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Issue Contents

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New IRS Guidance on the Qualified Business Income Deduction

-by Robert P. Achenbach, Jr.

In spite of the partial governmental shutdown of the IRS, the IRS has managed to issue new guidance concerning the qualified business income deduction (QBID) in final regulations, new proposed regulations, a Notice and a Revenue Procedure.

Final Regulations

The proposed regulations governing QBID were issued in August 2018 [1] and the IRS has now adopted as final those regulations with several modifications.

The preamble to the final regulations discusses the comments received and identifies several limited modifications to the proposed regulations, adopting most of the proposed regulations as originally proposed.

Definition of Trade or Business

A qualified trade or business is any trade or business other than a specified service trade or business (SSTB) or a trade or business of an employee.[2] The TCJA 2017 did not define the terms "trade or business" but the proposed and final regulations state that the term trade or business is that used by I.R.C. § 162 and factors used by the numerous cases under that statute ruling as to whether a taxpayer had trade or business income.[3] As under the proposed regulations, the final regulations define the term "trade or business" as

> ". . . a section 162 trade or business other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under §1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1))."

Thus, the mere rental of farm property without regular and continuous participation in the activity by the landlord or an agent does not rise to the level of a trade or business and the rent income is not included in QBI.[4] However, that extreme case rarely occurs and most rental of farmland is a trade or business eligible for deductions for related expenses under I.R.C. § 162. Where farm rental activity does not rise to the level of a trade or business, farm rental income is reported on Form 4835, *Farm Rental Income and Expenses*, and

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Schedule E, but is not included in self-employment income on Schedule SE.

The proposed regulations extended the definition of trade or business beyond I.R.C. § 162 in one circumstance. Solely for purposes of the QBI, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the other trade or business is commonly controlled.[5]

In the discussion of the final regulations, the IRS noted that (1) clarification was needed regarding whether this proposed rule applies to situations in which the rental or licensing is to a commonly controlled C corporation; (2) the rule in the proposed regulations could allow passive leasing and licensing-type activities to benefit from I.R.C. § 199A even if the counterparty is not an individual or a pass-through entity; (3) the exception should be limited to scenarios in which the related party is an individual or a pass-through entity and that the term related party be defined with reference to existing attribution rules under I.R.C. §§ 267, 707, or 414. The final regulations clarify these rules by limiting this special rule to situations in which the related party is an individual or an pass-through entity. Further, the final regulations provide that the related party rules under I.R.C. § 267(b) or 707(b) will be used to determine relatedness for purposes of Treas. Reg. § 1.199A-4 and this special rule.[6]

I.R.C. § 199A(d)(3)(A)(ii) provides that "only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business (SSTB) shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition (UBIA) of qualified property of the taxpayer for the taxable year for purposes of applying this section." The final regulations provide that, for taxpayers with taxable income within the phase-in range, QBI from an SSTB must be reduced by the applicable percentage before the application of the netting and carryover rules described in Treas. Reg. § 1.199A-1(d)(2)(iii)(A). The final regulations clarify that the SSTB limitations also apply to qualified income received by an individual from a publicly trade partnership.

Disregarded Entities

The proposed regulations did not address the treatment of disregarded entities for purposes of I.R.C. § 199A. Treas. Reg. § 1.199A-1(e)(2) of the final regulations provide that an entity with a single owner that is treated as a disregarded entity not separate from its owner under Treas. Reg. § 301.7701-3 is disregarded for purposes of I.R.C. § 199A and Treas. Reg. §§ 1.199A-1 through 1.199A-6. Thus, trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of I.R.C. § 199A.

Veterinarians

One comment to the proposed regulations argued that veterinary medicine should not be considered an SSTB because the delivery of veterinary care is different than delivery of human health care since veterinary patients are property and the nature of the animal may dictate the level of veterinary care provided by the owner. In addition, many veterinary practices have other streams of income such as retail, laboratory and diagnostic services, boarding and grooming services, and pharmacies, requiring the segregation of those streams of income.

Rev. Rul. 91-30,[7] involved a corporation in which employees spent all of their time in the performance of veterinary services, including diagnostic and recuperative services as well as activities, such as the boarding and grooming of animals, that were incidental to the performance of these services. The ruling holds that a corporation whose employees perform veterinary services is a qualified personal service corporation within the meaning of I.R.C. §§ 448(d)(2) and 11(b)(2) and a personal service corporation within the meaning of I.R.C. § 441(i). Thus, the final regulations continue the long-standing treatment of veterinary services as the performance of services in the field of health for purposes of I.R.C. § 199A.

Commodities Businesses

Some comments to the proposed regulations suggested that the final regulations provide that a trade or business is not engaged in the performance of services of investing, trading, or dealing in commodities, an SSTB, if the business regularly takes physical possession of the underlying commodity in the ordinary course of its trade or business. Under the final regulations, for purposes of I.R.C. § 199A, gains and losses from the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities are qualified active sales, and gains and losses from qualified active sales are not taken into account in determining whether a person is engaged in the trade or business of dealing in commodities. Similarly, income, deductions, gains, or losses from a hedging transaction[8] entered into in the normal course of a commodities business conducted by a producer, processor, merchant, or handler of commodities are treated as gains and losses from qualified active sales that are part of that trade or business.

New Proposed Regulations

The August proposed regulations included several requests from the IRS for comments on issues not covered by the proposed (and now final) regulations. The IRS has now issued additional proposed regulations in response to the comments.[9]

Prior Suspended Losses. Treas. Reg. § 1.199A-3(b)(1)(iv) provides that previously disallowed losses or deductions (including under I.R.C. §§ 465, 469, 704(d), and 1366(d)) allowed in the taxable year are generally taken into account for purposes of computing QBI except to the extent the losses or deductions were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018. The final regulations also provide a first-in-first-out ordering rule. The new proposed regulations amend Treas. Reg. § 1.199A-3(b)(1)(iv) to provide that such losses are treated as a loss from a separate trade or business. To the extent that losses relate to a publicly traded partnership, the losses must be treated as losses from a separate publicly traded partnership. Treas. Reg. § 1.199A-3(b)(1)(iv)(B) provides that attributes of the disallowed loss are determined in the year the loss is incurred.

Trusts and Estates. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant unadjusted basis immediately after acquisition (UBIA) of depreciable property must be allocated among the trust or estate and its various beneficiaries. Treas. Reg. § § 1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's QBI and W-2 wages is determined based on the proportion of the trust's or estate's distributable net income (DNI) that is deemed to be distributed to that beneficiary for that taxable year. The proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. If the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.

In order to prevent circumvention of the QBI threshold amounts by creating multiple trusts, new Prop. Treas. Reg. § 1.199A-6(d)(3)(vii) provides that a trust formed or funded with a principal purpose of receiving a deduction under I.R.C. § 199A will not be respected for purposes of determining the threshold amount under I.R.C. § 199A.

Safe Harbor for Rental Real Estate Trade or Business

The IRS has issued a Notice which announces a proposed Revenue Procedure providing a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of the QBI deduction.[10] Relevant passthrough entities as defined in Treas. Reg. § 1.199A-1(b)(10) may also use this safe harbor in order to determine whether a rental real estate enterprise is a trade or business as defined in I.R.C. § 199A(d). If an enterprise fails to satisfy these requirements, the rental real estate enterprise may still be treated as a trade or business for purposes of I.R.C. § 199A if the enterprise otherwise meets the definition of trade or business in Treas. Reg. § 1.199A-1(b)(14).

A "rental real estate enterprise" is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties. The individual or relevant passthrough entity relying on this revenue procedure must hold the interest directly or through an entity disregarded as an entity separate from its owner under Treas. Reg. § 301.7701-3. Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents, with some exceptions[11]) as a single enterprise.

To qualify for treatment as a trade or business under the safe harbor, the rental real estate enterprise must

(1) maintain separate books and records to reflect income and expenses for each rental real estate enterprise;

(2) for taxable years beginning prior to January 1, 2023, perform 250 or more hours of "rental services" per year with respect to the rental enterprise;[12] and

(3) maintain contemporaneous records, including time reports, logs, or similar documents, of (i) the hours of all services performed; (ii) a description of all services performed; (iii) the dates on which such services were performed; and (iv) who performed the services for taxable years beginning after December 31, 2018.

"Rental services" include: (1) advertising to rent or lease the real estate; (2) negotiating and executing leases; (3) verifying information contained in prospective tenant applications; (4) collection of rent; (5) daily operation, maintenance, and repair of the property; (6) management of the real estate; (7) purchase of materials; and (8) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners. "Rental services" does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.

The safe harbor can be obtained by filing a statement with the return which claims the QBID for the rental enterprise.[13]

Revenue Procedure on W-2 Wages

The IRS has issued a Revenue Procedure[14] which provides three methods of calculating W-2 wages for purposes of QBID.

Definition of W-2 Wages under TCJA 2017 and Regulations

The term "W-2 wages" means the total wages subject to wage withholding, elective deferrals,[15] and deferred compensation paid by the qualified trade or business to employment its employees during the calendar year ending during the taxpayer's tax year.[16]

W-2 wages do not include (1) any amount that is not properly allocable to qualified business income or (2) any amount that is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.[17]

W-2 wages are to be determined in three steps (1) determination of total W-2 wages,[18] (2) allocation of the wages to each trade or business,[19] and (3) determination of which wages for each business are allocable to the QBI for each business.[20]

Three Methods for Calculating W-2 Wages

The new Revenue Procedure[21] provides three methods for calculating W-2 wages.

Unmodified Box Method. Under the unmodified box method, W-2 wages are calculated by taking, without modification, the lesser of—

(1) the total entries in Box 1 of all Forms W-2 filed with the Social Security Administration (SSA) by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or

(2) the total entries in Box 5 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

Modified Box 1 method. Under the Modified Box 1 method, the taxpayer makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the taxpayer. W-2

wages under this method are calculated as follows—

(1) total the amounts in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

(2) subtract from the total in (1) amounts included in Box 1 of Forms W-2 that are not wages for federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under I.R.C. § 3402(o); and

(3) add to the amount obtained in (2) the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

Tracking wages method. Under the tracking wages method, the taxpayer actually tracks total wages subject to federal income tax withholding and makes appropriate modifications. W-2 wages under this method are calculated as follows—Total the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with SSA by the taxpayer for the calendar year; plus the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

The revenue procedure also provides a method for calculating W-2 wages for taxpayers with short taxable years.

ENDNOTES

[1] REG-107892-18, 83 Fed. Reg. 40884 (Aug. 16, 2018). See Achenbach, "Qualified Business Income – New Proposed Regulations, Part I," 29 *Agric. L. Dig*. 121 (2018); See Achenbach, "Qualified Business Income – New Proposed Regulations, Part II," 29 *Agric. L. Dig*. 129 (2018); See Achenbach, "Qualified Business Income – New Proposed Regulations, Part III," 29 *Agric. L. Dig*. 137 (2018).

[2] Pub. L. No. 115-97, § 11011, 131 Stat. 2066 (2017), *adding* I.R.C. § 199A(d).

[3] Treas. Reg. § 1.199A-1(b)(13).

[4] Note that, if the landlord's participation rises to the level of "material participation," the rent in most cases is not only trade and business income but self-employment income, reported on Schedule SE. See Harl, *Farm Income Tax Manual*, § 8.05[3] (2018) for discussion of leasing of farm property as a trade or business for self-employment purposes.

[5] Prop. Treas. Reg. § 1.199A-1(b)(13); Prop. Treas. Reg. § 1.199A-4(b)(1)(i).

[6] Treas. Reg. § 1.199A-4(b).

[7] 1991-1 C.B. 61

[8] See definition in Treas. Reg. § 1.1221-2(b).

[9] REG-134652-18, 84 Fed. Reg. __ (2019).

[10] Notice 2019-7, I.R.B. 2019-__, __.

[11] Real estate used by the taxpayer (including an owner or beneficiary of a relevant passthrough entity relying on this safe harbor) as a residence for any part of the year under I.R.C. § 280A is not eligible for this safe harbor. Real estate rented or leased under a triple net lease is also not eligible for this safe harbor.

[12] For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year. 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise. For an enterprise held for less than five years, the 250 hours must be performed each year.

[13] The statement must be signed by the taxpayer, or an authorized representative of an eligible taxpayer or relevant passthrough entity, which states: "Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete."

[14] Rev. Proc. 2019-11, I.R.B. 2019-__.

[15] See I.R.C. § 402(g)(3)

[16] Treas. Reg. § 1.199A-1(b)(15). Deferred compensation includes compensation deferred under I.R.C. § 457, and the amount of any designated Roth contributions, as defined in I.R.C. § 402A.

[17] See Treas. Reg. § 1.199A-2(b)(2)(iii).

[18] Treas. Reg. § 1.199A-2(b)(2).

[19] Treas. Reg. § 1.199A-2(b)(3) (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).

[20] Treas. Reg. § 1.199A-2(b)(4) (W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under Treas. Reg. § 1.199A-3.).

[21] Rev. Proc. 2019-11, I.R.B. 2019-__.

CASES, REGULATIONS AND STATUTES

BANKRUPTCY

CHAPTER 12

PLAN. The debtors were a limited liability company and a limited partnership, both owned by two brothers. The debtors filed an amended plan which provided for periodic payments to the secured creditors funded primarily by the debtors' farming income and supplemented by custom trucking and combining revenue. Although the creditors objected to several aspects of the plan, including interest rates, terms of payment and retention of liens, the main issue was whether the plan was feasible under Section 1225(a)(6). The court stated that the test under Section 1225 was that a chapter 12 plan is considered feasible if the