

# THE SECTION 199A FINAL REGULATIONS – IMPORTANT CLARIFICATIONS, PART 1

## WHAT IS A QUALIFIED TRADE OR BUSINESS?

By Steve Beck

I.R.C. § 199A enables individuals, certain trusts and estates (collectively, “individuals”) to deduct up to 20% of their combined qualified business income (QBI) from a domestic business operated as a pass-through (i.e., Subchapter K partnerships, Subchapter S corporations, sole proprietorships and disregarded entities) (collectively, RPEs). This deduction is hereafter referred to as the 199A deduction.

The basic effect of the 199A deduction is to reduce the maximum individual income tax rate on combined QBI of RPEs from 37% to 29.6% (i.e., 37%, multiplied by 80%). Therefore, it helps to partially bridge the gap between the maximum 37% income tax rate applying to individuals and the lower 21% income tax rate applying to corporations. The 199A deduction, however, applies only for tax years beginning after 2017 and before 2026.

Today’s CPA included an article titled, “Pass-Through Entities Not Left Out of Tax Reform,” in the May/June 2018 issue that discussed the 199A deduction based on the provisions of the Internal Revenue Code (I.R.C.), which was the only guidance available at the time of publication. That article noted many issues that remained outstanding at the time. Since then, the Treasury Department and Internal Revenue Service (collectively, Treasury) have issued final regulations (the 199A regulations), which clarify important issues regarding the 199A deduction. T.D. 9847 (Feb. 12, 2019).

This article is the first of a two-part series discussing important provisions of the 199A regulations. This article

focuses on the important clarifications in the 199A regulations addressing whether an individual or RPE is engaged in a qualified trade or business (QTB), which is required to have any QBI eligible for the 199A deduction.

A second article will address the provisions in the 199A regulations that provide tax return preparers with opportunities for assisting their clients with maximizing the amount of the 199A deduction and potential pitfalls that could eliminate the amount of their clients’ 199A deduction.

The QTB concept is important in determining whether a client is eligible for the 199A deduction. The amount of the 199A deduction is generally calculated based on 20% of the individual’s QBI from a QTB. Thus, in order to have any QBI eligible for the 199A deduction, the individual (or RPE in which the individual owns an interest) must be engaged in a QTB.

A QTB is any trade or business, except for the trade or business of performing services as an employee and a specified service trade or business (an SSTB). I.R.C. § 199A(d)(1). Thus, there are three important concepts for determining whether an individual or RPE is engaged in a QTB:

- What is a trade or business for purposes of I.R.C. § 199A?
- What constitutes services as an employee?
- What constitutes an SSTB?

These three concepts are discussed in the following three sections of this article.

## What is a Trade or Business for Purposes of I.R.C. § 199A?

The term “trade or business” is not defined under I.R.C. § 199A. The 199A regulations, however, define a “trade or business” as an activity qualifying as such under I.R.C. § 162 (other than working as an employee). Treas. Reg. § 1.199A-1(b)(14). I.R.C. § 162 permits taxpayers to deduct all the ordinary and necessary expenses paid or incurred in carrying on trade or business that are reasonable in amount.

The Preamble to the 199A regulations (the Preamble) notes that the I.R.C. § 162 definition of trade or business is derived from a large body of existing case law. This case law provides that whether the activities of a taxpayer constitute a trade or business requires an examination of the facts and circumstances of the particular case. *Higgins v. Comm’r*, 312 U.S. 212, 217 (1941).

In addition, courts typically apply two factors in determining whether an activity rises to the level of a trade or business. First, the taxpayer’s activities must be considerable, regular and continuous to constitute a trade or business. See *Comm’r v. Groetzinger*, 480 U.S. 23 (1987). Second, the taxpayer must enter into and carry on the activity with a good faith intention to derive a profit or with the belief that profit can be derived from the activity. See *id.*

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Significant questions have arisen regarding whether rental real estate activities qualify as a trade or business for purposes of the 199A deduction. In response, the Preamble notes that the relevant factors for determining whether a rental real estate activity constitutes an I.R.C. § 162 trade or business include the:

- Type of rented property (whether commercial or residential);
- Number of properties rented;
- Daily involvement of the owner or the owner’s agents;
- Types and significance of any ancillary services provided under a lease; and
- Terms of the lease (e.g., a net lease, as opposed to a traditional lease, and a short-term or long-term lease).

In promulgating the 199A regulations, Treasury ultimately declined to provide any bright-line standard regarding whether a particular rental real estate activity is a trade or business for purposes of the 199A deduction. However, Treasury released Notice 2019-07, which contains a proposed Revenue Procedure detailing a proposed safe harbor (the safe harbor), under which an individual or RPE would be able to treat a rental real estate business as a trade or business solely for purposes of the 199A deduction.

## The Rental Real Estate Safe Harbor

The proposed Revenue Procedure would provide that a rental real estate activity that satisfies the standards of the safe harbor would be deemed to constitute a trade or business for purposes of the 199A deduction. Conversely, the standards of the proposed Revenue Procedure would not prohibit an individual or RPE engaged in rental real estate activities from qualifying for the 199A deduction in situations in which the safe harbor standards are not satisfied.

The safe harbor applies to a “rental real estate enterprise” (RREE), which is an interest in real property held for the production of rents. An RREE may consist of an interest in multiple properties. An individual or RPE relying on the safe harbor must hold the interest directly or through a disregarded entity.

Taxpayers must either treat each property held for the production of rents as a separate enterprise or all similar properties held for the production of rents (except for certain excluded properties) as a single enterprise. For purposes of the aforementioned treatment, commercial and residential real estate may not be part of the same enterprise, and taxpayers may not vary their treatment from year to year unless there has been a significant change in facts and circumstances.

The safe harbor provides that an RREE will be treated as a trade or business for purposes of the 199A deduction if the following three requirements are satisfied. First, the individual or RPE conducting the RREE must maintain separate books and records to reflect the income and expenses for each RREE.

Second, the RREE must involve at least a certain threshold of rental services for each year and the required frequency for satisfying that threshold varies depending on the tax year at issue. For tax years prior to 2023, at least 250 hours of “rental services” must be performed each year with respect to the RREE. In contrast, for tax years after 2022, the aforementioned standard of at least 250 hours of “rental services” must

generally be satisfied in any three of the prior five consecutive tax years ending with the tax year at issue.

If, however, the RREE has been conducted for fewer than five years, the 250-hour threshold must be satisfied for each of the prior years in which the RREE has been conducted to satisfy the safe harbor for a tax year after 2022.

“Rental services” for purpose of the 250-hour threshold include:

- Advertising to rent or lease the real estate;
- Negotiating and executing leases;
- Verifying information contained in prospective tenant applications;
- Collection of rent;
- Daily operation, maintenance and repair of the property;
- Management of the real estate;
- Purchase of materials; and
- Supervision of employees and independent contractors.

These rental services may be performed by owners or by employees, agents and/or independent contractors of the owners. However, the following do not constitute “rental services” for purposes of the safe harbor:

- 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.

Third, the taxpayer or RPE must maintain contemporaneous records, including time reports, logs or similar documents, regarding the following:

- Hours of all services performed;
- Description of all services performed;
- Dates on which such services were performed; and
- Who performed the services.

The safe harbor also requires that these records must be made available for inspection at the request of the IRS. The safe harbor provides, however, that this contemporaneous records requirement is not applicable to taxable years beginning prior to Jan. 1, 2019.

Certain rental real estate arrangements are excluded from the safe harbor. These excluded arrangements consist of real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on the safe harbor) as a residence for any part of the year under I.R.C. § 280A and real estate rented or leased under a triple net lease. A triple net lease for this purpose includes a

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lease agreement that requires the tenant or lessee to pay (all or a portion of the) taxes, fees and insurance, and be responsible for maintenance activities for (all or a portion of) a property in addition to rent and utilities.

The safe harbor provides useful certainty for taxpayers who can document satisfaction of the 250-hour threshold. However, the documentation required under the safe harbor may impose additional administrative complexity on rental real estate businesses. For this reason, taxpayers who are confident they can establish that their rental real estate operations involve regular, continuous and considerable activities carried on for profit under the I.R.C. § 162 common law standards may choose to forego the additional documentation complexity that would be needed to obtain the protections of the safe harbor.

## Common Control Rental Property

The 199A regulations also provide a special rule that enables an individual or RPE to treat certain rental or licensing of tangible or intangible property as a trade or business for purposes of I.R.C. § 199A, even though that activity would not otherwise rise to the level of an I.R.C. § 162 trade or business.

This special rule applies only if the property is rented or licensed to a trade or business that is subject to “common control.” Treas. Reg. § 1.199A-1(b)(14). “Common control” for this purpose means that the same person or group of persons, directly or indirectly, owns 50% or more of the issued and outstanding shares of the corporation or capital and profits interests in the partnership. Treas. Reg. § 1.199A-4(b)(1)(i).

Thus, under this principle, a rental activity that neither rises to the level of an I.R.C. § 162 trade or business nor qualifies under the safe harbor may still be treated as a QTB if the property is rented to a QTB that is controlled by the same person or group of persons. This special rule enables individuals to include rental income as QBI in situations in which the individuals own their operating





business in one entity and own the related real property used by that operating business in a separate entity for liability protection purposes.

## What is an Employee for Purposes of I.R.C. § 199A?

As mentioned previously, a QTB does not include the performance of services as an employee. Treas. Reg. § 1.199A-5(a)(3), (d)(1). Thus, no items of income, gain, loss and deduction from performing services as an employee constitute QBI. Treas. Reg. § 1.199A-5(d)(1). Accordingly, no individual may claim a 199A deduction for wage income, regardless of the amount of that individual's taxable income. Treas. Reg. § 1.199A-5(a)(3).

Whether wages are earned as an employee is determined based on the proper classification of the worker for federal employment tax purposes. Treas. Reg. § 1.199A-5(d)(2). Thus, misclassification of a worker as an independent contractor is irrelevant.

In addition, an individual is presumed to be an employee for purposes of the 199A deduction if that individual was previously properly treated as an employee for federal employment tax purposes by the employer and that individual is subsequently treated as other than an employee by that employer with regard to the provision of substantially the same services directly or indirectly

to that employer (or a related person). Treas. Reg. § 1.199A-5(d)(3).

This presumption continues for three years after the individual is no longer treated as an employee and applies regardless of whether the individual provides services directly or indirectly through an entity. The presumption, however, may be rebutted upon a showing that, under federal tax common law standards, the individual is performing services in a capacity other than as an employee.

## What is an SSTB?

### SSTB Categories

An SSTB involves the performance of services in the following statutorily designated fields:

- Health;
- Law;
- Accounting;
- Actuarial science;
- Performing arts;
- Consulting;
- Athletics;
- Financial services; or
- Brokerage services.

An SSTB also involves the performance of services that consist of investing and investment management,

trading and dealing in securities, partnership interests or commodities. I.R.C. §199A(d)(2)(B). All of the aforementioned fields of services that are explicitly listed as constituting an SSTB are hereafter referred to as the “listed categories.”

In addition, an SSTB includes any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees. I.R.C. §199A(d)(1). This “reputation or skill” category initially caused considerable concerns, but those concerns are significantly addressed by the 199A regulations, as discussed below.

The regulatory descriptions of the listed categories are relatively straightforward and thus are not discussed here. Instead, this article focuses on the meaning of the “consulting” and “reputation or skill” categories, because they have been the source of greater uncertainty.

### **“Consulting”**

“Consulting” means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Treas. Reg. §1.199A-5(b)(2)(vii). Consulting also includes providing advice and counsel regarding public advocacy or lobbying with the intention of influencing decisions made by governmental agencies or legislators.

Consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses. For this purpose, the determination of whether a person’s services are sales or economically similar services will be based on all the facts and circumstances of that person’s business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided.

In addition, consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.

The 199A regulations contain three examples distinguishing between situations that constitute consulting for purposes of the 199A deduction and those that do not. First, if a business advises clients regarding making their personnel structures more efficient, without providing any temporary workers to the clients or receiving compensation based on the client’s use of temporary workers, that business involves consulting

services for purposes of SSTB status. Treas. Reg. §1.199A-5(b)(3), Ex. 8.

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Conversely, if the business merely involves providing temporary workers to clients for a fixed fee, that business may not involve consulting services, even if the temporary workers provide consulting advice to the clients. Treas. Reg. §1.199A-5(b)(3), Ex. 9.

Lastly, if a business involves licensing software to customers for a flat price, that business may not involve consulting services, even if the business involves advising customers regarding the particular software that may best fit the customers’ needs. Treas. Reg. §1.199A-5(b)(3), Ex. 10.

### **“Reputation or Skill”**

In addition, an SSTB includes any trade or business in which the principal asset is the reputation or skill of one or more of its owners or employees. I.R.C. §199A(d)(1). This “reputation or skill” category initially caused a lot of concern that it would be interpreted broadly to cause a wide range of service businesses to be considered an SSTB even though they were not specifically identified by Congress. The 199A regulations alleviate these concerns.

The reputation or skill category means any trade or business that consists of any of the following activities (or any combination thereof):

- A trade or business in which a person receives fees, compensation or other income for endorsing products or services;
- A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual’s image, likeness, name, signature, voice, trademark or any other symbols associated with the individual’s identity; or
- Receiving fees, compensation or other income for appearing at an event or on radio, television or another media format. Treas. Reg. §1.199A-5(b)(2)(xiv).



For these purposes, a person is considered as "receiving fees, compensation or other income" if that person receives a partnership interest or S corporation stock and the corresponding allocable share of income, deduction, gain or loss from the partnership or S corporation. Treas. Reg. §1.199A-5(b)(2)(xiv)(D).

Notably, the 199A regulations provide that the reputation or skill category "means" (as opposed to "includes") the aforementioned personal likeness-type activities. Thus, the 199A regulations appear to limit the scope of the "reputation or skill" category to those specific personal likeness-type activities

specifically described therein.

### Attribution of SSTB Status

The 199A regulations also contain a rule through which a trade or business that would ordinarily be eligible for QTB treatment is instead treated as an SSTB, but only to the extent that it provides goods or services to a commonly owned SSTB. Treas. Reg. §1.199A-5(c)(2). Common ownership for this purpose includes the direct or indirect ownership of 50% or more of both trades or businesses by related persons within the meaning of I.R.C. §§ 267(b) or 707(b).

The 199A regulations clarify that the treatment of the otherwise qualifying trade or business as an SSTB is only with respect to the related persons who comprise the common ownership interest in the two businesses. Thus, if a business is owned by two persons (Alison and Brenda), Alison owns more than 75% of the business and 100% of an SSTB, Brenda owns only 25% of the business and none of the SSTB, and the business derives all of its income from performing non-SSTB services for the SSTB, that business will be treated as an SSTB as to Alison, but not Brenda.

The 199A regulations contain an example illustrating a situation in which SSTB status is attributed to a

non-SSTB business that derives its income from a commonly controlled SSTB. The example involves a partnership (Law Firm) that provides legal services to clients, owns its own office building and employs 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 through a contract with Partnership 1 provides administrative services to Partnership 1 in exchange for fees.

All three of the partnerships are owned by the same people (the original owners of Law Firm). Because Partnership 2 provides all of its property to Partnership 1, and Partnership 3 provides all of its services to Partnership 1, Partnerships 1, 2 and 3 would be treated as one SSTB for purposes of I.R.C. § 199A. Treas. Reg. § 1.199A-5(c)(2)(iii)(A).

If, however, Partnership 2 rents only 50% of the building to Partnership 1 and the other 50% is rented to unrelated third party tenants, only 50% of Partnership 2's leasing activity would be treated as an SSTB. The other 50% would be eligible for treatment as a QTB. Treas. Reg. § 1.199A-5(c)(2)(iii)(B).

### Claiming the 199A Deduction

The 199A regulations provide a great deal of additional clarity regarding the threshold issue of whether a client is engaged in a QTB and is, therefore, potentially eligible to claim the 199A deduction. Specifically, the 199A regulations provide a potential safe harbor that, if finalized, will provide taxpayers in the rental real estate business with protection in qualifying for the 199A deduction.

Once a client has satisfied the eligibility requirements for the 199A deduction, the next challenge is applying the 199A regulations in the manner that maximizes the amount of the client's 199A deduction. The next article in this series will discuss the manner in which the 199A regulations provide professionals with opportunities to assist their clients in doing so.

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