CALIFORNIA REAL PROPERTY LAW JOURNAL

CALIFORNIA TAX LAWYER

R.P. VOL. 37, NO. 3, 2019 | C.T.L. VOL. 28, NO. 2 2019

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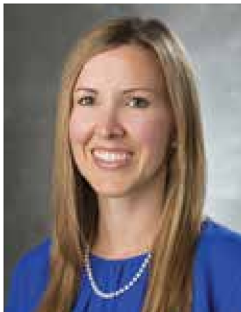
The Section 199A Deduction: Concepts & Examples

By Laura L. Buckley[1] & Ethan B. Shakoori[2]



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I. INTRODUCTION

In the Tax Cuts and Jobs Act of 2017 ("TCJA"), Congress created Internal Revenue Code (IRC) section 199A to address, among other things, concerns regarding increases in business income taxation. TCJA addressed these concerns for taxpayers investing in Subchapter C corporations by reducing the income tax rate on C corporations from 35 to 21 percent and making a similar reduction with respect to the highest ordinary income tax rates for individuals, trusts, and estates from 39.6 to 37 percent.

The legislative history of TCJA reveals that Congress noted that the reduction in the corporate tax rate to 21 percent failed to abate general concerns regarding the income tax rate applicable to business income taxed to individuals, trusts, and estates.[3] To create parity between C corporations and pass-through entities (and sole proprietorships), Congress enacted section 199A as individual tax reform, allowing investors in domestic businesses operating as a sole proprietorship, partnership, or S corporation to take a deduction of up to 20 percent of "Qualified Business Income," subject to certain limitations.[4] This so-called "pass-through deduction" applies to tax years beginning January 1, 2018 and ending December 31, 2025,[5] and is also available to trusts and estates that invest in certain pass-through entities. Employees and owners of certain service businesses may be out of luck, though.

In determining who can benefit from the section 199A deduction, Congress set guardrails based on, among other things, the type of business generating the income, the taxable income of the taxpayer, and whether the business is employing employees. As discussed in detail below, these guardrails (which for example may require the taxpayer to calculate W-2 wages under section 199A(b)(2)(B)(i) and (ii) and (b)(4)(A), and "unadjusted basis" of "Qualified Property" under section 199A(b)(2)(B)(ii) and (b)(6)), dictate who can benefit from the deduction and by how much.

This article does not, in any way, provide an all-encompassing guide to the intricate world of section 199A. Rather, it provides a thorough overview of what the authors believe are section 199A's need-to-know concepts, with a focus on real estate activities. There are many important details associated with the different aspects of section 199A that go unmentioned because they are outside this article's scope and purpose. For those who have read section 199A, its attendant Treasury Regulations, and administrative pronouncements, it goes without saying that section 199A is incredibly complicated and will provide ample opportunity for practitioners to interpret and opine.

II. FINAL TREASURY REGULATIONS

On August 8, 2018, just eight months after section 199A was enacted, the Internal Revenue Service ("IRS") published Proposed Treasury Regulations and Notice 2018-64 (providing guidance on calculating W-2 wages for section 199A purposes).[6] After trekking through a daunting 104-page Preamble and 80 pages of Proposed Treasury Regulations, 335 comments were submitted to the IRS requesting additional guidance.[7]

On January 18, 2019, amid a government shutdown, the IRS issued 247 pages of Final Treasury Regulations ("Treasury Regulations"),[8] Revenue Procedure 2019-11,[9] and Notice 2019-07[10] to clarify some of the deduction's mechanics.[11] Similar to the Notice released with the Proposed Treasury Regulations, Revenue Procedure 2019-11, issued with the Final Treasury Regulations, addressed W-2 wage calculations, and Notice 2019-07 addressed the trade or business safe harbor for Rental Real Estate Enterprises. Both are explained in detail below in Sections V and VI.

III. QUALIFIED BUSINESS INCOME

The section 199A deduction only applies to certain income, namely Qualified Business Income ("QBI"), which is the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business.[12] Qualified items of income, gain, deduction, and loss are those that are (1) effectively connected with the conduct of a domestic trade or business, and (2) included or allowed in the taxpayer's taxable income of the current year. However, the following categories of items are not qualified items included in QBI for section 199A purposes:[13]

(1) short- and long-term capital gain and loss;

(2) dividends and dividend equivalents as described in IRC section 954(c)(1)(G);

(3) interest income;

(4) gain or loss from commodity transactions;

(5) any gain, deduction, or loss accounted for in determining the net income from notional principal contracts as described in IRC section 954(c)(1)(F);

(6) amounts received from an annuity unless received in connection with a trade or business;

(7) any deduction or loss allocated to an amount described in the above six categories;

(8) reasonable compensation received by a shareholder in a S corporation; and

(9) payments to a partner as described in IRC section 707(a), or guaranteed payments to a partner as described in IRC section 707(c), for services provided to a trade or business, regardless of whether the partner is an individual or a Relevant Passthrough Entity ("RPE").

If the total QBI amount is negative, that negative amount will be carried forward to the subsequent tax year and treated as a separate trade or business for section 199A purposes.[14] This carry forward does not preclude the loss from being deducted pursuant to other IRC provisions.[15]

IV. SPECIFIED THRESHOLD AMOUNT

In enacting section 199A, Congress chose to set certain limitations or guardrails that may apply to reduce or eliminate the deduction if a taxpayer's taxable income exceeds specified thresholds. Thus, while the section 199A deduction is taken at the owner level based on items generated by the pass-through entity (or sole proprietorship) conducting the Qualified Trade or Business ("QTB"), the amount of the deduction, and whether it is even available is determined, among other things, upon the taxable income of the owner. Section 199A categorizes taxpayers into three categories: those below the so-called "Specified Threshold Amount," those within the phase-in range, and, finally, those above the threshold and phase-in-range.[16] Each category is subject to different rules governing how the section 199A deduction is calculated.

For the 2018 tax year, the Specified Threshold Amount was $157,000 of taxable income for single filers and trusts

and estates, and $315,000 for married couples filing joint returns.[17] For 2019, the threshold increased to $160,700 and $321,400 respectively.[18]

A. Below the Threshold

Taxpayers whose taxable income is below the threshold may take the section 199A deduction in an amount equal to the lesser of:

(1) the sum of 20 percent of total QBI, 20 percent of all qualified real estate investment trust ("REIT") dividends, and 20 percent of all qualified publicly traded partnership ("PTP") income, which will also be referred to as the "combined QBI;" or

(2) 20 percent of the taxpayer's taxable income less net capital gain.[19]

Thus, taxpayers below the threshold are subject to a limitation on their deduction equal to 20% of the taxpayer's ordinary income.

The W-2 basis, Unadjusted Basis Immediately after Acquisition ("UBIA"), and Specified Service Trade or Business ("SSTB") limitations discussed in detail below in sections V and VI are not applicable to taxpayers below the threshold.[20]

Below is an example of how the deduction works for below-the-threshold taxpayers:

> A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The QBI from the business is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000 x 20% = $16,200).[21]

B. Within the Phase-In Range

Taxpayers with taxable income up to $50,000 over the Specified Threshold Amount ($100,000 for joint filers), are within the phase-in range. In contrast to the threshold amounts, the phase-in range is not adjusted annually for inflation.[22]

These taxpayers are subject to the W-2, UBIA, and SSTB limitations, but with phase-in rules.

For example, to determine the amount of SSTB QBI, W-2 wages, and UBIA Qualified Property used in calculating a phase-in-range taxpayer's section 199A deduction, the phase-in taxpayer, for each SSTB, must calculate the "Applicable Percentage."[23] The example below illustrates this calculation, providing insight into how SSTB QBI is included in the phase-in taxpayer's section 199A deduction:

> A married couples' share of qualified items from QTB number 1 is $800,000 of gross revenue, $200,000 in W-2 wage expense, and $255,000 in other expenses. Before application of the phase-in rules, the taxpayers' QBI is $345,000 ($800,000 - $200,000 - $255,000). This exceeds the Specified Threshold Amount ($315,000) by $30,000, thus it is within the $100,000 phase-in range for married, joint filers. Therefore, the Applicable Percentage is $100,000 minus $30,000, which is $70,000 divided by $100,000, which is 70%. To determine QBI, the taxpayers will multiply the qualified items from the QTB by the Applicable Percentage ($800,000 x 70%) – ($200,000 x 70%) – ($255,000 x 70%), which will result in $241,500 of QBI. Finally, taxpayers will include in their combined QBI amount 20% of the QBI calculated above, $48,300.[24]

Like the rest of section 199A, the phase-in rules are both specific and intricate. The example above illustrates well the SSTB phase-in rule, yet, the phase-in rules for the W-2 wage basis limitation and the UBIA limitation are not as straight forward. Practitioners are encouraged to spend some time familiarizing themselves with these calculations.

C. Above the Threshold

Taxpayers whose income exceeds both the Specified Threshold Amount and the phase-in range are subject to the W-2, UBIA, and SSTB limitations.[25] These limitations are detailed in Sections V and VI below.

To determine the QBI deduction for taxpayers above the threshold amount, the so-called "QBI Component" must be calculated pursuant to the strict procedures in the Treasury Regulations. To calculate the QBI Component, the taxpayer must determine—for each trade or business—the lesser of:

(1) 20 percent of the QBI for the trade or business; or

(2) the greater of:

(i) 50 percent of W-2 wages for that trade or business, or

(ii) the sum of 25 percent of W-2 wages for that trade or business and 2.5 percent of UBIA of Qualified Property for that trade or business.[26]

The QBI Component is aggregated across all the taxpayer's trades or businesses.[27]

Once the QBI Component is calculated, these "above-the-threshold taxpayers" may deduct the lesser of:

(1) the sum of the QBI Component and the qualified REIT/PTP component (20 percent of all qualified REIT dividends and qualified PTP income received by the taxpayer); or

(2) 20 percent of the taxpayer's taxable income less net capital gain.[28]

The Treasury Regulations provide the following example:

> E, an unmarried individual, operates a business as a sole proprietorship. The business generates $1,000,000 of QBI in 2018. Solely for purposes of this example, assume that the business paid no wages and holds no Qualified Property for use in the business. After allowable deductions unrelated to the business, E's total taxable income for 2018 is $980,000. Because E's taxable income exceeds the Specified Threshold Amount, E's section 199A deduction is subject to the W–2 wage and UBIA limitations (for which there were no wages and no Qualified Property). Thus, E's section 199A deduction is zero because E's taxable income is above the Specified Threshold Amount yet E's QTB paid no wages and held no Qualified Property.[29]

V. QUALIFIED TRADE OR BUSINESS

Section 199A applies to QBI derived from Qualified Trades or Businesses ("QTBs").[30] Section 199A(d)(1)(B) expressly excludes wage income from QBI. Moreover, SSTBs are generally excluded from being considered QTBs.[31] So, what is included as a "trade or business" for purposes of section 199A? To answer that question, the Preamble to the Treasury Regulations references IRC section 162, noting that the "trade or business" language from IRC section 162 is both practical for the IRS and familiar to taxpayers.[32] However, what constitutes a "trade or business" is the subject of voluminous case law and administrative guidance. Moreover, "trade or business" is not defined in any Treasury Regulation and, as the voluminous case law might suggest, the judiciary has struggled to provide a definitive, uniform definition.

The most commonly used factors in determining whether a trade or business exists for section 162 purposes are: (1) the level of the taxpayer's activity in the trade or business, and (2) whether the taxpayer is engaged in the activity for profit.[33] For example, in determining whether a full-time gambler carried on a trade or business, the U.S. Supreme Court in the most recent section 162 case, *Commissioner v. Groetzinger*, noted that "if one's gambling activity is pursued full-time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of [section 162]."[34] Thus, the facts and circumstances clearly matter in determining whether an activity rises to the level of a trade or business under section 162.

The Treasury Regulations for section 199A provide that where rental or licensing of tangible or intangible property does not rise to the level of a section 162 trade or business, it still may be 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.[35]

A. Rental Real Estate

When section 199A was enacted, there was great uncertainty on whether rental real estate activity qualified for the deduction. Taxpayer and practitioner concerns were not without merit as courts consider only certain types of profit-minded rental real estate activities a trade or business. For example, the Second Circuit in *Grier v. United States* held that an activity where the taxpayer inherited a tenant-occupied home, continued to rent the home, and then eventually sold the home did not rise to the level of a trade or business.[36] The IRS acknowledges that there are certain circumstances where the rental of a single unit rises to the level of a trade or business.[37] However, the IRS is careful to note that the activity of renting real property does not rise, as a matter of law, to the requisite level for section 162 purposes in every case.[38]

The Preamble to the Treasury Regulations lists relevant factors in determining whether a rental real estate activity rises to the level required under section 162. This non-exclusive list includes:

(1) the type of rented property (commercial or residential);

(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; and

(5) the terms of the lease (net lease, short-term lease, long-term lease, etc.).

The Preamble to the Treasury Regulations also suggests that the IRS will scrutinize (1) taxpayers who own a tenancy in common in a piece of rental property and treat that interest as a trade or business but not as a separate entity, and (2) taxpayers that fail to comply with the information filing requirements under IRC section 6041.[39] Section 6041 provides that persons engaged in a trade or business making a payment of $600 or more to a payee must file an information return.

1. Safe Harbor

Thankfully, the IRS issued Notice 2019-07 with the final Treasury Regulations, which provides a safe harbor for rental income should the taxpayer adhere to specific and strict requirements. The safe harbor provides that "Rental Real Estate Enterprises" may be treated as QTBs for section 199A purposes.[40] Rental Real Estate Enterprises ("RREEs") are interests in one or more real properties held by the taxpayer for the production of rental income.[41] Those one or more properties, however, must all be either commercial or residential real estate, meaning RREEs cannot be comprised of both commercial and residential real estate.[42] Thus, there is no safe harbor for mixed-use buildings.[43] Moreover, the taxpayer taking advantage of the safe harbor must hold the interest directly or through a disregarded entity,[44] and the taxpayer must treat each rental property as its own enterprise or join all similar property in a single enterprise.[45]

The safe harbor has four requirements:[46]

(1) separate books and records adequately reflecting income and expenses must be maintained for each enterprise;[47]

(2) for tax years before 2023, the taxpayer must perform at least 250 hours of "rental services"; for tax years beginning after December 31, 2022, at least 250 hours of rental services must be performed in three of the five consecutive years that end with the taxable year;[48]

(3) the service records must be kept contemporaneously;[49] and

(4) the taxpayer must include, along with the tax return claiming the section 199A deduction, a statement that the above-mentioned requirements have been fulfilled.[50]

Owners, employees, agents, and independent contractors can perform rental services, including advertising, negotiating and executing leases, verifying tenant information in applications, collecting rent, maintenance, material purchases, and supervision of employees and independent contractors.[51]

Real estate used as a residence at any point during the taxable year and triple-net leases are expressly deemed ineligible for the safe harbor.[52] A rental activity that fails to meet the safe harbor can still qualify for the section 199A deduction under the section 162-based definition of a trade or business.[53]

2. Rentals to Commonly Controlled QTB

Moreover, as discussed above, the Treasury Regulations provide that the activity of renting property to a commonly controlled trade or business may qualify as a QTB.[54] Thus, an activity where a property is leased through a triple net lease to a commonly controlled trade or business could qualify as a QTB even where that activity would otherwise not qualify as a trade or business under section 162. The commonly controlled lessee must be an individual or RPE, not a C corporation, and "commonly controlled" means persons under sections 267(b) and 707(b), but at a 50% common ownership level, not "more than 50%" as is stated in those sections.

B. Specified Service Trade or Business

In defining QBIs, and thereby limiting the section 199A deduction to income only from QBI, Congress disallowed the deduction for certain types of businesses. Thus, if the taxable income of the taxpayer is beyond the threshold amounts discussed in Section IV, and the income is from a type of business that Congress chose to exclude from the definition of QTB, then the deduction is zero. These excluded businesses are SSTBs, which are defined as any trade or business providing services in one or more of the following fields:

> Health, law, accounting, actuarial, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, dealing in securities, and any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.[55]

The Treasury Regulations address what constitutes performed services in each separate field. In addition, there are certain specific rules that taxpayers taking the section 199A deduction must follow.

Below are examples of how the SSTB general rule intertwines with the Specified Threshold Amount. The first concerns taxpayers whose taxable income is above the Specified Threshold Amount, while the second concerns taxpayers below the Specified Threshold Amount:

> A married accounting firm partner with $100,000 guaranteed payment, $200,000 income earned by spouse, and $200,000 distributive share from accounting firm would be above the Specified Threshold Amount (because total income is $500,000 and threshold is only $315,000). Thus, the guardrails that Congress enacted with section 199A, such as the type of business generating the income, come into play. Here, the taxpayer would get no section 199A deduction because this type of business, an accounting firm, is an SSTB and, thus, does not constitute a QTB for section 199A purposes (and guaranteed payments are expressly excluded from the definition of QBI). In other words, because this taxpayer makes a lot of money (over the threshold amount) and is an accountant (an SSTB), he/she cannot take advantage of the section 199A deduction.
>
> The next tax year, the same married accounting firm partner with $100,000 guaranteed payment, $100,000 distributive share from accounting firm, and non-working spouse would be able to take advantage of the section 199A deduction with respect to the $100,000 distributive share, reducing taxable income from $200,000 to $180,000, even though accounting services is an SSTB. This is because the taxpayer's taxable income is below the Specified Threshold Amount.

There are two de minimis rules for SSTB income generated by trades or businesses with both SSTB and non-SSTB income.[56] The two rules distinguish trades or businesses with gross receipts of $25 million or less from those with gross receipts greater than $25 million.[57] A trade or business with gross receipts of $25 million or less is not a SSTB if less than 10 percent of its gross receipts are derived from performing any of the services, or activities incident to any of the specified services mentioned above.[58] Trades or businesses with gross receipts greater than $25 million, however, are not SSTBs if less than 5 percent of its gross receipts are derived from performing any of the services mentioned above.[59]

Below is an example applying one of the de minimis rules to a trade or business with gross receipts of less than $25 million:

> Landscape LLC sells lawn care and landscaping equipment and also provides advice and counsel on landscape design for large office parks and residential buildings. The landscape design services include advice on selection and placement of trees, shrubs, and flowers and are considered to be consulting, an SSTB. Landscape LLC separately invoices for its landscape design services and does not sell the trees, shrubs, or flowers it recommends for use in the landscape design. Landscape LLC maintains one set of books and records and treats the equipment sales and design services as a single trade or business for purposes of sections 162 and 199A. Landscape LLC has gross receipts of $2 million. $250,000 of the gross receipts is attributable to the landscape design services, which is, again, an SSTB activity.
>
> Because the gross receipts from the consulting services exceeds 10 percent of Landscape LLC's total gross receipts, the entirety of Landscape LLC's trade or business is considered an SSTB.[60] Furthermore, because the trade or business is an SSTB, if an owner's taxable income is above the Specified Threshold Amount, his/her section 199A deduction will be zero.

Anticipating creative practitioners, another rule provides that all or a portion of a non-SSTB trade or business may be considered a SSTB trade or business if (1) property or services are provided to a SSTB, and (2) there is at least 50 percent common ownership of the non-SSTB and the SSTB.[61] Below is an example illustrating this "tainting" rule:

> Law Firm is a partnership that provides legal services to clients, owns its own office building, and employ its own administrative staff. Law Firm divides into three partnerships. Partnership 1 performs legal services to clients. Partnership 2 owns the office building and rents the entire building to Partnership

1. Partnership 3 employs the administrative staff and provides administrative services to Partnership 1 in exchange for fees. All three partnerships are owned by the same people. Because Partnership 2 provides property to Partnership 1, and Partnership 3 provides services to Partnership 1, Partnerships 2 and 3 will be treated as SSTBs.[62]

VI. W-2 LIMITATION AND UNADJUSTED BASIS IMMEDIATELY AFTER ACQUISITION

In calculating the section 199A deduction, you may remember that we must first calculate the QBI Component for the taxpayer with taxable income above the Specified Threshold Amount—for each trade or business—which is the lesser of:

(1) 20 percent of the QBI for the trade or business; or

(2) the greater of:

(i) 50 percent of W-2 wages for that trade or business, or

(ii) the sum of 25 percent of W-2 wages for that trade or business and 2.5 percent of UBIA of Qualified Property for that trade or business.[63]

A. Calculating W-2 Wages

Taxpayers with taxable income above the Specified Threshold Amount are subject to a limitation based on W-2 wages, calculated with respect to each trade or business, on the amount of QBI applicable for the section 199A deduction.[64] W-2 wages are defined as amounts paid by a taxpayer for the employment of employees during the taxable year.[65] W-2 wages do not include amounts not properly allocable to QBI arising from a QTB and do not include amounts not included in returns filed with the Social Security Administration.[66] The definition does include, however, wages subject to wage withholding under IRC section 3401(a), elective deferrals under IRC section 402(g)(3), deferred compensation under IRC section 457, and Roth contributions under IRC section 402A.[67] So, there are some planning opportunities.

The final Treasury Regulations and Revenue Procedure 2019-11, released contemporaneously with the Treasury Regulations, provide a three-step process to determine W-2 wages paid for each trade or business:[68]

(1) the taxpayer must determine the total W-2 wages paid during the taxable year;[69]

(2) the W-2 wages must be allocated to the trade or business where they were earned;[70] and

(3) the taxpayer must determine the amount of W-2 wages, respectively for each business, that constitutes QBI derived from a QTB.[71]

B. The Wage Plus Basis Limitation: Unadjusted Basis Immediately After Acquisition and Qualified Property

As noted above, the wage plus basis limitation equals:

(1) the sum of 25 percent of W-2 wages (calculated as provided in the preceding subsection) for that trade or business, plus

(2) 2.5 percent of Unadjusted Basis Immediately after Acquisition ("UBIA") of Qualified Property for that trade or business (see the QBI Component calculation).[72]

Section 199A does not define "unadjusted basis" or "immediately after acquisition." Review of other relevant IRC sections, however, leads to the conclusion that a taxpayer's "unadjusted basis" in property is the basis (as determined under sections 1012, 1014, or 1015) prior to any adjustments under section 1016.[73]

This alternate method of calculating the QBI Component benefits taxpayers that have QTBs with depreciable property, but too few employees to claim the full, or any, section 199A deduction for that QTB based solely on W-2 wages.[74] UBIA is the basis of Qualified Property on the date the property is placed into service.[75] Neither adjustments for tax credits nor adjustments for portions of the basis that the taxpayer treated as an expense (such as depreciation, bonus depreciation, and section 179 depreciation) are included in calculating UBIA.[76] Reductions in basis attributable to the taxpayer's non-business use of the Qualified Property within the taxable year, however, are considered.[77]

Below, is an example illustrating the wage plus basis limitation in calculating the section 199A deduction for a taxpayer with taxable income above the Specified Threshold Amount:

Taxpayer has $400,000 in QBI from her wholly owned QTB. Taxpayer has taxable income of $500,000. There are $200,000 in W-2 wages and there is $10 million of UBIA of Qualified Property with respect to the QTB. Taxpayer's wage-basis limit is $300,000, equal to the greater of $100,000

(50 percent of W-2 wages) and $300,000, the sum of $50,000 (25 percent of W-2 wages) and $250,000 (2.5 percent of the UBIA of Qualified Property). This taxpayer's combined QBI amount is $80,000, equal to the lesser of $80,000 (20 percent of combined QBI) and $300,000 (taxpayer's wage plus basis limitation). Therefore, taxpayer's section 199A deduction is $80,000.[78]

1. *Qualified Property*

The wage plus basis limitation is only available for "Qualified Property." Qualified Property:

> means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167—
>
> (i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,
>
> (ii) which is used at any point during the taxable year in the production of qualified business income, and
>
> (iii) the depreciable period for which has not ended before the close of the taxable year.[79]

For purposes of section 199A, "Depreciable Period" means:

> with respect to Qualified Property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer 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.[80]

Thus, for section 199A purposes, Qualified Property receives a ten year life from its placed-in-service date even if the useful life would otherwise be shorter.

Below is an example where property does not qualify as Qualified Property because the Depreciable Period ends before the end of the tax year:

> A calendar-year taxpayer acquires seven-year property for use in her QTB on July 1, 2008. The Depreciable Period for the property is ten years, as ten years is longer than the recovery period for seven-year property. The Depreciable Period for the property ends on June 30, 2018. As the Depreciable Period ended before the end of 2018, the property is not Qualified Property for 2018.[81]

Finally, property (1) acquired within 60 days of the end of the tax year, (2) disposed of within 120 days of acquisition, and (3) not used in the trade or business for at least 45 days prior to disposition is not Qualified Property for section 199A purposes unless the taxpayer can prove that the principal purpose of the acquisition and subsequent disposition was not to increase the section 199A deduction.[82]

2. *Depreciable Period Following Section 351 or 721 Contribution*

Treasury Regulation sections 1.199A-2(c)(2) and (c)(3) provide rules to determine the placed-in-service date and UBIA when a taxpayer acquires Qualified Property in a transferred basis transaction (for example, a section 721 contribution to a partnership or a section 351 contribution to a corporation). The transferee's UBIA of Qualified Property acquired in such transactions is the same as the transferor's UBIA in the property, decreased by the amount of money received by the transferor or increased by the amount of money paid by the transferee to acquire the property.[83]

Moreover, the Qualified Property that was transferred in said transaction would be treated as placed in service as of the date the transferor placed the property in service to the extent the transferee's UBIA in the Qualified Property does not exceed the transferor's UBIA in such property.[84] If any portion of the transferee's UBIA in the Qualified Property exceeds the transferor's UBIA in such property, that portion of the property is treated as placed in service on the date of the transfer.[85]

3. *Property Acquired Through 1031 Exchange*

The Treasury Regulations provide UBIA-specific rules for Qualified Property acquired in a section 1031 exchange. For such property, the UBIA of the Qualified Property acquired equals the UBIA of the property exchanged with certain possible adjustments.[86] The Treasury Regulations provide that the UBIA of the replacement property in a like-kind exchange is decreased by excess boot or increased by the amount of money paid or the fair market value of other property transferred by the taxpayer to acquire the property.[87]

The Treasury Regulations define excess boot as the amount of money or the fair market value of other property received by the taxpayer over the amount of appreciation in the relinquished property.[88] If the taxpayer acquires more than one like-kind Qualified Property in a section

1031 exchange, then the UBIA is apportioned between the qualified replacement properties proportionate to their fair market values.[89]

The following example is illustrative of this concept:

> On January 5, 2012, A purchases Real Property X for $1 million and placed it in service in A's trade or business. A's trade or business is not an SSTB. A's basis in Real Property X under section 1012 is $1 million. Real Property X is Qualified Property within the meaning of section 199A(b)(6).
>
> On January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million, but Real Property Y has a value of $1.5 million. A therefore adds $200,000 in cash to the exchange of Real Property X for Real Property Y. On January 15, 2019, A places Real Property Y into service. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482. A's UBIA in Real Property Y is $1.2 million ($1 million in UBIA from Real Property X plus $200,000 cash paid by A to acquire Real Property Y).
>
> Because the UBIA of Real Property Y exceeds the UBIA of Real Property X, Real Property Y is treated as being two separate Qualified Properties for purposes of section 199A. One property has a UBIA of $1 million (the portion of A's UBIA of $1.2 million in Real Property Y that does not exceed A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A. The other property has a UBIA of $200,000 (the portion of A's UBIA of $1.2 million in Real Property Y that exceeds A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 15, 2019, which is the date on which Real Property Y was first placed in service by A.[90]

VII. AGGREGATION

Generally, for purposes of calculating the QBI Component, each trade or business is treated separately.[91] However, the Treasury Regulations allow taxpayers and RPEs to aggregate trades or businesses, at either the individual or entity level, to simplify application of the W-2 and wage plus UBIA limitations to businesses conducted over multiple entities. Aggregation is permitted if:

(1) the same person or group or persons own 50 percent or more of each trade or business being aggregated;

(2) the ownership interest existed for a majority of the taxable year;

(3) all items attributable to each trade or business are reported on the taxable year's returns; and

(4) none of the trades or businesses are SSTBs.[92]

In addition, the trades or businesses being aggregated must satisfy the relationship requirement by conforming to at least two of three factors:

(1) the trades or businesses provide products, property, or services customarily offered together;

(2) the trades or businesses share facilities or centralized business elements; or

(3) the trades or businesses coordinate with one or more trades or businesses in the aggregated group.[93]

Once the taxpayer or RPE chooses to aggregate trades or businesses, such aggregation must be consistently reported in all later tax years.[94] Generally, a taxpayer or RPE that fails to aggregate will not be able to aggregate on an amended return.[95] There is, however, an exception for amended returns filed for the 2018 tax year.[96] To satisfy annual disclosure requirements, taxpayers must attach a statement identifying each trade or business aggregated including:

(1) a description of each trade or business;

(2) the entity's name and EIN;

(3) whether the entity was formed, acquired, disposed, or ceased operations;

(4) the trade or business of an RPE in which the taxpayer holds an ownership interest; and

(5) any other information the Commissioner requires (a catchall intended to capture whatever reporting requirement the IRS may come up with in the future).[97]

If the disclosure requirements are not satisfied, the IRS may disaggregate the trades or businesses. When the IRS disaggregates trades or businesses, the taxpayer is prohibited

from aggregating those trades or businesses for three years. So be aware.

The following example illustrates the aggregation principles well:

> E, an individual, wholly owns and operates a catering business and a restaurant through separate disregarded non-SSTB entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all the receivables, and prepares payroll for each business. E maintains a website and print advertising materials that reference both the catering and restaurant business. Moreover, E uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and a truck not used or associated with the restaurant.
>
> E may treat the catering business and the restaurant as a single trade or business for purposes of section 199A because all of the relevant factors for aggregation under section 199A have been met. The restaurant and catering business are held in disregarded entities so A will be treated as operating each of these businesses directly; both businesses offer prepared food to customers; and the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting.[98]

VIII. PENALTIES

Despite the complexities section 199A presents to taxpayers, Congress lowered the threshold to apply accuracy-related penalties where the section 199A deduction was claimed. Section 6662 provides that an additional tax, or penalty, of 20% of the underpayment is added if the understatement exceeds the greater of 10% of the tax required to be shown on the return or $5,000.[99] Congress amended section 6662 to provide that for those claiming the section 199A deduction, the general rule is revised by substituting 5% for 10%, regardless of whether the section 199A deduction influences the understatement.[100]

IX. CONCLUSION

Section 199A is new and it is complicated; translation: there will be more notices issued by the IRS to clarify its approach to section 199A, as well as litigation from taxpayers endeavoring to define how and when the deduction applies. In the meantime, section 199A offers essential tax planning opportunities, and requires a fresh look at issues such as choice of entity, how and to whom real property is leased, and aggregation of real property interests.

Endnotes

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2. Ethan B. Shakoori, J.D., 858-692-1603, ebshakoori@law.cwsl.edu. The author wishes to thank the reviewers, Higgs Fletcher & Mack, LLP, and California Western School of Law.
3. H.R. Rep. No. 115th Cong., 1st Sess., at 129 (2017).
4. Pisem, *Qualified Business Income Deduction: Section 199A*, 537 T.M., § I.A, at 1.
5. Pub. L. No. 115-97, § 1101(e); I.R.C. § 199A(i).
6. Pisem, *supra* note 4, § I.A., at 2.
7. Sally P. Schreiber, *Qualified Business Income Deduction Regs. and other Guidance Issued*, J. Acct. (Jan. 22, 2019), https://www.journalofaccountancy.com/news/2019/jan/sec-199a-qbi-deduction-201920483.html.
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10. Notice 2019-07, 2019-09 I.R.B. 740, 2019 WL 267994.
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16 *See* Treas. Reg. § 1.199A-1.

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18 Alistair M. Nevius, *Inflation Adjustments and Tax Tables Issued for 2019*, Tax Adviser (Nov. 15, 2018), https://www.thetaxadviser.com/news/2018/nov/2019-tax-tables-irs-201820129.html.

19 Treas. Reg. § 1.199A-1(c).

20 § 1.199A-1(c).

21 § 1.199A-1(c)(3)(i), ex. (1).

22 Pisem, *supra* note 4, § III.E.(1), at 1.

23 IRC § 199A(d)(3)(A); Treas. Reg. § 1.199A-1(d)(2)(i).

24 Pisem, *supra* note 4, § III.E.(2)(a), at 4.

25 Treas. Reg. § 1.199A-1(d).

26 § 1.199A-1(d)(2)(iv).

27 § 1.199A-1(d)(2)(iv).

28 § 1.199A-1(d)(1).

29 § 1.199A-1(d)(4)(i), Ex. (1).

30 § 199A(b)(2)(A).

31 § 1.199A-5(a)(2). As mentioned in section IV, the SSTB limitation does not apply to taxpayers below the threshold. For taxpayers within the phase-in range, SSTBs are considered QTBs but the amount of QBI subject to the section 199A deduction is reduced.

32 § 1.199A-1(b)(14).

33 *Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), *aff'd per curium*, 218 F.2d 603 (2d Cir. 1955); Pisem, *supra* note 4, § III.C.(1)(a), at 1.

34 *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

35 Treas. Reg. § 1.199A-1(b)(14).

36 *Grier*, 218 F.2d 603.

37 Steven B. Gorin, *Income Tax Issues and Planning Strategies for Business Entities*, ALI CLE Course Material, Nov. 3, 2016, SY010 ALI-CLE 881 (Westlaw 2019).

38 *Id. See Ostrom v. Comm'r*, 113 T.C.M. (CCH) 1529 (2017) (holding that the taxpayer failed to show that she performed more than 50% of personal services, and more than 750 hours, in real property trades or businesses during the tax year at issue. Accordingly, she could not deduct the rental activity losses); *see also Jasionowski v. Comm'r*, 66 T.C. 312 (1976) (holding that petitioners, experienced in the rental business, who leased a property to their long-time friend for half the market value and deducted the losses, did not have the requisite profit motive to have their activities qualify as those of a trade or business).

39 Preamble, T.D. 9847, 84 Fed. Reg., at 2956.

40 Notice 2019-07, 2019-09 I.R.B. 740, 2019 WL 267994.

41 Pisem, *supra* note 4, § III.C.(1)(b), at 3.

42 *Id.*

43 Pisem, *supra* note 4, § III.C.(1)(b).

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46 *Id.*; Alistair Nevius, *Section 199A Rental Real Estate Activity Safe Harbor Proposed*, Tax Adviser (Apr. 1, 2019), https://www.thetaxadviser.com/issues/2019/apr/sec-199A-rental-real-estate-activity-safe-harbor-proposed.html.

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.*

51 *Id.*

52 *Id.*

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56 § 1.199A-5(c); *see* Thomas A. Orr, *Section 199A and the Aggregation of Trades or Businesses*, Tax Adviser (Apr. 1, 2019), 2019 WL 15315174.

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58 § 1.199A-5(c)(1)(i).

59 § 1.199A-5(c)(1)(ii).

60 § 1.199A-5(c)(1)(iii)(A), ex. (1); Orr, *supra* note 56.

61 Treas. Reg. § 1.199A-5(c)(2)(i).

62 § 1.199A-5(c)(2)(iii)(A), ex. (1).

63 § 1.199A-1(d)(2)(iv).
64 I.R.C. § 199A(b)(2).
65 § 199A(b)(4)(A); Treas. Reg. § 1.199A-2(b)(2)(i).
66 Rev. Proc. 2019-11, 2019-09 I.R.B. 742, 2019 WL 267993.
67 Treas. Reg. § 1.199A-2(b)(2)(i).
68 Treas. Reg. § 1.199A-2(b); Rev. Proc. 2019-11, 2019-09 I.R.B. 742, 2019 WL 267993.
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70 Treas. Reg. § 1.199A-2(b)(3).
71 § 1.199A-2(b)(4).
72 I.R.C. § 199A(b)(2)(B)(ii).
73 Pisem, *supra* note 4, § III.D.(3)(c), at 9.
74 *Id.* § III.D.(3)(a).
75 Treas. Reg. § 1.199A-2(c)(2).
76 § 1.199A-2(c)(3).
77 § 1.199A-2(c)(3).
78 Pisem, *supra* note 4, § III.D.(3)(a), at 6-7.
79 IRC § 199A(b)(6)(A).
80 § 199A(b)(6)(B); *see also* Pisem, *supra* note 4, § III.D.(3)(b), at 7.
81 § 199A(b)(6)(B), ex. (20).
82 Treas. Reg. § 1.199A-2(c)(1)(iv).
83 § 1.199A-2(c)(2)-(c)(3).
84 *Id.*
85 *Id.*
86 Treas. Reg. § 1.199A-2(c)(3)(ii).
87 *Id.*
88 *Id.*
89 *Id.*
90 § 1.199A-2(c)(4), ex.(1), (4).
91 § 1.199A-4(a).
92 § 1.199A-4(b); *see* Jordan Empey, *Final Guidance Issued on the New 20% Pass-Through QBI Deduction*, SKR + Co (Mar. 18, 2019), https://www.skrco.com/final-qbi-deduction-regulations-clarify-questions-on-section-199a/.
93 Treas. Reg. § 1.199A-4(b)(1)(v)(C).
94 § 1.199A-4(c)(1).
95 Pisem, *supra* note 4, § III.F.(2)(e), at 6.
96 Preamble, T.D. 9847, 84 Fed. Reg., 2956; Treas. Reg. § 1.199A-4(c)(1).
97 Treas. Reg. § 1.199A-4(c)(4).
98 *See* § 1.199A-4(b)(1)(v)(C), ex. (1).
99 I.R.C. § 6662(a), (b)(2), (d)(1)(A).
100 § 6662(d)(1)(C); Treas. Reg. § 1.199A-1(e)(6).

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