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Understanding the Benefits of the New Section 199A Deduction

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CHAPTER 18
SECTION 199A¹
TABLE OF CONTENTS

18.1	Introduction to the Section 199A Deduction	1
18.2	Ancillary Consequences of Section 199A Deduction	3
18.2.1	Ancillary Items Impacted by Section 199A Deduction.....	3
18.2.2	Items Not Impacted by the Section 199A Deduction.....	4
18.3	Steps in Computing Section 199A Deduction	5
18.4	Taxable Income Ceiling on Section 199A Deduction.....	7
18.4.1	20% of Taxable Income Limitation.....	7
18.4.2	Taxable Income Limitation	8
18.5	Calculating Amount of the Section 199A Deduction	8
18.5.1	Section 199A Deduction: Taxable Income Equal to or Less than Threshold Amount.....	8
18.5.1.1	Total QBI Amount	9
18.5.1.2	Qualified REIT Dividends and Qualified PTP Income... 	9
18.5.2	Section 199A Deduction: Taxable Income Exceeds Threshold Amount.....	10
18.5.2.1	Taxable Income Exceeds Ceiling Amount.....	10
18.5.2.1.1	Determining the QBI Component.....	10
18.5.2.2	Taxable Income Within Phase-In Range	12
18.5.2.2.1	Determining the QBI Component.....	12
18.5.2.2.2	Adjustment to QBI Component For Taxable Income Within the Phase- In Range	12

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	18.5.2.2.3	Adjustment to QBI Component for Taxable Income Within Phase-In Range and one or more of the Trades or Businesses is a SSTB.....	13
	18.5.2.2.3.1	Individual Engaged only in a SSTB	13
	18.5.2.2.3.2	Individual Engaged in Multiple Trades or Businesses one of Which is a SSTB	14
18.6	QBI – Defined.....		15
18.6.1	Qualified Items.....		15
18.6.2	Items Not Taken into account as qualified items		16
	18.6.2.1	Qualified REIT Dividends and Qualified PTP Income	16
	18.6.2.2	Section 1231	16
	18.6.2.3	Dividends.....	17
	18.6.2.4	Interest	17
	18.6.2.5	Annuities.....	17
	18.6.2.6	CFC Income	17
	18.6.2.7	Notional Principal Contracts.....	17
	18.6.2.8	Compensation	17
	18.6.2.9	Guaranteed Payments	18
	18.6.2.10	Section 707(a) Payments for Compensation.....	18
18.6.3	Adjustments In Computing QBI		19
	18.6.3.1	Wage Expense.....	19
	18.6.3.2	Allocation of Items Among Multiple Businesses.....	19
	18.6.3.3	Section 751(a) and (b) Gain or Loss.....	19
	18.6.3.4	Guaranteed Payments for Capital	19
	18.6.3.5	Section 481 Adjustments	20
	18.6.3.6	Suspended Losses	20

18.6.3.7	NOLs and 461(l).....	20
18.6.3.7.1	NOLs.....	20
18.6.3.7.2	Section 461(l).....	20
18.7	Trade or Business Defined.....	21
18.7.1	Trade or Business Defined	22
18.7.2	Aggregation of Multiple Trades or Businesses	22
18.7.2.1	Requirements For Aggregation	22
18.7.2.2	Items Aggregated.....	24
18.7.2.3	Reporting Requirements	25
18.7.2.4	Effective Dates	25
18.8	Trade or Businesses that do not qualify for the Section 199A Deduction ..	26
18.8.1	SSTB	26
18.8.1.1	SSTB Includes Trade or Business Defined in Section 1202(e)(3)(A)	26
18.8.1.1.1	Performance of Services in Field of Health	27
18.8.1.1.2	Performance of Services in Field of Law ...	27
18.8.1.1.3	Performance of Services in the Field of Accountancy	28
18.8.1.1.4	Field of Actuarial Science.....	28
18.8.1.1.5	Field of Performing Arts	28
18.8.1.1.6	Field of Consulting.....	28
18.8.1.1.7	Field of Financial Services	29
18.8.1.1.8	Field of Athletics	29
18.8.1.1.9	Field of Brokerage Services	30
18.8.1.1.10	Any Trade or Business in which the Principal Asset is Reputation or Skill of an Employee or Owner.....	30

18.8.1.2	Services in Investing, Investment Management, Trading, or Dealing in Securities, Partnership Interests or Commodities.....	31
18.8.1.3	<i>De Minimis</i> Exception.....	32
18.8.1.4	Anti-Avoidance Rules.....	33
18.8.2	Trade or Business of Performing Services as an Employee.....	34
18.8.2.1	Misclassified Employees.....	35
18.8.2.2	Officers as Employees	35
18.8.2.3	Anti-Avoidance Rule.....	35
18.8.3	Effective Dates.....	36
18.9	Cap For Section 199A Deduction	36
18.9.1	W-2 Wages	36
18.9.1.1	W-2 Wages Allocable to QBI	36
18.9.1.1.1	First Step.....	36
18.9.1.1.1.1	Calendar Year Requirement	37
18.9.1.1.1.2	Wages Defined.....	37
18.9.1.1.2	Second Step.....	38
18.9.1.1.3	Third Step.....	39
18.9.1.2	Allocations of W-2 wages by an RPE to Its Owners ...	39
18.9.1.3	Effective Date	39
18.9.2	UBIA of Qualified Property	39
18.9.2.1	Qualified Property Defined.....	40
18.9.2.2	UBIA Defined	40
18.9.2.2.1	UBIA Not Adjusted for Depreciation or Amortization	40
18.9.2.2.2	Basis Adjustments under Section 734(b) or Section 743.....	40
18.9.2.2.3	Additions to Basis.....	40

18.9.2.3	UBIA for Qualified Property Transferred in Non-Recognition Transactions.....	41
18.9.2.4	Anti-Avoidance Rules.....	41
18.9.3	Depreciable Period Defined.....	41
18.9.3.1	Additional Depreciation.....	42
18.9.3.2	Non-Recognition Transfers of Qualified Property	42
18.9.4	Section 1031 Like Kind Exchanges	42
18.9.5	Partnerships and S Corporations	42
18.9.6	Effective Date.....	43
18.10	Reporting Under Section 199A for PREs and PTPs.....	43
18.10.1	Computational and Reporting Rules for RPEs	43
18.10.1.1	Computational Steps	43
18.10.1.2	Reporting Steps	44
18.10.2	Computational and Reporting Rules for PTPs	44
18.10.2.1	Computation Rules	45
18.10.2.2	Reporting Rules	45

Appendix A.18.11

Examples Contained In Proposed Regulations

A.18.11.1	Proposed Regulations: 1.199A-1(c)(3) Examples Illustrating Computation of Section 199A Deduction When Taxable Income Is Less than or Equal to the Threshold Amount	46
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Example 1: Computation of Section 199A Deduction Determined With Reference to Taxable Income Limitation

Example 2: Taxable Income Reduced by Net Capital Gains

Example 3: Caps Not Relevant to Individuals with Taxable Income at or Below Threshold Amount/Wages Paid by Trade or Business to Owner Not Included in QBI

Example 4: Taxable Income Limitation With Qualified PTP Income and Qualified REIT Dividends

A.18.11.2 Proposed Regulations: 1.199A-1(d)(4) Examples Illustrating Computation of Section 199A Deduction When Taxable Income Greater than Threshold Amount -----47

Example 1: QBI Component Limited by Cap

Example 2: QBI Component Limited by Cap

Example 3: Trade or Business Operated Through Partnership and Individual's Section 199A Deduction Determined by Reference to Individual's Share of QBI, W-2 Wages and UBIA of Qualified Property from Partnership

Example 4: Taxable Income Limitation Applicable; Net Loss from Qualified PTP Income for Year Does Not Offset QBI But Is Carried Forward to Next Succeeding Year

Example 5: QBI Component Adjusted Because Taxable Income Within the Phase-In Range

Example 6: : QBI Component Adjusted Because Taxable Income Within the Phase-In Range and Trade or Business is a SSTB

Example 7: Section 199A Deduction May Be Significantly Reduced Without Choice to Aggregate Trades or Businesses

Example 8: Choice to Aggregate Trades or Businesses May Be Beneficial

Example 9 Negative QBI from one Trade or Business Will Offset Positive QBI from another Trade or Business Regardless of Aggregation Choice of Individual

Example 10: W-2 Wages and UBIA of Qualified Property of Trade or Business with Negative QBI Still Included in QBI Component When Businesses Aggregated

Example 11: Cumulative Negative QBI Will Carry Forward to Next Succeeding Year as a Loss in that Year

Example 12: Benefits of Aggregation and Impact of Negative QBI of Trade or Business

A.18.11.3 Proposed Regulation Section 1.199A-2(c)(4) Example regarding determination of UBIA with respect to qualified property. Unless otherwise stated assume that the trade or business is not a SSTB. -----56

Example 1: UBIA in Computing the Cap Is Not Adjusted by Depreciation

Example 2: UBIA and Qualified Period for Replacement Property in Like-Kind Exchange

Example 3: UBIA in Transferred Basis Property in Contribution to S Corporation

A.18.11.4 Proposed Regulation Section 1.199A-4(d) Examples on aggregation rules-----57

Example 1: Aggregation of Trades or Businesses Permitted

Example 2: Aggregation of Trades or Businesses Operated Through Multiple RPE Permitted with Common Control of RPEs

Example 3: Aggregation May Not Be Permitted Even With Common Ownership

Example 4: Aggregation Permitted: Individual Free to Choose Trades or Businesses to be Aggregated; Aggregations made at Individual Owner Level and not by an RPE

Example 5: Aggregation Permitted: Common Ownership under Aggregation Rule

Example 6: Aggregation Not Permitted for Trades or Business Without Common Operations or Coordination

Example 7: Aggregation Not Permitted; Trades or Business Do Not Share Common Operations or Coordination

Example 8: Aggregation Permitted: Trades or Businesses Share Common Operations or Coordination

Example 9: Aggregation Permitted: Attribution Rules for Common Control Test

Example 10: Aggregation Permitted: Minority Owner in Multiple RPEs May Choose to Aggregate

Example 11: Aggregation Permitted: Individual Owners Not Required To Make Same Aggregation Choices

Example 12: Aggregation Not Permitted: Only Trades or Business May Be Aggregated and Non-Trade or Business Activity May Not Be Aggregated With Trades or Businesses

Example 13: Aggregation Permitted: Coordination Test Satisfied

A.18.11.5 Proposed Regulation Section 1.199A-5(b)(3) Example illustrating the rules regarding the definition of SSTB-----61

Example 1 Field of Performing Arts

Example 2 Field of Athletics

Example 3 Field of Consulting

Example 4 Field of Consulting: Individual Not Engaged

Example 5 Field of Financial Services

Example 6 Field of Brokerage Services

Example 7 Reputation and Skill of Employees and Owners

Example 8 Reputation and Skill of Employees and Owners

Example 9 Reputation and Skill of Employees and Owners

A.18.11.6 Proposed Regulation Section 1.199A-5(c)(2)(iv): Example illustrating the rules regarding the definition of SSTB with respect to so called "crack and pack" transactions -----63

Example: "Crack-and-Pack" Transaction

A.18.11.7 Proposed Regulations Section 1.199A-5(b)(c)(3)(ii): Example Illustrating When an Entity Commonly Controlled with an SSTB Will Be Incidental to that SSTB -----63

A.18.11.8 Proposed Regulation Section 1.199A-5(d)(3)(i) Examples illustrating Proposed Regulations Attack on Attempted Transmogrification of Employee to Non-Employee for purposes of Section 199A-----64

Example 1: Non-Employee Status Denied

Example 2: Non-Employee Status Denied; Presumption of Employee Status Not Rebutted

Example 3: Non-Employee Status Accepted; Presumption of Employee Status Rebutted

Chapter 18

SECTION 199A DEDUCTION

18.1 Introduction to the Section 199A Deduction

The Tax Cuts and Jobs Act² added Section 199A to the Code.³ That section provides individuals, estates and trusts conducting a trade or business directly or through a pass-through entity with a significant new deduction (the “Section 199A Deduction”), which in some cases may equal 20% of the net income from the trade or business. On August 8, 2018, the Internal Revenue Service (“IRS”) issued Proposed Regulations (REG-107892-18)(the “Proposed Regulations”) providing computational, definitional, and anti-avoidance guidance under Section 199A. The discussion below begins with an overview of the Section 199A Deduction, and then takes a more granular look layering in the multiple exceptions and limitations to the basic rules.

- A. **Persons Who Get the Tax Benefit:** Section 199A provides a new deduction for a taxpayer other than a corporation⁴ engaging in a trade or business either directly as a sole proprietor⁵ or through a partnership, S corporation, or trust or estate that passes through income and loss to its beneficiaries (collectively referred to as Relevant Passthrough Entities, or “RPE”).⁶ A Section 199A Deduction may also be available with respect to qualified cooperative dividends.⁷ This discussion focuses solely on the Section 199A as it applies to individuals conducting trades or businesses directly or through an RPE that is either a partnership or S corporation.
- B. **The Tax Benefit Defined:** An individual’s Section 199A Deduction is equal to 20% of the individual’s qualified business income as defined in Paragraph 18.6 (“QBI”)⁸, limited, however, above certain income levels, to the greater of two caps, one of which is determined by reference to W-2 wages and the other by reference to W-2 wages and unadjusted tax basis immediately after the acquisition (“UBIA”) of certain qualified property.⁹ For individuals with taxable income below certain threshold amounts (\$157,500 or \$315,000 in the case

² P. L. 115-97.

³ Unless otherwise stated, all Section references are to the Internal Revenue Code of 1986, as amended.

⁴ Section 199A(a). This would include a C corporation and presumably an S corporation to the extent it was subject to taxes under the Code, e.g., the tax imposed by Section 1374 on recognized built-in gain of an S corporation..

⁵ This would include an individual that conducted the trade or business through an entity disregarded as an entity separate from the taxpayer, e.g., a wholly-owned LLC.

⁶ Note that the Proposed Regulations define an RPE as a partnership (other than a publicly traded partnership) or an S corporation that is owned, directly or indirectly by at least one individual, estate or trust. Also, a trust or estate is treated as an RPE to the extent it passes through QBI (as defined below), W-2 wages (as defined below), and unadjusted basis of qualified property (as defined below), qualified REIT dividend (as defined below) or qualified REIT income (as defined below). Prop. Reg. Section 1.199A-1(b)(9). This Chapter does not address the application of Section 199A to trusts or estates.

⁷ Section 199A(a)(2).

⁸ The term qualified business income is defined in Section 199A(c)(1) and the Proposed Regulations as the net amount of qualified items of income, gain, deduction, loss with respect to any trade or business as determined under Section 199A(c) and Prop. Reg. Section 1.199A-3. Section 199A(c)(1); Prop. Reg. Section 1.199A-1(b)(4).

⁹ Section 199A(b). Prop. Reg. Section 1.199A-1(c).

of joint return filers)(“Threshold Amounts”)¹⁰ the caps are ignored, i.e., the deduction is determined simply by reference to QBI.¹¹ For individuals with taxable income in excess of the Threshold Amount but not in excess of a ceiling (\$207,500 or \$415,00 in the case of joint return filers)(“Ceiling Amount”), the cap limits are phased in, i.e., the amount of the deduction is subject to the limitation of the applicable cap the greater the individual’s taxable income exceeds the Threshold Amount. Section 199A also provides for a 20% deduction of the individual’s qualified REIT dividend and qualified publicly traded partnership income.¹² In no event may the deduction for each trade or business exceed 20% of the individual’s taxable income after all other deductions—including the standard deduction—and reduced further for net capital gains.¹³

- C. **Tax Benefit Is Limited to Certain Trades or Businesses:** To qualify for the tax benefit, for individuals above the Ceiling Amount, the trade or business conducted by the individual or RPE generally must be a “qualified trade or business,”¹⁴ (“QTB”), which generally is a trade or business other than one providing certain enumerated specified services (“SSTB”) such as the practice of law or accounting.¹⁵ For individuals with taxable income below the Threshold Amounts, however, the exclusion for SSTB is ignored.¹⁶ For individuals with taxable income in excess of the Threshold Amounts but not in excess of the Ceiling Amount, the benefit of the Section 199A Deduction is phased out.¹⁷
- D. **Only QBI Is Included in Computing the Section 199A Deduction:** QBI generally is equal to the individual’s net operating income for the year from a domestic trade or business. The net income is reduced by certain items such as investment income and expenses, as well as capital gains and losses including Section 1231 gains and losses.¹⁸
- E. **Computing the Tax Benefit With Multiple Trades or Businesses:** For individuals with taxable income equal to or less than the Threshold Amount, the QBI for all trades and businesses (including a SSTB) is aggregated in computing the Section 199A Deduction, and the caps are ignored. For individuals with taxable income greater than the Threshold Amount, generally, the Section 199A Deduction is determined by reference to each separate trade or business, whether conducted directly or indirectly through an RPE, so that the individual must separately determine the QBI, W-2 wages and unadjusted basis of qualified property for each business.¹⁹ As explained below, the individual may in certain instances choose to aggregate separate trades or businesses, other than SSTB, for purposes of calculating

¹⁰ Section 199A(e)(2); Prop. Reg. Section 1.199A-1(b)(11). The Threshold Amounts are adjusted by cost-of-living adjustments. Prop. Reg. Section 1.199A-1(b)(11).

¹¹ Section 199A(b)(3); Prop. Reg. Section 1.199A-1(c).

¹² Section 199A(b)(1)(B); Prop. Reg. Section 1.199A-1(c).

¹³ Section 199A(b)(1); Prop. Reg. Section 1.199A-1(c)(1).

¹⁴ Section 199A(c)(1). The term QTB is defined in Section 199A(d).

¹⁵ Section 199A(d); Prop. Reg. Section 1.199A-3. The complete list of businesses included within the term specified service trade or business is found in Section 199A(d)(2) and Prop. Reg. Section 1.199A-5.

¹⁶ Section 199A(d)(3); Prop. Reg. Section 1.199A-1(c)(1).

¹⁷ Section 199A(d)(3); Prop. Reg. Section 1.199A-1(d).

¹⁸ Section 199A(c); Prop. Reg. Section 1.199A-1(b)(4).

¹⁹ Prop. Reg. Section 199A-1(d)(2)(ii). Section 199A did not address aggregation of separate trades or businesses.

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