined QBI deduction. Because the deduction does not exceed their $76,880 ($384,400 × 20%) taxable income limit, they can claim the full $47,715.

Milton and Athena's 2019 taxable income is calculated in **Figure 1.17**.

FIGURE 1.17 Milton and Athena's 2019 Taxable Income—with the QBI Deduction

AGI	$444,400
Itemized deductions	(60,000)
Taxable income before the QBI deduction	$384,400
QBI deduction	(47,715)
Taxable income	$336,685

Figure 1.18 shows Milton and Athena's 2019 Form 8995-A, Qualified Business Income Deduction.

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FIGURE 1.18 Milton and Athena's 2019 Form 8995-A

Form **8995-A** Department of the Treasury Internal Revenue Service

Qualified Business Income Deduction

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form8995A* for instructions and the latest information.

OMB No. XXXX-XXXX
2019
Attachment Sequence No. **55A**

Name(s) shown on return	Your taxpayer identification number
Milton and Athena Freewater	aaa-bb-cccc

Part I Trade, Business, or Aggregation Information

Complete Schedule A, B, C, and/or D, as applicable, before starting Part I. Attach additional worksheets when needed. See instructions.

1	(a) Trade, business, or aggregation name	(b) Check if specified service	(c) Check if aggregation	(d) Taxpayer identification number	(e) Check if patron
A	Milton's business	☐	☐	xx-xxxxxxx	☐
B	Athena's business	☐	☐	yy-yyyyyyy	☐
C		☐	☐		☐

DRAFT AS OF April 15, 2019

Part II Determine Your Adjusted Qualified Business Income

			A	B	C
2	Qualified business income from the trade, business, or aggregation. See instructions	2	140,000	160,000	
3	Multiply line 2 by 20% (0.20). If your taxable income is $160,700 or less ($160,725 if married filing separately; $321,400 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3	28,000	32,000	
4	Allocable share of W-2 wages from the trade, business, or aggregation	4	20,000	60,000	
5	Multiply line 4 by 50% (0.50)	5	10,000	30,000	
6	Multiply line 4 by 25% (0.25)	6	5,000	15,000	
7	Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7	220,000	400,000	
8	Multiply line 7 by 2.5% (0.025)	8	5,500	10,000	
9	Add lines 6 and 8	9	10,500	25,000	
10	Enter the greater of line 5 or line 9	10	10,500	30,000	
11	W-2 wage and qualified property limitation. Enter the smaller of line 3 or line 10	11	10,500	30,000	
12	Phased-in reduction. Enter amount from Part III, line 26, if any. See instructions	12	16,975	30,740	
13	Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12	13			
14	Patron reduction. Enter the amount from Schedule D, line 6, if any	14			
15	Qualified business income component. Subtract line 14 from line 13	15	16,975	30,740	
16	Total qualified business income component. Add all amounts reported on line 15 ▶	16	47,715		

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FIGURE 1.18 Milton and Athena's 2019 Form 8995-A (continued)

Form 8995-A (2019) Page **2**

Part III Phased-in Reduction

Complete Part III only if your taxable income is more than $160,700 but not $210,700 ($160,725 and $210,725 if married filing separately; $321,400 and $421,400 if married filing jointly) and line 10 is less than line 3. Otherwise, skip Part III.

Line	Description				A	B	C
17	Enter amounts from line 3			17	28,000	32,000	
18	Enter the amounts from line 10			18	10,500	30,000	
19	Subtract line 18 from line 17			19	17,500	2,000	
20	Taxable income before qualified business income deduction	20	384,400				
21	Threshold. Enter $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly)	21	321,400				
22	Subtract line 21 from line 20	22	63,000				
23	Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	23	100,000				
24	Phase-in percentage. Divide line 22 by line 23	24	63.00 %				
25	Total phase-in reduction. Multiply line 19 by line 24			25	11,025	1,260	
26	Qualified business income after phase-in reduction. Subtract line 25 from line 17. Enter this amount here and on page 1, Part II, line 12, for the corresponding trade or business			26	16,975	30,740	

Part IV Determine Your Qualified Business Income Deduction

Line	Description				
27	Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from Part II, line 16	27	47,715		
28	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss). See instructions	28	0		
29	Qualified REIT dividends and PTP (loss) carryforward from prior years	29	(0)		
30	Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-	30	0		
31	REIT and PTP component. Multiply line 30 by 20% (0.20)	31	0		
32	Qualified business income deduction before the income limitation. Add lines 27 and 31 ▶			32	47,715
33	Taxable income before qualified business income deduction	33	384,400		
34	Net capital gain. See instructions	34	0		
35	Subtract line 34 from line 33. If zero or less, enter -0-			35	384,400
36	Income limitation. Multiply line 35 by 20% (0.20)			36	76,880
37	Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 ▶			37	47,715
38	DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37			38	0
39	Total qualified business income deduction. Add lines 37 and 38 ▶			39	47,715
40	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or greater, enter -0-			40	(0)

Form **8995-A** (2019)

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PRACTITIONER NOTE

Understatement Penalty

Generally, for individual taxpayers there is a substantial understatement penalty when the understatement exceeds the greater of $5,000 or 10% of the correct tax for the year [I.R.C. § 6662(d)(1)(A)]. However, for a taxpayer claiming the QBI deduction, the 10% threshold is reduced to 5% [I.R.C. § 6662(d)(1)(C)]. The penalty rate is 20% of the underpayment that is attributable to the substantial understatement [I.R.C. § 6662(a)]. The reduction of the underpayment threshold applies to any taxpayer claiming the QBI deduction. The understatement does not have to be caused by the QBI deduction but could be caused by any overstated deduction or understated income.

Definition of W-2 Wages

For purposes of the W-2 wage and capital limit, W-2 wages include the following:

- Wages as defined in I.R.C. § 3401(a)
- Elective deferrals as defined in I.R.C. § 402(g)(3)
- Compensation deferred under I.R.C. § 457
- Designated Roth contributions as defined in I.R.C. § 402A

[Treas. Reg. § 1.199A-2(b)(2)(i)]

Wages paid in Puerto Rico also qualify [I.R.C. § 199A(f)(1)(C)(ii)].

Items That Are Not Included

W-2 wages do not include any amount that is not properly allocable to QBI. They also do not include any amount that is not properly included in a return filed with the Social Security Administration on or before the sixtieth day after the due date (including extensions) for such return. Special rules apply to corrected W-2s.

Guaranteed payments to partners are not reported on Form W-2. Instead, these payments are reported on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc. Therefore, guaranteed payments are not included in the definition of W-2 wages.

Example 1.10 Partnership and S Corporation Compensation

Tom Taylor and Chris Clayton are equal owners of TSI, LLC, a professional education firm. TSI provides several seminars each year on software for quality control in manufacturing businesses. Tom is the speaker at several of these seminars, but most of the seminars are conducted by outside speakers that TSI hires as independent contractors. TSI rents all the equipment that it uses to conduct its business. In 2018, TSI's net income was $200,000.

Tom and Chris both have other full-time businesses. Tom is a quality control engineer and Chris is a software designer. Each has taxable income above the phasein range, and the W-2 wage and capital limit applies in full to both Tom and Chris. If Tom and Chris operate TSI as a partnership, neither owner can claim a QBI deduction because there are no W-2 wages and no qualified property.

To claim the QBI deduction, Tom and Chris could

- have TSI characterize the outside speakers as employees and pay them W-2 wages,
- elect to have TSI be taxed as an S corporation and pay Tom and Chris W-2 wages, or
- have TSI purchase the property that it uses for its seminars.

CROSS-REFERENCE

Choice of Entity

See pages 474–480 in the *2018 National Income Tax Workbook* for a discussion of how the choice of business entity can increase or reduce the QBI deduction.

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Leased Employees

In some cases, wages may be paid by a person other than the common law employer. Examples include the following:

- Common paymasters [I.R.C. § 3511]
- Professional employer organizations [I.R.C. § 7705]
- Statutory employers [I.R.C. § 3401(d)(1)]
- Agents [I.R.C. § 3504]

In determining W-2 wages, an individual or pass-through entity can include W-2 wages paid by another person and reported by the other person on Forms W-2 listing the other person as the employer. The W-2 wages must be paid to common law employees or officers of the individual or pass-through entity for employment by the individual or pass-through entity. The person paying the W-2 wages and reporting the W-2 wages on Forms W-2 cannot include those wages for purposes of determining his or her own W-2 wages [Treas. Reg. § 1.199A-2(b)(2)(ii)].

Example 1.11 Common Paymaster and W-2 Wages

Alfredo Battista is a shareholder-employee in two S corporations, Anchor and Boat. In 2019, Alfredo earned $90,000 wages from Anchor Corporation and $80,000 wages from Boat Corporation. Anchor and Boat have a common paymaster arrangement under which Boat pays all the salaries directly to Alfredo, and Anchor reimburses Boat for its portion of the wages and payroll taxes. Alfredo receives Form W-2 from Boat reporting $170,000 of wages for the year. However, Anchor includes $90,000 in its own W-2 wages and Boat includes $80,000 in its W-2 wages for purposes of section 199A.

Example 1.12 Professional Employer Organization

Pal Corporation, an S corporation, is a retailer with several locations in two states. Pal Corporation has approximately 150 employees. Pal engages CPEO, Inc., a certified professional employer organization to act as the employer organization on behalf of all 150 employees. In 2019, CPEO filed Forms W-2 that reported $300,000,000 of wages paid in 2018. CPEO paid $50,000,000 of these wages to persons working at Pal locations, under direction of Pal management. Pal, and not CPEO, is the common-law employer of these persons for purposes of section 199A. Therefore, Pal claims $50,000,000 of W-2 wages for 2018. CPEO cannot treat the same $50,000,000 of wages as part of its own W-2 wages.

CROSS-REFERENCE

Professional Employer Organizations

See pages 77–81 in the *2018 National Income Tax Workbook* for a discussion of professional employer organizations.

Allocation of Wages to QBI

W-2 wages include only wages allocable to QBI [I.R.C. § 199A(b)(4)(B)]. Wages allocable to foreign source income or to investment income that does not constitute trade or business income are not included in W-2 wages for purposes of the QBI deduction.

A proprietor or relevant pass-through entity (RPE) that conducts multiple activities in the year must determine the W-2 wages paid with respect to a trade or business that are properly allocable to QBI.

PRACTITIONER NOTE

RPE

Relevant pass-through entity (RPE) means a partnership [other than a publicly traded partnership (PTP)] or an S corporation that is 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.

The section 199A regulations provide the following three-step process to allocate wages:

1. Determine the total W-2 wages paid and properly reported for the year.

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2. Allocate the wages to different trades or businesses.
3. Determine the amount of wages that are allocable to the QBI of each trade or business.

[Treas. Reg. § 1.199A-2(b)(1)].

Step 1. Determine Total W-2 Wages

Rev. Proc. 2019-11, 2019-09 I.R.B. 742, provides three methods for determining W-2 wages. The taxpayer must calculate W-2 wages using one of the following methods:

- The *unmodified box method* takes the lesser of the total entries on Form W-2, box 1 (all wages); or the total entries on Form W-2, box 5 (Medicare wages) [Rev. Proc. 2019-11, § 5.01].
- The *modified box 1 method* starts with the total entries on Form W-2, box 1. The employer must subtract from the box 1 total any amounts that are not wages for federal income tax withholding purposes, such as supplemental unemployment benefits. The employer then adds the total amounts reported in box 12 under codes D [elective 401(k) deferrals], E [elective 403(b) deferrals], F [elective 408(k)(6) deferrals], G [elective 457(b) deferrals], and S [section 408(p) SIMPLE plan salary reductions] [Rev. Proc. 2019-11, § 5.02].
- The *tracking wages method* requires actual tracking of wages paid. The employer totals the wages subject to federal income tax withholding that are paid to the taxpayer's employees for employment by the taxpayer and that are reported on Forms W-2 filed with the SSA. The employer then adds amounts reported in box 12 under codes D [elective 401(k) deferrals], E [elective 403(b) deferrals], F [elective 408(k)(6) deferrals], G [elective 457(b) deferrals], and S [section 408(p) SIMPLE plan salary reductions] [Rev. Proc. 2019-11, § 5.03].

PRACTITIONER NOTE

Health Insurance Premiums

Health insurance premiums paid by an S corporation on behalf of an employee who owns more than 2% of the corporation's shares must be treated as W-2 wages for the shareholder-employee [Rev. Rul. 91-26, 1991-1 C.B. 184]. However, these premiums are generally not subject to employment taxes [IRS Announcement 92-16, 1992-5 I.R.B. 53]. The unmodified box method does not treat shareholder-employee health premiums as W-2 wages, because this amount is included in box 1, but not box 5.

Step 2. Allocate Wages to Trades or Businesses

After calculating total W-2 wages for a tax year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W-2 wages must be allocated to the trade or business that generated those wages. If W-2 wages are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under Treas. Reg. § 1.199A-3(b)(5).

Under Treas. Reg. § 1.199A-3(b)(5), if an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances. The individual or RPE may use a different reasonable method for different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one tax year to another and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all facts and circumstances. The books and records maintained for a trade or business must be consistent with the allocations.

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Step 3. Allocation of Wages to QBI

After determining W-2 wages for each trade or business, each individual or RPE must identify the amount of W-2 wages properly allocable to QBI for each trade or business (or aggregated trade or business). W-2 wages are properly allocable to QBI if the associated wage expense is included in the calculation of QBI under Treas. Reg. § 1.199A-3. An RPE must allocate and report the wage expense and the associated W-2 wages to the partners or shareholders of the RPE.

UBIA of Qualified Property

As discussed earlier, the W-2 wage and capital limitation limits the QBI deduction to the greater of

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

[I.R.C. § 199A(b)(2)]

Qualified Property

I.R.C. § 199A(b)(6) defines *qualified property* as tangible and depreciable property that is held by, and available for use in, the qualified trade or business at the close of the tax year; and is used in the production of QBI. The depreciable period (defined later) must not have expired at the end of the individual or RPE's tax year [Treas. Reg. § 1.199A-2(c)(1)(i)].

PRACTITIONER NOTE

Property Excluded from UBIA

Because land is not depreciable, it does not constitute qualified property. Patents and other intangible property, including goodwill, are also not qualified property.

The property must be held and available for use at the end of the year [I.R.C. § 199A(b)(6)(A)(i)]. Therefore, any assets sold before the end of the year are not qualified property, even if they were used for production of QBI. Recently acquired property must be placed into service and must have been in use before the end of the year [Treas. Reg. § 1.199A-2(c)(1)(i)(B)].

However, property acquired within 60 days of the end of the tax year and disposed of within 120 days after acquisition is presumed not to be UBIA unless it was used in the production of QBI for at least 45 days. This presumption is rebuttable if the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the section 199A deduction [Treas. Reg. § 1.199A-2(c)(1)(iv)].

Unadjusted Basis Immediately after Acquisition

The UBIA is the original basis of the qualified property. Depreciation deductions, including section 168 additional first-year depreciation and section 179 expensing, do not reduce the UBIA. However, UBIA does reflect the reduction in basis for the percentage of the individual's or RPE's nonbusiness use of property. Any capitalized improvement to qualified property that has already been place in service is treated as a separate item of qualified property [Treas. Reg. § 1.199A-2(c)(1)(ii)].

The determination of the UBIA of qualified property must be made for each trade or business (or aggregated trade or business) by the individual or RPE that directly conducts the trade or business (or aggregated trade or business). The UBIA of qualified property is presumed to be zero if it is not determined and reported for each trade or business (or aggregated trade or business).

Purchased Assets

For a purchased asset, the UBIA is its original cost under I.R.C. § 1012 [Treas. Reg. § 1.199A-2(c)(3)].

Example 1.13 UBIA of Purchased Property

Greg Hobson purchased a truck for $90,000 on February 21, 2018. He purchased it from a dealership in which he was a 60% partner and was thus unable to claim additional first-year depreciation or section 179 expensing. His regular depreciation deduction in 2018 was $18,000. The truck's UBIA is $90,000. The UBIA will remain the same

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until the earlier of the date that Greg disposes of the truck or the end of its depreciable period (discussed later).

Property Acquired from a Decedent

The UBIA of qualified property acquired from a decedent and immediately placed in service is generally the I.R.C. § 1014 FMV at the date of the decedent's death [Treas. Reg. § 1.199A-2(c)(3)(v)]. For purposes of this rule only, a new depreciable period for the property starts on the date of the decedent's death.

Nonrecognition Transactions

The final section 199A regulations make several changes in the determination of UBIA of

1. qualified property contributed to a partnership or S corporation in a nonrecognition transaction,
2. qualified property received in a like-kind exchange, and
3. qualified property acquired pursuant to an involuntary conversion.

Generally, UBIA of qualified property remains unadjusted as a result of these three types of transactions.

Contribution to Partnership or S Corporation

If qualified property is contributed to a partnership or S corporation in a nonrecognition transaction, it generally retains its UBIA on the date it was first placed in service by the contributing partner or shareholder. Specifically, Treas. Reg. § 1.199A-2(c)(3)(iv) provides that, solely for the purposes of section 199A, if qualified property is acquired in a transaction described in I.R.C. § 168(i)(7)(B) (certain business nonrecognition transactions and certain transactions between affiliated group members), the transferee's UBIA in the qualified property is the same as the transferor's UBIA in the property, either

1. decreased by the amount of money received by the transferor in the transaction, or
2. increased by the amount of money paid by the transferee to acquire the property in the transaction.

Example 1.14 UBIA after Transfer to S Corporation

Chuck Lin operates a trade or business that is not an SSTB. He operated the business as a sole proprietorship. On January 5, 2011, Chuck purchased equipment for $10,000 and placed it in service in his trade or business. Chuck's basis in the equipment under section 1012 is his $10,000 cost basis. The equipment is qualified property.

The equipment's recovery period under I.R.C. § 168(c) is 10 years, and Chuck depreciates the equipment under the general depreciation system by using the straight-line depreciation method, a 10-year recovery period, and the half-year convention. As of December 31, 2018, Chuck's basis in the equipment, as adjusted for depreciation deductions, is $2,500 ($10,000 cost – $7,500 accumulated depreciation).

On January 1, 2019, Chuck incorporated the sole proprietorship and elected to treat the newly formed entity as an S corporation for federal income tax purposes. Chuck contributed the equipment and all other assets of the trade or business to the S corporation in a nonrecognition transaction under I.R.C. § 351. The S corporation immediately placed all the assets in service.

Chuck's UBIA of the equipment from 2011 through 2018 is its $10,000 cost basis, regardless of any later depreciation deductions and resulting basis adjustments. The S corporation's basis in the equipment is $2,500, the basis of the property under I.R.C. § 362 at the time the S corporation places the property in service. The S corporation's UBIA in the equipment is $10,000, which is Chuck's UBIA in the equipment [Treas. Reg. § 1.199A-2(c)(4), Example 8].

Like-Kind Exchanges and Involuntary Conversions

If property that is qualified property (replacement property) is acquired in a like-kind exchange that qualifies for deferral of gain or loss under I.R.C. § 1031, then the UBIA of such property is the same as the UBIA of the qualified property exchanged (relinquished property). The UBIA of the replacement property is decreased by excess boot or increased by the amount of money paid or the FMV of property not of a like kind to the relinquished property (other property) transferred by the taxpayer to acquire the replacement property

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[Treas. Reg. § 1.199A-2(c)(3)(ii)]. The rule is the same for qualified property acquired pursuant to an involuntary conversion under I.R.C. § 1033.

Example 1.15 UBIA of Property in a Like-Kind Exchange

Edith Bruce owned a nonresidential building that she had placed in service in February 2004. The building had an original cost of $1,000,000. On September 16, 2019, Edith exchanged this building for another building. At the time of the exchange, the original building's adjusted basis was $600,427. Edith paid $350,000 in addition to the relinquished building and acquired a new building with a $1,500,000 FMV. Edith's UBIA in the replacement property is $1,350,000 ($1,000,000 UBIA of the relinquished property + $350,000 paid for the replacement property).

Partnership Basis Adjustments

I.R.C. § 743(b) basis adjustments are treated as qualified property to the extent the adjustment reflects an increase in the FMV of the underlying qualified property. Only these excess section 743(b) basis adjustments are treated as qualified property. Otherwise, basis adjustments under I.R.C. §§ 734(b) and 743(b) are not treated as qualified property [Treas. Reg. § 1.199A-2(a)(3)(iv)]. If the excess section 743(b) basis adjustment is negative, it reduces the partner's UBIA.

Allocating UBIA

For qualified property held by a partnership, each partner's share of the UBIA of qualified property is determined in accordance with how the partnership would allocate depreciation under Treas. Reg. § 1.704-1(b)(2)(iv)(g) on the last day of the tax year. Each S corporation shareholder's share of the UBIA of qualified property is the share of the unadjusted basis 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.

Depreciable Period

The depreciable period of the property must not have ended before the close of the tax year [I.R.C. § 199A(b)(6)(A)(iii)]. In general, the *depreciable period* means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of

1. the date that is 10 years after such date, or
2. the last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of any application of section 168(g) (the alternative depreciation system).

Thus, for property with a MACRS life of more than 10 years, the depreciable period ends with the last year in which there is a full year's MACRS deduction [Treas. Reg. § 1.199A-2(c)(2)(i)(B)]. For other property the depreciable period ends 10 years after the date that the property is placed in service [Treas. Reg. § 1.199A-2(c)(2)(i)(A)].

PRACTITIONER NOTE

Depreciation Schedule

Assets with a MACRS period that is less than 10 years may be fully depreciated and no longer be listed on the depreciation schedule. The tax practitioner will have to add back the unadjusted basis of these assets to calculate the UBIA limit.

Example 1.16 Depreciable Period of Personal Property

Monty Dolan purchased business equipment for $50,000 on July 1, 2018. The depreciable period of this property ends on July 1, 2023. The last year in which the depreciable period has not ended is 2022. Therefore, Monty may claim UBIA on this equipment through December 31, 2027.

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Following section 168(i)(7)(B) nonrecognition transfers, the transferee's depreciable period is the same as the transferor's depreciable period if the transferee's UBIA does not exceed the transferor's UBIA (carryover basis) [Treas. Reg. § 1.199A-2(c)(2)(iv)(A)]. If the transferee's UBIA exceeds the transferor's UBIA at the time of the transfer, such as gain recognized on a transfer to a corporation, the depreciable period of the excess UBIA begins on the date of the transfer [Treas. Reg. § 1.199A-2(c)(2)(iv)(B)].

Example 1.17 Depreciable Period after Contribution to Corporation

Monty from Example 1.16 contributed the purchased equipment to an S corporation on July 1, 2019. The transfer was tax free, and the corporation's basis in the equipment is the same as Monty's. The corporation's depreciable period is the same as Monty's. If Monty had recognized any gain on the transfer, the corporation's depreciable period on the new basis would begin July 1, 2019.

For property received in a like-kind exchange or after an involuntary conversion, to the extent that the basis of the relinquished or involuntarily converted property becomes the basis of the replacement property, the depreciable period of the relinquished or involuntarily converted property becomes the depreciable period of the replacement property [Treas. Reg. § 1.199A-2(c)(2)(iii)(A)(1)]. For any basis in the replacement property that exceeds the basis in the relinquished or involuntarily converted property, the depreciable period begins on the date of the transfer [Treas. Reg. § 1.199A-2(c)(2)(iii)(A)(2)].

Example 1.18 Depreciable Period after Like-Kind Exchange

On January 5, 2012, Ogden Smith purchased qualified real property in Seattle, Washington, for $1,000,000. He placed the property in service in his trade or business on that date. Ogden's trade or business is not an SSTB. Ogden's UBIA in the property was $1,000,000. As of December 31, 2018, Ogden's basis in the Seattle property, as adjusted for depreciation deductions, was $821,550. Ogden's UBIA was still $1,000,000.

On January 15, 2019, Ogden entered into a like-kind exchange to exchange the Seattle property for property in Walla Walla, Washington. At the time of the exchange, his adjusted basis in the Seattle property was $820,482, and the value of the Seattle property had appreciated to $1,300,000. The FMV of the Walla Walla property was $1,500,000, so Ogden paid $200,000 cash for the exchange. Ogden placed the Walla Walla property in service on January 15, 2019.

Ogden's UBIA in the Walla Walla property is $1,200,000, which is the $1,000,000 UBIA from the Seattle property plus the $200,000 cash paid to acquire the Walla Walla property. Because the UBIA of the Walla Walla property exceeds the UBIA of the Seattle property, the Walla Walla property is treated as two separate qualified properties. One property has a UBIA of $1,000,000, and its depreciable period began January 5, 2012. The other property has a UBIA of $200,000, and its depreciable period began January 15, 2019.

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AGGREGATION OF ACTIVITIES

This section explains when a taxpayer can aggregate trades or businesses to increase the QBI deduction.

Usually, a taxpayer with interests in more than one trade or business must separately calculate the QBI deduction for each business [I.R.C. § 199A(b)(1)(A)]. When applying the W-2 wage and capital limit, the W-2 wages and qualified property for one trade or business may not be combined with the wages and qualified property from another trade or business.

The taxpayer can combine separate activities into a single trade or business if, for example, one business has W-2 wages and the other does not (aggregation). The grouping must meet the requirements for aggregation under Treas. Reg. § 1.199A-4. This section discusses the aggregation rules that apply to the QBI component. It then explains when aggregation increases the QBI deduction, and when aggregation may reduce the QBI deduction.

Aggregation Requirements

To qualify for aggregation, the trades or businesses that are aggregated must meet the following three conditions:

1. Each business is not a specified service trade or business.
2. There is a business relationship.
3. There is common ownership.

PRACTITIONER NOTE

Trade or Business

Each activity must be a trade or business. A taxpayer cannot aggregate a trade or business with an investment or a hobby activity. Treas. Reg. § 1.199A-4(d)(13) gives an example of a taxpayer who owns a majority interest in a sailboat racing team and a majority interest in a marina. The sailboat racing team is not a trade or business, and the taxpayer cannot aggregate the racing team with the marina.

Figure 1.19 gives an overview of the aggregation requirements. Each of the requirements is discussed in greater detail later.

Not an SSTB

A taxpayer cannot aggregate an SSTB with any other trade or business [Treas. Reg. § 1.199A-4(b)(1)(iv)]. A taxpayer who owns two or more SSTBs cannot aggregate those businesses.

CROSS-REFERENCE

Commonly Owned Businesses

Certain activities that would not independently be treated as SSTBs may be treated as SSTBs if they provide property or services to other SSTBs and there is greater-than-50% common ownership [Treas. Reg. § 1.199A-5(c)(2)]. See the "Qualified Business Income Deduction: Specified Service Trades or Businesses" chapter for a discussion and examples of this rule.

Business Relationship

There must be a connection between each of the businesses to be aggregated. Each business must share at least two of the following attributes with the others:

1. The businesses must provide products, property, or services that are the same or customarily offered together.
2. The businesses must share the same facilities or business functions, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
3. There must be coordination or interdependence between (or among) the businesses.

[Treas. Reg. § 1.199A-4(b)(1)(v)]

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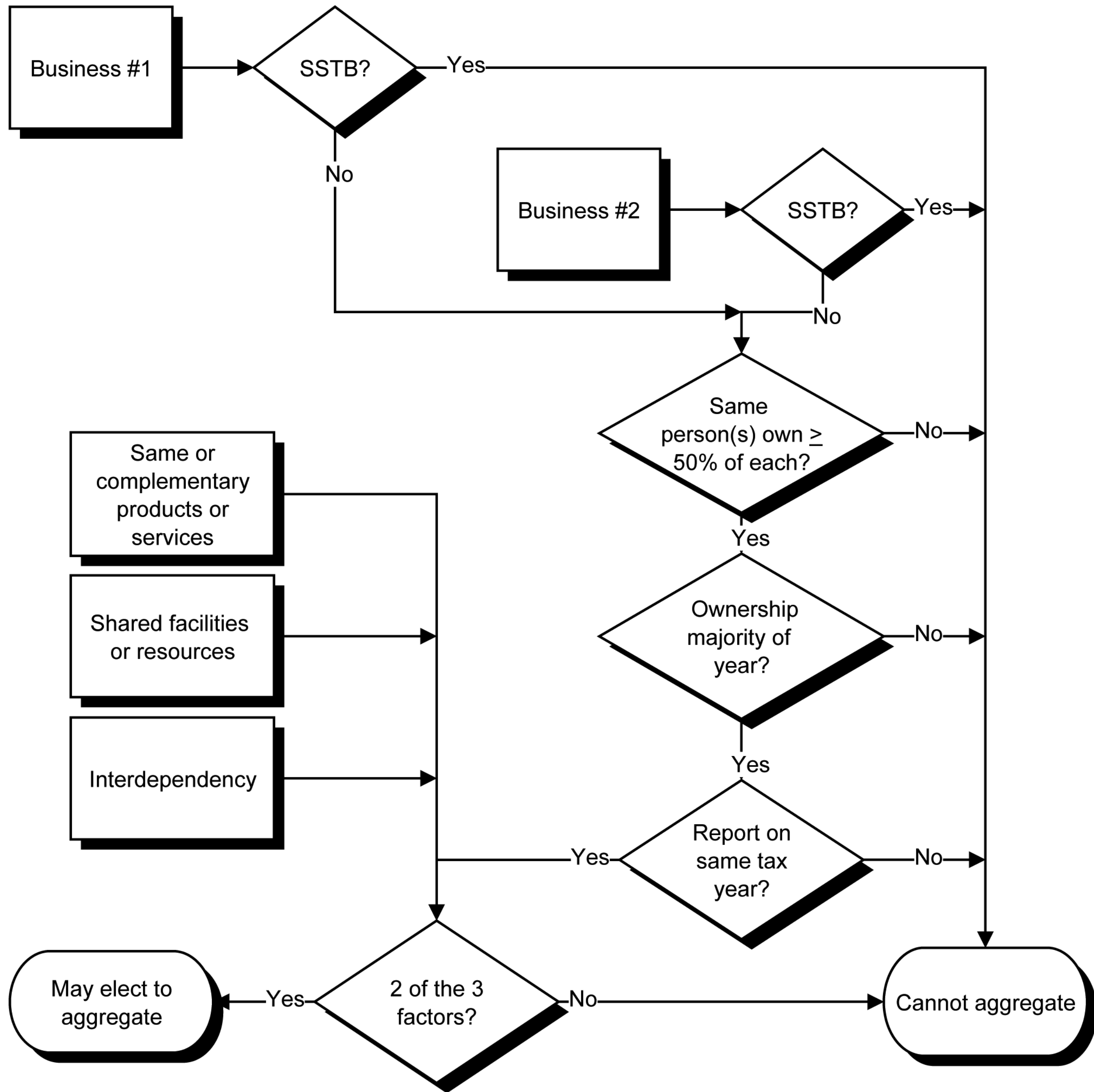
FIGURE 1.19 Aggregation Rules for Section 199A



Example 1.19 Similar Products, Shared Facilities

A restaurant and a catering business are under common ownership. They use the same kitchen. The products are similar, and the two activities share facilities. Therefore, the owners may elect to aggregate these businesses [Treas. Reg. § 1.199A-4(d), Example 1].

Example 1.20 Dissimilar Products, Shared Business Functions

A clothing manufacturer and a pet food business are under common ownership. The products are not similar, but the two activities share common management. Because the shared management is the only business function test that the two businesses satisfy, the owners cannot elect to aggregate these businesses [Treas. Reg. § 1.199A-4(d), Example 3].

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OBSERVATION

Rental Activities

The example in Treas. Reg. § 1.199A-4(d)(17) creates a rule that is not otherwise stated in section 199A or the regulations. The example states that nonresidential real estate rentals and residential real estate rentals are not the same type of property, and they do not provide similar services. In the example, both businesses share significant centralized business elements, but the owner cannot aggregate these activities.

Common Ownership

To aggregate more than one trade or business, a person, or group of persons, must own at least 50% of each trade or business [Treas. Reg. § 1.199A-4(b)(1)(i)]. Incidents of ownership include outright ownership, stock in an S corporation, and a capital or profits interest in a partnership.

Satisfaction of the ownership test extends to all owners of an entity, and not only persons who have a 50% or greater ownership in the entity.

Example 1.21 Ownership for Tax Year

The same eight persons own interests in four partnerships and four S corporations. The ownership percentages are shown in **Figure 1.20**.

FIGURE 1.20 Partnership and S Corporation Ownership

	PS1	PS2	PS3	PS4	SC1	SC2	SC3	SC4
Art Allen	10%	5%	4%	8%	6%	5%	7%	9%
Brenda Bailey	9%	10%	5%	4%	8%	6%	3%	7%
Charlie Carter	7%	9%	10%	5%	4%	8%	6%	9%
Deanna Davis	4%	7%	9%	10%	5%	4%	8%	6%
Earl Edwards	8%	4%	7%	9%	10%	5%	4%	8%
Fiona Floyd	6%	8%	4%	7%	9%	10%	5%	4%
Greg Gordon	12%	6%	8%	4%	7%	9%	10%	5%
Hannah Harris	5%	12%	6%	8%	4%	7%	9%	10%
Total	61%	61%	53%	55%	53%	54%	52%	58%

Although each individual owns a small percentage interest in each entity, each can aggregate any of these entities with any or all the others if they meet the other requirements for aggregation. One individual owner's aggregation election is not binding on the other owners.

PRACTITIONER NOTE

Aggregation Is Irrevocable

The aggregation election is generally binding on all future years, unless circumstances change.

Attribution Rules

For purposes of the ownership test, the I.R.C. §§ 267(b) and 707(b) attribution rules apply [Treas. Reg. § 1.199A-4(b)(1)(i)]. **Figure 1.21** shows the attribution rules.

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FIGURE 1.21 Constructive Ownership Relationships of Sections 267(b) and 707(b)

I.R.C. § 267(b) defines a related party to include the following:	
267(b)(1)	Members of a family, including brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, ancestors beyond grandparents) and lineal descendants (children, grandchildren, lineal descendants beyond grandchildren)—but not nieces, nephews, aunts, uncles, cousins, in-laws, and step-relatives
267(b)(2)	An individual and a corporation in which the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock
267(b)(3)	Two corporations that are members of the same controlled group within the meaning of I.R.C. § 1563(a), substituting "more than 50%" for "at least 80%" and without regard to insurance companies or stock owned by any I.R.C. § 401(a) employees' trust
267(b)(4)	A grantor and a fiduciary of any trust
267(b)(5)	A fiduciary of a trust and fiduciary of another trust if the same person is the grantor of both trusts
267(b)(6)	A fiduciary of a trust and a beneficiary of such trust
267(b)(7)	A fiduciary of a trust and a beneficiary of another trust if the same person is the grantor of both trusts
267(b)(8)	A fiduciary of a trust and a corporation in which the trust or the grantor of the trust owns, directly or indirectly, more than 50% of the value of the outstanding stock
267(b)(9)	A person and an I.R.C. § 501 tax exempt organization that is controlled directly or indirectly by the person, or if the person is an individual, by members of the individual's family
267(b)(10)	A corporation and a partnership if the same persons own more than 50% of the value of the outstanding stock of the corporation and more than 50% of the capital interest or the profits interest in the partnership
267(b)(11)	An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation
267(b)(12)	An S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation
267(b)(13)	An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest
I.R.C. § 267(c) considers both direct and indirect ownership in defining related persons. The I.R.C. § 267(c) constructive ownership rules for purposes of applying section 267(b) include the following:	
267(c)(1)	Stock owned by a corporation, partnership, estate, or trust, directly or indirectly, is deemed owned proportionately by the entity's shareholders, partners, or beneficiaries
267(c)(2)	Stock owned by an individual's family, directly or indirectly, is deemed owned by the individual
267(c)(3)	Stock owned by an individual's partner, directly or indirectly, is deemed owned by the individual if the individual otherwise owns any stock in the corporation (without regard to family attribution).
267(c)(4)	An individual's family includes only his or her brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants
267(c)(5)	Stock constructively owned by a person because of section 267(c)(1) is deemed owned by that person for the purpose of applying section 267(c)(1), (2), or (3), but stock constructively owned by an individual because of section 267(c)(2) or (3) is not deemed owned by the individual to make another person the constructive owner of the same stock under those sections
I.R.C. § 707(b)* relationships include the following:	
707(b)(1)(A)	A partnership and a person owning, directly or indirectly, more than 50% of the capital or profits interest in such partnership
707(b)(1)(B)	Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interest

* I.R.C. § 707(b) takes into account certain direct and indirect ownership in defining related persons [Treas. Reg. § 1.707-1(b)(3)].

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Practitioner Note

Attribution under the Proposed Regulations

The 2018 proposed regulations had narrow constructive ownership rules. An individual was considered to own the interests held by his or her spouse, children, grandchildren, and parents [Prop. Treas. Reg. § 1.199A-4(b)(3)]. There were no other indirect ownership rules and no sibling attribution. Persons relying on the 2018 proposed regulations must follow these rules on their 2018 tax returns.

To meet the ownership test, there must be common ownership for more than one-half of the tax year [Treas. Reg. § 1.199A-4(b)(1)(ii)]. The common ownership must exist on the last day of the tax year.

Example 1.22 Year-End Ownership Required

Jeannie Eagle owned an apartment complex on Main Street for the entire 2019 tax year. At the beginning of 2019 she owned a property management company that was located in the apartment complex and provided management services for the apartments. Jeannie sold the property management company on December 15, 2019. Even if the other requirements for aggregation are met, Jeannie cannot aggregate these activities. She did not own the property management company at the end of the year.

To meet the ownership test for aggregation, all the businesses must have the same tax year, not including short tax years [Treas. Reg. § 1.199A-4(b)(1)(iii)].

Example 1.23 Different Tax Year and Short Tax Year

Sally Taylor, Vic Forrest, and Paula Newton each owned one-third of the High Hills Partnership, which operated a shopping center. They also each owned one-third of the Green Valley Partnership, which operated another shopping center. They each owned one-third of Centers, Inc., an S corporation that managed the two shopping centers. High Hills and Centers, Inc. each used the calendar year for 2019. Green Valley had a fiscal year that ended September 30, 2019.

Each of the three can elect to aggregate the income, W-2 wages, and UBIA of High Hills and Centers, Inc. However, they cannot aggregate Green Valley for 2019, because it did not have the same tax year. If Green Valley changed to the calendar year in 2019, it would be eligible for aggregation in 2020 (assuming it meets the other requirements for aggregation).

Deciding When to Aggregate

Aggregation is beneficial if one of the businesses has more W-2 wages or UBIA than it needs to meet the W-2 wage and capital limitation, and the QBI deduction of the other business is reduced by that limitation. Without excess wages or UBIA, aggregation may reduce the QBI deduction.

Example 1.24 Aggregation Increases QBI Deduction

Alice and Bernie Oliver are married and file a joint return for 2019. Their taxable income is above the phasein range so they are subject to the W-2 wage and capital limit on all their income. They are not subject to the taxable income limit.

Alice and Bernie are the 100% owners of Alice's Restaurant and Bernie's Boutique, both of which are S corporations. The boutique and the restaurant operate from the same facility, and the restaurant owns all the property and equipment. The boutique runs a small gift shop in the restaurant lobby. Restaurant patrons get a discount on the merchandise in the boutique.

Figure 1.22 shows the QBI items for each business.

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FIGURE 1.22 QBI Items

	Alice's Restaurant	Bernie's Boutique
Net income (all QBI)	$1,000,000	$1,000,000
W-2 wages	$ 600,000	$ 150,000
UBIA of qualified property	$3,000,000	$ 0

Figure 1.23 compares the QBI deductions for the restaurant and the boutique as separate trades or businesses, and the deduction if they are aggregated.

FIGURE 1.23 Separate and Aggregated Deductions

	Alice's Restaurant	Bernie's Boutique	Aggregated
Tentative QBI deduction (20% of QBI)	$200,000	$200,000	$400,000
Limits			
50% W-2 wages	$300,000	$ 75,000	$375,000
25% W-2 wages + 2.5% UBIA	$225,000	$ 37,500	$262,500
Greater of (1) or (2) limit	$300,000	$ 75,000	$375,000
QBI deduction [lesser of tentative QBI deduction or (3) limit]	$200,000	$75,000	$375,000
Savings (cost) of aggregation			$100,000

Alice's Restaurant has more W-2 wages than it needs to support a deduction for 20% of its income. The QBI deduction for Bernie's Boutique is reduced by the W-2 wage and capital limitation. Aggregation allows Bernie's Boutique to use the excess W-2 wages and increases the overall QBI deduction by $100,000.

Aggregation is not advantageous in all situations. If one business does not have excess W-2 wages or UBIA of qualified property, aggregation may reduce the QBI deduction.

Example 1.25 Aggregation Reduces QBI Deduction

Conway and Deanna Jenkins are married and file a joint return for 2019. Their taxable income is above the phasein range and they are subject to the W-2 wage and capital limit on all their income. They are not subject to the taxable income limit. Conway and Deanna are the 100% owners of Deanna's Ski Shop, Inc. and the Conway Ski Resort, Inc., both of which are S corporations.

The ski shop and the ski resort operate from the same facility, and the ski resort owns all the property and equipment. The ski shop sells and rents skis and boots for use at the ski resort. Ski resort passholders get a discount on the merchandise in the ski shop.

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Figure 1.24 shows the QBI items for each business.

FIGURE 1.24 QBI Items

	Conway Ski Resort	Deanna's Ski Shop
Net income (all QBI)	$1,000,000	$1,000,000
W-2 wages	$ 0	$ 400,000
UBIA of qualified property	$5,000,000	$ 0

Figure 1.25 compares the QBI deductions for the shop and the resort as separate trades or businesses, and the deduction if they are aggregated.

FIGURE 1.25 Comparison of QBI Deduction

	Conway Ski Resort	Deanna's Ski Shop	Aggregated
Tentative QBI deduction (20% of QBI)	$200,000	$200,000	$400,000
Limits			
50% W-2 wages	$ 0	$200,000	$200,000
25% W-2 wages + 2.5% UBIA	$125,000	$100,000	$225,000
Greater of (1) or (2) limit	$125,000	$200,000	$225,000
QBI deduction [lesser of tentative QBI deduction or (3) limit]	$125,000	$200,000	$225,000
Savings (cost) of aggregation			($100,000)

The ski shop has only enough W-2 wages to avoid a reduction in its QBI deduction. If Conway and Deanna aggregate the two entities, the effect is a loss of 25% of the ski shop's W-2 wages without any offset for the ski resort's UBIA. Aggregation reduces their QBI deduction by $100,000.

OBSERVATION

Aggregation vs. Disaggregation

There is no general rule for determining when aggregation is beneficial. Thus, the tax practitioner will likely have to calculate the QBI deduction for each trade or business separately, and for each grouping of trades or businesses.

RPEs and Aggregation

An RPE can aggregate its activities at the entity level if they meet the requirements for aggregation. The RPE can aggregate trades or businesses that it operates directly. It can also aggregate trades or businesses that it operates through a lower-tier RPE if it is consistent with the aggregation of the lower-tier RPE [Treas. Reg. § 1.199A-4(b)(2)(ii)]. This aggregation at the entity level is binding on all owners.

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Cross-Reference

SSTBs

An RPE may want to separate business activities if one activity is an SSTB and the other is not. See the "Qualified Business Income Deduction: Specified Service Trades or Businesses" chapter for a discussion of a de minimis rule that allows a trade or business to have a de minimis amount of SSTB income, and an antiabuse rule that characterizes the provision of property and services to an SSTB as a separate SSTB.

Example 1.26 Aggregation by RPE

Low Country is a partnership that operates a restaurant and a movie theater. The restaurant and theater operate in the same facility and offer package deals to customers of both businesses. They share centralized accounting, purchasing, human resources, and other management functions. Low Country owned 100% of both businesses throughout 2019. Low Country may aggregate the QBI items of the two businesses [Treas. Reg. § 1.199A-4(d), Example 15].

Once a partnership or S corporation has elected to aggregate its businesses, no partner or shareholder can disaggregate these same businesses. However, any shareholder or partner can elect to aggregate the partnership or S corporation businesses if the entity has not chosen to do so.

Example 1.27 Aggregation of RPE Activities by Members

The facts are the same as in Example 1.26, except that Low Country did not elect to aggregate the theater and restaurant. Any of Low Country's partners can aggregate their interests in these two businesses or keep them separate. The election made by any partner does not affect any other partner.

Any partner who owned a restaurant that shared business functions, such as contractual supplier discounts, with Low County would be able to aggregate its restaurant with the restaurant owned by Low Country. Similarly, any partner who owned a theater that shared business functions with Low Country's theater could also aggregate the interests in the theaters. However, if Low County aggregated its theater and restaurant, no partner could disaggregate these two activities at the owner level [Treas. Reg. § 1.199A-4(d), Example 15].

For an owner to aggregate an outside activity with operations already aggregated by an RPE, the owner's activity must meet the business relationship tests with all the businesses aggregated by the RPE.

Example 1.28 Member's Aggregation of Outside Activity

High Country, a partnership, owns 60% of Low Country (from Examples 1.26 and 1.27). High Country owns a food service business, which shares some of the management and purchasing functions with Low Country's restaurant. If Low Country does not aggregate the restaurant and theater, High Country may aggregate its food service activity with Low Country's restaurant, but not with the theater. If Low Country aggregates the restaurant and the theater, High Country cannot combine its own food service with the aggregated activities [Treas. Reg. § 1.199A-4(d), Example 15].

Consistency and Reporting Requirements

Aggregation reporting and consistency requirements apply to both individual owners and RPEs.

Individual Consistency and Reporting

Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent tax years. However, an individual can add a newly created or newly acquired trade or business to an existing aggregated trade or business if it meets the requirements for aggregation.

In a subsequent year, if there is a significant change in facts and circumstances and an individual's prior aggregation of trades or businesses no

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longer qualifies for aggregation, then the trades or businesses will no longer be aggregated. The individual must determine a new permissible aggregation (if any).

Individual Disclosure

For each tax year, individuals must attach a statement to their returns identifying each aggregated trade or business. The statement must contain the following:

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 tax year
4. Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest
5. Such other information as the IRS may require in forms, instructions, or other published guidance

Form 8995-A provides a schedule to report aggregation information. **Figure 1.26** shows part of the aggregation schedule.

FIGURE 1.26 Form 8995-A Schedule B

Schedule B **Aggregation of Business Operations**

Aggregation 1:

1 Provide a description of the aggregated trade or business and an explanation of the factors met that allow the aggregation in accordance with Regulations section 1.199A-4. In addition, if you hold a direct or indirect interest in a relevant pass-through entity (RPE) that aggregates multiple trades or businesses, you must attach a copy of the RPE's aggregations.

DRAFT AS OF April 15, 2019

2 Has this trade or business aggregation changed from the prior year? This includes changes in the aggregation due to a trade or business being formed, acquired, disposed of, or ceasing operations. If yes, explain.

3	**(a)** Name of trade or business	**(b)** Taxpayer identification number	**(c)** Qualified business income/(loss)	**(d)** W-2 wages	**(e)** UBIA
4	**Totals.** Total columns (c), (d), and (e). Enter the total amounts on Schedule C or on page 1, Part II, for the corresponding aggregation, as appropriate. See instructions				

Aggregation 2:

1 Provide a description of the aggregated trade or business and an explanation of the factors met that allow the aggregation in accordance with Regulations section 1.199A-4.

2 Has this trade or business aggregation changed from the prior year? This includes changes in the aggregation due to a trade or business being formed, acquired, disposed of, or ceasing operations. If yes, explain.

3	**(a)** Name of trade or business	**(b)** Taxpayer identification number	**(c)** Qualified business income/(loss)	**(d)** W-2 wages	**(e)** UBIA
4	**Totals.** Total columns (c), (d), and (e). Enter the total amounts on Schedule C or on page 1, Part II, for the corresponding aggregation, as appropriate. See instructions				

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Individual Failure to Disclose

If an individual fails to attach the required aggregation statement to his or her return, the IRS can disaggregate the individual's trades or businesses. The individual cannot aggregate trades or businesses that the IRS has disaggregated for the subsequent 3 tax years [Treas. Reg. § 1.199A-4(c)(2)(ii)].

RPE Consistency and Reporting

Once an RPE chooses to aggregate two or more trades or businesses, the RPE must consistently report the aggregated trades or businesses in all subsequent tax years. However, an RPE, like an individual, can add a newly created or newly acquired trade or business to an existing aggregated trade or business (other than the aggregated trade or business of a lower-tier RPE) if it meets the aggregation requirements [Treas. Reg. § 1.199A-4(c)(3)].

In a subsequent year, if there is a significant change in facts and circumstances and an RPE's prior aggregation of trades or businesses no longer qualifies for aggregation, then the trades or businesses will no longer be aggregated. The RPE must determine a new permissible aggregation (if any).

RPE Disclosure

For each tax year, RPEs (including each RPE in a tiered structure) must attach a statement to each owner's Schedule K-1 (Form 1120S or Form 1065) identifying each aggregated trade or business. The statement must contain the following:

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 tax 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 IRS may require in forms, instructions, or other published guidance

[Treas. Reg. § 1.199A-4(c)(4)(i)]

RPE Failure to Disclose

If an RPE fails to attach the aggregation statement, the IRS can disaggregate the RPE's trades or businesses. The RPE cannot aggregate trades or businesses that are disaggregated by the IRS for the subsequent 3 tax years.

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QUALIFIED BUSINESS LOSS A QBI loss will offset other QBI income, and a net loss will carry forward.

Under Treas. Reg. § 1.199A-1(d)(2)(iii)(A), if an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. The adjusted QBI is then used to apply the W-2 wage and capital limit. The W-2 wages and UBIA of qualified property from the trades or businesses that produced net negative QBI are not taken into account and are not carried over to the subsequent year.

If the total QBI amount is less than zero, the portion of the individual's section 199A deduction related to QBI is zero for the tax year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding tax years.

Current-Year Qualified Business Loss

A loss from a qualified business offsets income from other qualified businesses.

- If the overall QBI is positive, it reduces the QBI from each other business proportionately [Treas. Reg. § 1.199A-1(d)(2)(iii)(A)].
- If the overall QBI is negative, the QBI component is zero, and the negative amount is a carryforward, which offsets QBI in future years [Treas. Reg. § 1.199A-1(d)(2)(iii)(B)].

Example 1.29 Loss from Qualified Business

Sam Calloway is a single taxpayer with salary income and interests in three businesses that are not SSTBs. In 2019, Sam had $150,200 salary income. Sam also operates a golf course, a restaurant, and a clothing boutique. The businesses are all unrelated and cannot be aggregated. In 2019, Sam's QBI from the golf course was $150,000, and his share of the W-2 wages was $40,000. His QBI from the restaurant was $150,000, and his share of the W-2 wages was $30,000. He had a $20,000 QBI loss from the clothing boutique, and his share of the W-2 wages was $20,000. The three businesses lease their property and equipment and had no qualified property. Sam's taxable income is shown in **Figure 1.27**.

FIGURE 1.27 Sam's 2019 Taxable Income (QBI Loss)

Salary income	$150,200
QBI ($150,000 + $150,000 – $20,000)	280,000
AGI	$430,200
Standard deduction	(12,200)
Taxable income before the QBI deduction	$418,000

Sam must reduce his QBI from the golf course and the restaurant businesses by the QBI loss from the boutique. As his QBI from each business was the same, Sam allocates the $20,000 QBI loss to the businesses in equal shares. Thus, his QBI from each business is $140,000 ($150,000 – $10,000). Sam's tentative QBI deduction for each business is $28,000 ($140,000 × 20%).

Sam's QBI deduction for the golf course business is limited to the lesser of $28,000 or $20,000 ($40,000 W-2 wages × 50%). Sam's QBI deduction for the restaurant is limited to the lesser of $28,000 or $15,000 ($30,000 W-2 wages × 50%). Sam's total QBI deduction is $35,000 ($20,000 + $15,000). Sam cannot use the W-2 wages of the boutique to increase his QBI deduction. The combined QBI deduction is less than 20% of his taxable income ($83,600), and he can claim the full $35,000 deduction.

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Sam calculates his taxable income as shown in **Figure 1.28**.

FIGURE 1.28 Sam's Taxable Income (QBI Loss)

AGI	$430,200
Standard deduction	(12,200)
Taxable income before the QBI deduction	$418,000
QBI deduction	(35,000)
Taxable income	$383,000

When the overall result of the QBI rules is negative QBI, the negative amount carries forward and offsets future QBI [I.R.C. § 199A(c)(2)].

Example 1.30 QBI Loss Carryover

The facts are the same as in Example 1.29, except that his share of the boutique loss is $400,000. This loss exceeds the combined income from the other qualified businesses. Sam's 2019 taxable income is shown in **Figure 1.29**.

FIGURE 1.29 Sam's 2019 Taxable Income (QBI Loss Carryover)

Salary income	$150,200
QBI ($150,000 + $150,000 – $400,000)	(100,000)
AGI	$ 50,200
Standard deduction	(12,200)
Taxable income	$ 38,000

Because there is no QBI, there is no QBI deduction for 2019. The negative combined QBI of $100,000 carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next tax year. However, for income tax purposes, the $100,000 loss may offset Sam's $150,200 of salary income.

Figure 1.30 shows the Loss Netting and Carryforward schedule from Form 8995-A.

FIGURE 1.30 Form 8995-A Schedule C

Schedule C **Loss Netting and Carryfoward**

1	Trade, business, or aggregation name	(a) Qualified business income/(loss)	(b) Reduction for loss netting (see instructions)	(c) Adjusted qualified business income (Combine (a) and (b). If zero or less, enter -0-.)

2	Qualified business net (loss) carryforward from prior years. See instructions	2	( )
3	Total trade or business losses. Combine the negative amounts on lines 1, column (a), and 2 for all trades or businesses	3	( )
4	Total trade or business income. Add the positive amounts on line 1, column (a), for all trades or businesses	4	
5	Losses netted with income of other trades or businesses. Enter in the parentheses on line 5 the smaller of the absolute value of line 3 or line 4. Allocate this amount to each trade or business on line 1, column (b). See instructions	5	( )
6	Qualified business net (loss) carryfoward. Subtract line 5 from line 3. If zero or more, enter -0- . . .	6	( )

DRAFT AS OF April 15, 2019

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Effect of Aggregation on Income and Losses

Aggregation or disaggregation may have no effect on the overall QBI deduction when one or more of the businesses has income and one or more has losses. Losses must offset gains, regardless of whether the taxpayer elects to aggregate the activities. However, an aggregation election can allow inclusion of the W-2 wages and UBIA of qualified property of the loss business for purposes of calculating the W-2 wage and capital limit.

Example 1.31 Income and Loss without Aggregation

Tiffani Hoffer owns 100% of three S corporations, Alpha, Inc.; Bravo, Inc.; and Charlie, Inc. The corporations lease all their equipment and have no qualified property. The 2019 income, losses, and W-2 wages of the corporations are shown in **Figure 1.31**. Figure 1.31 also shows the calculation of Tiffani's QBI deduction.

FIGURE 1.31 Alpha, Bravo, and Charlie 2019 QBI Items—Separate

	Alpha	Bravo	Charlie
Income (loss)	$1,000,000	$1,000,000	($600,000)
Effect of loss	(300,000)	(300,000)	600,000
Net QBI after allocation of loss from Charlie	$ 700,000	$ 700,000	$ 0
W-2 wages	$ 500,000	$ 0	$500,000
50% W-2 wages	$ 250,000	$ 0	$250,000
Tentative QBI deduction (20% of QBI)	$ 140,000	$ 140,000	$ 0
QBI deduction (lesser of 50% W-2 wages or tentative QBI deduction)	$ 140,000	$ 0	$ 0

Because the W-2 wage and capital limitation applies to each business separately, and the W-2 wages (and UBIA) from loss activities are not taken into account, Tiffani's QBI deduction for the year is $140,000 [Treas. Reg. § 1.199A-1(d)(4), Example 9].

If a taxpayer can aggregate one or more loss activities with those that produce income, the aggregated group is treated as a single business activity for purposes of section 199A.

Example 1.32 Income and Loss with Aggregation

The facts are the same as in Example 1.31 except that Tiffani aggregates all three of the activities. **Figure 1.32** shows the combined income and W-2 wages of the aggregated group. It also shows the calculation of Tiffani's QBI deduction.

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FIGURE 1.32 Alpha, Bravo, and Charlie 2019 QBI Items—Aggregated

	Alpha	Bravo	Charlie	Total
Income (loss)	$1,000,000	$1,000,000	($600,000)	$1,400,000
W-2 wages	$ 500,000	$ 0	$500,000	$1,000,000
50% W-2 wages	$ 250,000	$ 0	$250,000	$ 500,000
Tentative QBI deduction (20% of QBI)				$ 280,000
QBI deduction (lesser of 50% W-2 wages or tentative QBI deduction)				$ 280,000

Including Charlie, Inc.'s W-2 wages in the W-2 wage and capital limitation increases Tiffani's QBI deduction from $140,000 to $280,000 [Treas. Reg. § 1.199A-1(d)(4), Example 10].

Interaction with Other Loss Rules

In general, any loss from a qualified business that was disallowed in a prior year and is allowed in the current year is taken into account in computing QBI [Treas. Reg. § 1.199A-3(b)(1)(iv)]. These losses will generally reduce QBI in the current year. However, any losses or deductions that were disallowed, suspended, limited, or carried over from tax years beginning before January 1, 2018, are not taken into account for purposes of the QBI computation. These losses include the following:

- Loss disallowed due to lack of basis in S corporation by I.R.C. § 1366(d)
- Loss disallowed due to lack of basis in partnership by I.R.C. § 704(d)
- Losses from any activity that exceeded the owner's amount at-risk as defined in I.R.C. § 465
- Losses suspended by the passive activity loss limits of I.R.C. § 469

Example 1.33 Prior Suspended Losses Allowed in Current Year

Brenda Bradley is the sole shareholder of Breeze, Inc., an S corporation. In 2017, Breeze's loss exceeded Brenda's basis by $15,000. In 2018, Brenda did not increase her basis, and Breeze reported a $32,000 loss. Brenda could not deduct this loss because she had no remaining basis.

In 2019, Breeze had $85,000 income. Brenda's 2019 taxable income and QBI are shown in **Figure 1.33**.

FIGURE 1.33 Brenda's 2019 Taxable income and QBI

	Taxable Income	QBI
Income	$85,000	$85,000
Loss suspended from 2017	(15,000)	0
Loss suspended from 2018	(32,000)	(32,000)
Net income	$38,000	$53,000
QBI deduction (subject to taxable income limitation)*		$10,600

* $53,000 × 20%

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NOL Carryforward from 2017 and Earlier Years

A pre-2018 NOL carryforward does not affect QBI, but it reduces the taxpayer's taxable income. Thus, the NOL deduction may increase the QBI deduction if the taxpayer's taxable income exceeds the phasein range. The NOL deduction may reduce the QBI deduction by lowering the taxable income limit.

NOL Carryforward from 2018 and Later Years

An NOL carryforward from a tax year beginning after 2017 will also reduce taxable income. It may also directly reduce QBI. As stated earlier, negative QBI offsets other QBI, and any net negative QBI carries forward to offset QBI in subsequent years. Also, an excess business loss under I.R.C. § 461(l) is treated as an NOL carryover to the following tax year and is taken into account for purposes of computing QBI in the subsequent tax year in which it is deducted [Treas. Reg. § 1.199A-3(b)(1)(v)].

CROSS-REFERENCE

Business Losses

See the "Business Issues" chapter in the *2019 National Income Tax Workbook* for a further discussion of the excess business loss disallowance rule.

Example 1.34 NOL Resulting from Excess Business Loss

Simon Carlson, a single taxpayer, was the sole shareholder in Cars, Inc., an S corporation in 2018 and 2019. The income of Cars, Inc. is all QBI, and it pays enough wages each year so that the W-2 wage and capital limit does not apply.

In 2018, Cars reported a $400,000 loss. Simon had no other business income in 2018, so the excess business loss rule limited the loss deduction to $250,000. In 2018, Simon had nonbusiness income of $350,000 and nonbusiness deductions of $30,000. **Figure 1.34** shows Simon's 2018 taxable income.

FIGURE 1.34 Simon's 2018 Taxable Income and NOL

QBI loss	($400,000)
Excess business loss ($400,000 – $250,000)	150,000
Allowed loss	($250,000)
Nonbusiness income	350,000
Nonbusiness deductions	(30,000)
Taxable income	$ 70,000
NOL carryforward (excess business loss)	($150,000)

The $250,000 allowed QBI loss carries forward, solely to reduce future QBI. The $150,000 NOL carryforward must also reduce QBI in the year when it is allowed.

In 2019, Cars had $600,000 income, while Simon had nonbusiness income of $350,000 and nonbusiness deductions of $30,000. **Figure 1.35** shows Simon's 2019 QBI deduction, and **Figure 1.36** shows Simon's 2019 taxable income.

FIGURE 1.35 Simon's 2019 QBI Deduction

2019 QBI income	$600,000
QBI loss allowed in 2018	(250,000)
NOL carryforward from 2018	(150,000)
Total QBI	$200,000
QBI deduction ($200,000 × 20%)	$ 40,000

FIGURE 1.36 Simon's 2019 Taxable Income

Business income	$600,000
Nonbusiness income	350,000
QBI deduction (Figure 1.35)	(40,000)
Nonbusiness deductions	(30,000)
Taxable income before NOL deduction	$880,000
NOL deduction	(150,000)
Taxable income after NOL deduction	$730,000

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CROSS-REFERENCE

Previously Disallowed Losses

The final section 199A regulations provide a first-in, first-out ordering rule for previously suspended losses. Under proposed regulations, previously disallowed losses would be treated as losses from a separate trade or business. See the earlier discussion of the proposed regulations.

THE REIT/PTP COMPONENT The QBI deduction includes 20% of qualified REIT dividends and qualified PTP income.

Qualified real estate investment trust (REIT) dividends that are paid to investors may be eligible for the QBI deduction. Similarly, income from publicly traded partnerships (PTPs) may also qualify for this deduction. The REIT/PTP component of qualifying income is calculated separately from the QBI component (discussed in the previous section, "Qualified Business Income").

REIT Dividends

A REIT is a corporation, trust, or association that is taxable as a domestic corporation. A REIT owns, finances, or operates income-producing real property. REITs allows their investors to hold a diversified portfolio of real estate properties by purchasing shares in the REIT. A REIT must receive at least 95% of its gross income from dividends, interest, real property rents, gain from the sale of stock or other property, and other specified sources. The REIT must receive at least 75% of its gross income from real property rents, sales of real estate, interest on mortgages financing real property, and other specified sources [I.R.C. § 856]. The REIT must also pay at least 90% of its taxable income (other than net capital gain) as dividends to its shareholders, and it must have 100 or more owners. Investors may purchase their REIT shares or certificates on the open market.

A qualified REIT dividend is any dividend from a REIT received during the tax year that is not a capital gain dividend or a qualified dividend. I.R.C. § 857(b)(3)(B) generally defines a capital gain dividend as a REIT dividend designated by the REIT as a capital gain dividend in a written notice mailed to its shareholders within 30 days after the close of its tax year. A capital gain dividend is treated by the shareholders or holders of beneficial interests in the REIT as a gain from the sale or exchange of a capital asset held for more than 1 year.

Similarly, qualified dividends, defined in I.R.C. § 1(h)(11), are taxed at capital gain rates. A qualified dividend is a dividend received during the tax year from a domestic corporation or certain qualified foreign corporations. Certain holding period requirements apply [Treas. Reg. § 1.199A-3(c)(2)(ii)].

Qualified PTP Income

Qualified PTP income is the sum of the net amount of the taxpayer's allocable share of income, gain, deduction, and loss from a PTP, as defined in I.R.C. § 7704(b), that is not taxed as a corporation under section 7704(a); plus any gain or loss attributable to assets of the PTP giving rise to ordinary income under section 751(a) or (b) that is considered attributable to the trades or businesses conducted by the PTP [Treas. Reg. § 1.199A-3(c)(3)(i)].

A PTP is a partnership with interests traded on an established securities market or secondary market. It is treated as a corporation unless 90% or more of its gross income is passive-type income. The following qualifying income allows pass-through entity treatment of the PTP:

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1. Interest
2. Dividends
3. Real property rent
4. Gain from the sale or other disposition of real property
5. Income and gains from natural resources
6. Any gain from the sale or disposition of a capital asset used for the production of qualifying income
7. In certain cases, income and gains from commodities or futures, forwards, and options with respect to commodities

[I.R.C. § 7704(d)]

The PTP may need to segregate its sources of income for purposes of the QBI deduction. Income and losses from non-US sources, interest and dividends, and capital gains and losses do not qualify for the QBI deduction. However, other income from domestic sources, primarily real estate rents and natural resource income, does qualify for the deduction.

OBSERVATION

PTP Income from SSTB

Treas. Reg. § 1.199A-1(d)(3)(ii) states that an individual must take into account his or her share of SSTB income from PTPs. The SSTB limitation will apply to this portion of the income. See the discussion of the SSTB limitation in the "Qualified Business Income Deduction: Specified Service Trades or Businesses" chapter.

Deduction for Qualified REIT Dividends and PTP Income

Pursuant to I.R.C. § 199A(b)(1)(B), a taxpayer's QBI deduction includes 20% of the aggregate amount of qualified REIT dividends received by the taxpayer during the tax year and qualified PTP income included on the current year's tax return. This deduction is combined with the taxpayer's other QBI deductions for each qualified trade or business, after those deductions have been adjusted by the W-2 wage and capital limitation and the SSTB limitation.

Taxable Income Limitation

The combined qualified business income amount for the tax year is the sum of

- the deductible amounts determined for each qualified trade or business carried on by the taxpayer (the QBI component), and
- 20% of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income (the REIT/PTP component).

The taxpayer's total QBI deduction cannot exceed 20% of taxable income (less capital gain).

Example 1.35 REIT/PTP Component and QBI Component Combined

Ronald Jesper is a single taxpayer. In 2019, Ronald's taxable income (before the QBI deduction) was $150,000. His income included $80,000 in qualified REIT dividends and $100,000 in QBI from a real estate rental business. Ronald also had $10,000 in capital gain income.

Ronald's taxable income is below the phasein threshold, and he is not subject to the W-2 wage and capital limitation or the SSTB limitation. Ronald calculates his tentative QBI deduction as $36,000 [20% × ($80,000 + $100,000)]. Ronald's QBI deduction is limited to $28,000, which is 20% of his taxable income (before the QBI deduction) less capital gain [20% × ($150,000 − $10,000)]. Because $28,000 is less than $36,000, Ronald can claim a $28,000 QBI deduction.

PRACTITIONER NOTE

W-2 Wages/Capital Limitation

The deduction for a REIT dividend is not subject to the W-2 wages and capital limitation. Similarly, qualifying income from a PTP is not subject to that limit.

Losses

A loss from the QBI component does not offset income from the REIT/PTP component (and vice versa). The loss is carried forward separately [Treas. Reg. § 1.199A-1(d)(3)(iii)].

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Example 1.36 Loss from REIT/PTP Component

Camila Lopez is a single individual. Her 2019 taxable income was $155,000 before any QBI deduction as calculated in **Figure 1.37.**

FIGURE 1.37 Camila's 2019 Taxable Income

Salary	$82,200
Qualified dividend	15,000
Loss from PTP	(10,000)
Rental income	80,000
AGI	$167,200
Standard deduction	(12,200)
Taxable income before QBI deduction	$155,000

Because her taxable income is below the threshold, Camila is not subject to the W-2 wage and capital limit. She does not offset the PTP loss and the rental income, because they are different components. She must carry forward the $10,000 PTP loss to offset income from PTPs and REITs in subsequent years. **Figure 1.38** shows the computation of Camila's 2019 QBI deduction.

FIGURE 1.38 Camila's 2019 QBI Computation

Rental income, not reduced for PTP loss	$80,000
Tentative deduction for QBI component ($80,000 × 20%)	$16,000
Taxable income limit [($155,000 – $15,000) × 20%]	$28,000
QBI deduction (lesser of $16,000 or $28,000)	$16,000

Camila's 2019 QBI deduction is $16,000, and her final taxable income is $139,000 ($155,000 taxable income – $16,000 QBI deduction).

PARTNERSHIPS AND S CORPORATIONS

This section explains how partnerships and S corporations allocate and report QBI items to their owners.

C corporations cannot claim a QBI deduction. Partnership partners and S corporation shareholders claim the QBI deduction at the partner or shareholder level [I.R.C. § 199A(f)(1)(A)(i)]. Thus, partnerships and S corporations must calculate, allocate, and report the information necessary for each partner or shareholder to calculate his or her deduction.

PRACTITIONER NOTE

No Effect on Basis

The partnership partner or the S corporation shareholder claims the QBI deduction on his or her individual return. The deduction has no effect on the adjusted basis of a partner's interest in the partnership or on the adjusted basis of a shareholder's stock in an S corporation.

This section explains how partnerships and S corporations allocate and report QBI-related items to their partners or shareholders.

Computational Rules

A partnership or S corporation determines the items necessary for individuals who own interests in the entity to calculate their QBI deduction using the following four steps:

1. The entity must determine if it is engaged in one or more trades or businesses. The entity must also determine if any of its trades or businesses are an SSTB.
2. The entity must determine its QBI for each trade or business engaged in directly.
3. The entity must determine the W-2 wages and UBIA of qualified property for each trade or business engaged in directly.

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4. The entity must determine whether it has any qualified REIT dividends earned directly or through another entity. The entity must also determine the net amount of qualified PTP income earned directly or indirectly through investments in PTPs.

[Treas. Reg. § 1.199A-6(b)(2)]

See the earlier discussions of what constitutes QBI, W-2 wages, and UBIA of qualified property for information about how a partnership or S corporation calculates these items.

PRACTITIONER NOTE

Trusts and Estates

Under I.R.C. § 199A(f)(1)(B), trusts and estates must use rules like former I.R.C. § 199 (as in effect on December 1, 2017) to apportion W-2 wages and the UBIA of qualified property between the trust or estate and its beneficiaries. Treas. Reg. § 1.199A-6(d) contains special rules for applying section 199A to trusts and estates. See the "Trusts and Estates" chapter in the *2019 National Income Tax Workbook* for a discussion of the QBI deduction for trusts and estates.

Allocating QBI Items

Partnerships allocate each partner's share of QBI, W-2 wages, and UBIA of qualified property under the general rules of subchapter K. S corporations allocate these items under the general rules of subchapter S.

Partnership Allocations

A partnership must allocate to its partners an allocable share of each qualified item of income, gain, deduction, loss, and credit. Each partner's share of items depends on the agreed-upon ratio for sharing income, deductions, loss, and credit items. A partner's share of such items generally is determined by the partnership agreement. I.R.C. § 704 gives partnerships some discretion to determine how income, deductions, losses, and credits are allocated among the individual partners.

Any special allocation must be established in the partnership agreement and have substantial economic effect [I.R.C. § 704(b)(2)]. If the partnership agreement does not allocate a partner's share of income, gain, deduction, and loss (or the allocation does not have substantial economic effect), these items are determined in accordance with a partner's interest in the partnership [I.R.C. § 704(b)(1)].

W-2 wages are allocated in accordance with the allocation of wage expense to the partners. Unless there is a special allocation of wages, wages are allocated in the same ratio as the ordinary income of the partnership.

A partnership must allocate UBIA in qualified property in proportion to its allocation of book depreciation among the partners who hold an interest on the last day of the partnership's tax year [Treas. Reg. § 1.199A-2(a)(3)(ii)]. The preamble to the final section 199A regulations states that a partner who disposes of his or her entire interest before the end of the year does not receive any allocation of UBIA.

Example 1.37 Partnership Allocations of QBI and Related Items

Ray Richards, Sally Sullivan, and Terry Tyson are the only members of Rusty, LLC, which is treated as a partnership for tax purposes. Ray, the managing member, has a 40% interest in the LLC. Sally and Terry each own 30%. The LLC allocates only 10% of depreciation to Ray. Sally and Terry each receive a 45% distributive share of depreciation. All other items are allocated according to the member's interest in the LLC. **Figure 1.39** shows the LLC's 2019 income, deductions, and UBIA of qualified property allocations.

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FIGURE 1.39 Rusty, LLC's 2019 Income, Deductions, and UBIA of Qualified Property Allocations

	Total	Ray	Sally	Terry
Interest income	$30,000	$ 12,000	$ 9,000	$ 9,000
Rent income	250,000	100,000	75,000	75,000
W-2 wages	(30,000)	(12,000)	(9,000)	(9,000)
Depreciation	(120,000)	(12,000)	(54,000)	(54,000)
Net income	$130,000	$ 88,000	$ 21,000	$ 21,000
UBIA of qualified property	$2,500,000	$250,000	$1,125,000	$1,125,000

Figure 1.40 shows Rusty, LLC's 2019 Schedules K-1 (Form 1065).

FIGURE 1.40 Rusty, LLC's Schedule K and Schedule K-1 Information

	Total Schedule K	Ray Schedule K-1	Sally Schedule K-1	Terry Schedule K-1
Interest income	$ 30,000	$ 12,000	$ 9,000	$ 9,000
QBI*	$ 100,000	$ 76,000	$ 12,000	$ 12,000
W-2 wages	$ 30,000	$ 12,000	$ 9,000	$ 9,000
UBIA	$2,500,000	$250,000	$1,125,000	$1,125,000

* QBI does not include the interest income. QBI equals the rent income minus the W-2 wage and depreciation expenses that are attributable to the rent income ($250,000 –$30,000 – $120,000).

If the W-2 wage and capital limit applies in full to each of the members, and they are not subject to the taxable income limit, they calculate their QBI deductions as shown in **Figure 1.41**.

FIGURE 1.41 QBI Deductions—Special Allocation

	Ray	Sally	Terry
Tentative QBI deduction (20% of QBI)	$15,200	$ 2,400	$ 2,400
Limits			
(1) 50% W-2 wages	$ 6,000	$ 4,500	$ 4,500
(2) 25% W-2 wages + 2.5% UBIA of qualified property	$ 9,250	$30,375	$30,375
(3) Greater of (1) or (2) limit	$ 9,250	$30,375	$30,375
QBI deduction [lesser of tentative QBI deduction or (3) limit]	$ 9,250	$ 2,400	$ 2,400

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S Corporation Allocations

An S corporation must allocate to its shareholders a pro rata share of each qualified item of income, loss, deduction, and credit [I.R.C. § 1366]. S corporations cannot have more than one class of shares, and separately and non–separately stated items must be allocated to the shareholders based on the number of shares owned.

An S corporation shareholder's pro rata share of these items is calculated under I.R.C. § 1377(a)(1). Under this provision, each shareholder's share of the S corporation's items is determined by assigning an equal portion of the item to each day of the S corporation's tax year, and then dividing that portion pro rata among the shares outstanding on that day.

Example 1.38 Allocating QBI and Wages to S Corporation Shareholders

Juan and Jennifer Velazquez are the sole shareholders and employees of Riders, Inc., an S corporation that conducts a qualified trade or business. Juan owns 40% of the shares, and Jennifer owns 60% of the shares. The corporation paid Juan a $100,000 salary, and paid Jennifer a $40,000 salary. The corporation's 2019 QBI was $350,000. Riders, Inc. must allocate $56,000 [40% × ($100,000 + $40,000)] of the W-2 wages to Juan and $140,000 (40% × $350,000) of the QBI to Juan. Riders allocates the remaining $84,000 ($140,000 – $56,000) W-2 wages and the remaining $210,000 ($350,000 – $140,000) QBI to Jennifer.

Reporting

Treas. Reg. § 1.199A-6(b) requires pass-through entities to separately identify and report on Schedule K-1 (issued to the owners) each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property for each trade or business that the entity directly engages in. The entity must also specify whether any of the trades or businesses are SSTBs.

Partnerships report a partner's share of QBI items (QBI income, W-2 wages, and UBIA in qualified property) in box 20 (Other information) on Schedule K-1 (Form 1065). **Figure 1.42** shows the QBI item codes for box 20, as they appear on the 2018 Schedule K-1 (Form 1065).

FIGURE 1.42 Box 20 QBI Item Codes for Partnership Reporting

Code	Description
Z	Section 199A income
AA	Section 199A W-2 wages
AB	Section 199A unadjusted basis
AC	Section 199A REIT dividends
AD	Section 199A PTP income

S corporations report a shareholder's share of these items in box 17 (Other information) on Schedule K-1 (Form 1120S). **Figure 1.43** shows the QBI item codes for box 17, as they appear on the 2018 Schedule K-1 (Form 1120S).

FIGURE 1.43 Box 17 QBI Item Codes for S Corporation Reporting

Code	Description
V	Section 199A income
W	Section 199A W-2 wages
X	Section 199A unadjusted basis
Y	Section 199A REIT dividends
Z	Section 199A PTP income

A partnership or S corporation must report, on an attachment to Schedule K-1, any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations reported to it by any RPE in which the partnership or S corporation owns a direct or indirect interest. Partnerships and S corporations must also report each owner's allocated share of any qualified REIT dividends and qualified PTP income received directly by the entity.

PRACTITIONER NOTE

Additional Reporting

For a partner or shareholder to correctly calculate the QBI deduction, they will need additional information from the entity, such as SSTB income, section 1231 gains, and any aggregation elections at the entity level.

Failure to report QBI items may result in loss of the deduction. W-2 wages are presumed to be zero if not determined and reported for each trade or business [Treas. Reg. § 1.199A-2(a)(2)]. The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business [Treas. Reg. § 1.199A-2(a)(3)].

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QBI DEDUCTION FOR REAL ESTATE RENTALS This section explains when a real estate rental activity qualifies for the QBI deduction.

QBI includes the net income from qualified real estate activities if those activities give rise to a trade or business under I.R.C. § 162. In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to the following:

1. The type of rented property (commercial real property versus residential property)
2. The number of properties rented
3. The owner's or the owner's agent's day-to-day involvement
4. The types and significance of any ancillary services provided under the lease
5. The terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease)

[Preamble to the final section 199A regulations]

Self-Rentals

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 and the other trade or business are commonly controlled under Treas. Reg. § 1.199A-1(b)(14). This rule allows taxpayers to aggregate their trades or businesses with the associated rental or intangible property regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under Treas. Reg. § 1.199A-4(b). This rule applies only if the tenant is an individual or RPE.

Safe Harbor

Notice 2019-07, 2019-9 I.R.B. 740, provides notice of a proposed revenue procedure that will establish a safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A. Under the proposed safe harbor, a rental real estate enterprise may be treated as a trade or business if at least 250 hours of services are performed each tax year with respect to the enterprise. This includes services performed by owners, employees, and independent contractors. It includes time spent on the following:

- Maintenance
- Repairs
- Collection of rent
- Payment of expenses
- Provision of services to tenants
- Efforts to rent the property

Hours spent by any person with respect to the owner's capacity as an investor, such as arranging financing; procuring property; reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; and traveling to and from the real estate are not counted as hours of service with respect to the enterprise. The proposed safe harbor also would require that the owner keep separate books and records and separate bank accounts for the rental real estate enterprise.

Property leased under a triple net lease or used by the taxpayer (including an owner or beneficiary of an RPE) as a residence for any part of the year under I.R.C. § 280A would not be eligible under the proposed safe harbor. A rental real estate enterprise that satisfies the proposed safe harbor and is treated as a trade or business for purposes of section 199A is not necessarily a section 162 trade or business. Failure to meet the proposed safe harbor would not necessarily preclude rental real estate activities from being a section 162 trade or business.

CROSS-REFERENCE

QBI for a Real Estate Business

See the "Real Estate Tax Issues" chapter in the *2019 National Income Tax Workbook* for an additional discussion of claiming the QBI deduction for a real estate business.

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