Taxpayers Receive Much Needed Guidance on New 20 Percent "Pass-through" Deduction

On August 8, the United States Department of Treasury and the IRS released the long-awaited and highly anticipated proposed regulations for IRC Code Section 199A, the statute governing the new 20 percent deduction on "qualifying business income" allowed to owners of "pass-through" entities. While lingering questions remain, the proposed regulations include a significant number of interpretive rules, as well as definitional, computational and anti-avoidance guidance. The new rules are generally taxpayer-friendly and may be relied upon until the regulations are finalized. Therefore, it is imperative for taxpayers to understand these rules to ensure that they maximize any potential benefit from this new deduction.

"Pass-through" Deduction under Section 199A

Section 199A was enacted on December 22, 2017 in the Tax Cuts and Jobs Act, and generally provides a deduction against taxable income for individuals, trusts or estates of up to 20 percent of "qualified business income" (QBI) from a domestic trade or business operated as a sole proprietorship, partnership or S corporation. In general, a taxpayer's deductible amount with respect to each trade or business is the lesser of:

(i) 20 percent of the taxpayer's QBI from such business, or
(ii) to the extent the taxpayer's taxable income exceeds certain thresholds with a phase-in amount ($315,000 for taxpayers filing jointly and $157,500 for all others), the greater of:
  a) 50 percent of the business's W-2 wages (W-2 wages limit), or
  b) the sum of 25 percent of such W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property (UBIA of qualified property limit). Qualified property generally includes most depreciable property used in such business that is still within a depreciable period.

The wages and property limitations are phased in from $315,000 - $415,000 (married filing jointly) or $157,500 - $207,500 (all others) of taxable income. The deduction is fully available if taxable income is less than $315,000 (married filing jointly) or $157,500 (all others) – the "threshold amounts". The deduction generally cannot exceed 20 percent of taxpayer's taxable income, reduced by the taxpayer's net capital gain.

In another limitation, to the extent that a taxpayer's taxable income exceeds the threshold amounts with phase-in amounts, a taxpayer's QBI does not include income from a specified service trade or business (SSTB). *Therefore, taxpayers will not want their activities to be included within the list of SSTBs.* An SSTB includes the following:

(i) The performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services;
(ii) Any trade or business whose principal asset is the reputation or skill of one or more of its employees or owners (the reputation or skill clause); or
(iii) The performance of services that consist of investing and investing management, trading, or dealing in securities, partnership interests or commodities.

Specified Service Trade or Business – Banking, and Real Estate and Insurance Agents are Winners, and "Reputation or Skill" is Narrowly Defined

The proposed regulations require each pass-through entity to determine whether it conducts an SSTB and disclose that information to its owners, in addition to disclosing each owner's share of QBI, W-2 wages and UBIA of qualified property. The rules define many, but not all, of the specifically-listed SSTBs more narrowly. Practitioners were concerned that a broad interpretation of the reputation or skill clause could bring the local plumber or HVAC specialist, for example, into the definition of a SSTB. However, Treasury and the IRS decided that this clause was intended to describe only a narrow set of trades or businesses, not otherwise covered by the enumerated specified services. While questions still remain regarding certain activities, the proposed regulations clarify what services are, or are not, included in the following categories:

Accounting: the field of accounting includes return preparers, enrolled agents, financial auditors, bookkeepers and all services coming under the common understanding of accounting. The proposed rules also clarify that the field of accounting does not include payment processing (presumably, including payroll services) and billing analysis.

Athletics: the field of athletics includes the performance of services by individuals who participate in athletic competition such as athletes, coaches and team managers, and also sports teams that employ athletes. Not included are the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events, or broadcasting or otherwise disseminating video or audio of athletic events to the public.

Brokerage services: the proposed rules narrowly define brokerage services to include services in which a person arranges transactions between a buyer and a seller with respect to securities and therefore include services provided by stock brokers and other similar professionals. This category does not include services provided by real estate agents and brokers, or insurance agents and brokers. While the latter were big winners by being excluded from the definition of brokerage services, members of the insurance industry will need to carefully evaluate the extent

to which their revenue derived from non-placement-related activities may fall within "consulting" or "financial services".

Consulting: the performance of consulting services is broadly defined to include the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems but does not include sales or the provision of training and educational courses.

Financial services: this field is defined to include services typically provided by financial advisors, investment bankers, wealth planners, retirement advisors and other similar professionals, but does not include taking deposits or making loans. Retail banking activities are therefore not included in the list of excluded businesses.

Health: the performance of services in the field of health includes medical services provided by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals who provide medical services directly to a patient. It does not include the provision of services not directly related to a medical field, such as the operation of health clubs or health spas, payment processing, research, laboratory testing and the manufacture or sale of pharmaceuticals and medical devices.

Performing arts: this field includes the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers and directors. Not included are the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts, or persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

Reputation or skill clause: Treasury and the IRS made the taxpayer-friendly decision that "reputation or skill" must be interpreted in a manner that is both objective and easily administered. Therefore, the reputation or skill clause is limited to only the following fact patterns in which an individual or pass-through entity is engaged in a trade or business of:

(1) receiving income for endorsing products or services;
(2) licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark or any other symbols associated with an individual's identity; or
(3) receiving appearance fees or income, including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television and other media hosts.

The proposed regulations also provide the following helpful de minimis exceptions for SSTB activities:

- A trade or business is not an SSTB if less than 10 percent of the gross receipts (5 percent if the gross receipts are greater than $25 million) are attributable to the performance of services in a specified service activity; and
- The provision of consulting services does not include consulting that is embedded in, or ancillary to, the manufacture or sale of goods if there is no separate payment for the consulting services.

The proposed regulations address the third-party payor issue for the W-2 wages limit, clarify rules regarding UBIA of qualified property that are significant for real estate activities, provide computational rules for the calculation of QBI, provide guidance for aggregating trades or businesses and calculating QBI when a pass-through entity has multiple trades or businesses and confirm that estates and trusts are eligible to claim the deduction.

W-2 Wages Attributable to a Trade or Business – Taxpayer-Friendly Guidance

As expected, the proposed regulations permit taxpayers to use a third-party payor, such as a professional employer organization or an agent, to pay and report wages to their employees. If a taxpayer has more than one trade or business, the W-2 wages are allocated to each one proportionately. Finally, if the taxpayer acquires or disposes of a trade or business, the W-2 wages are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity.

UBIA of Qualified Property

Qualified property is depreciable tangible property held by a trade or business at the close of the taxable year, which is used in the production of QBI, and for which the depreciable period has not ended before the close of that year. The "depreciable period" begins when the property is first placed in service and ends on the later of (a) 10 years after the placed in-service date, or (b) the last day of the last full year in the applicable recovery period for tax depreciation purposes. For example, the depreciable period for 5-year property such as computer equipment is 10 years, while the depreciable period for 39-year nonresidential real property is the same 39 years.

The proposed regulations provide the following rules regarding the calculation of the basis of qualified property:

Acquisition date: the proposed regulations provide that "immediately after acquisition" means the date the property is placed in service.

Bonus depreciation and Section 179 expensing: UBIA is determined without regard to the claiming of bonus depreciation or expensing under Section 179.

Improvements to qualified property treated separately: in the case of any addition to, or improvement of, qualified property that is already placed in service by the taxpayer, such addition or improvement is treated as separate qualified property that is placed in service on the date of such addition or improvement.

Like-kind exchanges and involuntary exchanges: for purposes of determining the depreciable period, the date the *exchanged basis* in the replacement property is first placed in service by the trade or business is the date on which the relinquished property was first placed in service, and the date the *excess basis* in the replacement property is first placed in service is the date on which the replacement property was first placed in service. However, if a taxpayer elects to treat the replacement property as newly placed in service for depreciation purposes, thus restarting the depreciation lifespan, the entire replacement property's date in service for purposes of Section 199A will be the date on which the replacement property was first placed in service. The proposed regulations also state that the "unadjusted basis" of the acquired property will equal the adjusted basis of the exchanged property that had been depreciated over time.

Inside basis adjustments: special inside basis adjustments by partnerships under Sections 734(b) or 743(b) are not qualified property under the proposed regulations.

Computational Rules for Calculating QBI

The proposed regulations add the following rules if an individual or trust has multiple trades or businesses:

- The taxpayer must calculate the QBI from each trade or business and then net the amounts. If the net QBI of the taxpayer for any taxable year is less than zero, such amount is treated as a loss from a qualified trade or business in the succeeding taxable year.
- If one trade or business generates a loss but overall the taxpayer has net positive QBI, the loss must be netted with the trades or businesses having positive QBI. The net loss is apportioned among the trades or businesses with positive QBI in proportion to their relative amounts of QBI. The resulting net income of each trade or business becomes the taxpayer's QBI with respect to that trade or business, after which the limitation based on W-2 wages and UBIA of qualified property is applied to each trade or business.

New Rules Give Taxpayers Flexibility to Aggregate Multiple Entities

Practitioners were concerned that a taxpayer conducting multiple trades or businesses could have its 20 percent deduction limited due to the application of the W-2 wages limit or UBIA of qualified property limit on a business-by-business basis. The proposed regulations permit, but not require, taxpayers to group or "aggregate" multiple trades or businesses to maximize the benefits of the deduction, if the following four requirements are met:

(1) each trade or business must itself be a trade or business;

(2) the trades or businesses are majority owned by the same person, or group of persons (non-majority owners may benefit from the common ownership and are permitted to aggregate);

(3) none of the aggregated trades or businesses can be a SSTB; and

(4) the trades or businesses meet at least two of three factors demonstrating that they are part of a larger, integrated trade or business:

(i) they provide products and services that are the same (e.g., a restaurant and a food truck), or that are customarily provided together (e.g., a gas station and a car wash);

(ii) they share facilities or significant centralized business elements (e.g., common accounting, legal, human resources, IT resources, etc.); or

(iii) they are operated in coordination with, or reliance on, other businesses in the aggregated group (e.g., supply chain interdependencies).

Treatment of Pass-through Entity's Multiple Trades or Businesses

If a pass-through entity has more than one trade or business, items apportionable to QBI must be allocated among the trades or businesses using a reasonable method that is consistently applied from one taxable year to another, and which clearly reflects the income of each trade or business. Treasury and the IRS are requesting comments on whether "reasonable method" should be defined to include the direct tracing method, allocations based on gross income or other methods, and whether any safe harbors may be appropriate.

However, if a trade or business has 50% or more common ownership with an SSTB and has shared expenses with the SSTB, including shared wage or overhead expense, that trade or

business will be considered incidental to and part of the SSTB if the gross receipts of the trade or business are 5% or less of the total combined gross receipts of the trade or business and the SSTB. The proposed regulations use the example of a dermatologist providing medical services to patients on a regular basis who also sells skin care products to the patients. The latter activity will be considered part of the SSTB if its gross receipts do not exceed 5% of the combined revenue.

Trusts and Estates are Eligible for the Pass-through Deduction

The proposed regulations confirm the following:

Grantor trusts and Qualifying Subchapter S Trusts (QSSTs): the grantor, or the QSST's income beneficiary, computes its QBI with respect to the owned portion of the trust as if that QBI had been received directly by the owner.

Nongrantor trusts and estates: QBI is calculated at the trust or estate level and then allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust or estate's distributable net income.

Electing Small Business Trusts (ESBTs) are entitled to the deduction. The S, non-S and grantor portions of the ESBT separately consider QBI and other items.

Threshold amount: for 2018 the threshold amount applicable to a nongrantor trust or estate is $157,500.

Anti-Abuse Provisions

As expected, the rules also include several anti-abuse provisions designed to prevent taxpayers from transacting into Section 199A, such as through (i) spinning off their real property and administrative functions; (ii) converting employees to independent contractors only in form; (iii) using non-grantor trusts to multiply the available taxable income thresholds; and (iv) temporarily acquiring otherwise qualified property.

Separating activities: taxpayers cannot separate parts of what otherwise would be a SSTB, such as administrative functions, in an attempt to qualify those separated parts for the QBI deduction. Specifically, an SSTB includes any trade or business with 50 percent or more common ownership that provides more than 80 percent of more of its property or services to an SSTB. The proposed regulations include an example of a law firm that divides into three partnerships, with Partnership 1 performing the legal services, Partnership 2 owning the office building and renting the entire building to Partnership 1 and Partnership 3 employing the administrative staff

and providing administrative services to Partnership 1 for fees. For purposes of Section 199A all three partnerships will be treated as one SSTB.

Additionally, if a trade or business has 50 percent or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will itself be treated as an SSTB. For example, assume a dentist owns a dental practice and an office building, and rents half of the building to the dental practice and the other half to unrelated persons. The renting of half of the building to the dental practice will be treated as income from an SSTB.

Presumption for former employees: if an individual was treated as an employee by the person to whom he or she provided services, and is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services (either directly or indirectly through an entity), for purposes of Section 199A there is a rebuttable presumption that the individual is in the trade or business of performing services as an employee with regard to such persons. Services performed by an employee do not generate QBI.

Multiple trusts: another anti-abuse provision prevents taxpayers from creating multiple nongrantor trusts to own their businesses, so that each trust would have taxable income below the applicable threshold amount and thereby qualify for the deduction. The proposed regulations provide that, if two or more nongrantor trusts have substantially the same grantor and primary beneficiary, and a principal purpose for establishing the trusts is the avoidance of federal income tax, then such trusts will be treated as a single trust for Federal income tax purposes.

Qualified property anti-abuse rule: property will be disregarded as qualified property for purposes of the UBIA of qualified property limit if it is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in the business for at least 45 days, unless the taxpayer can demonstrate that the principal purpose of acquisition and disposition was other than increasing the deduction under Section 199A.

Definition of Trade or Business – Remaining Uncertainty and a Safe Harbor

Finally, the proposed regulations rely on the definition of trade or business in Section 162 to determine if an activity can take advantage of the QBI deduction, and do not further elaborate on how “trade or business” should be defined for purposes of Section 199A. Therefore, some uncertainly still exists as to when a rental activity will rise to the level of a trade or business. Regarding whether rental activities are considered trades or businesses under Section 162, case law has been unresolved but is generally favorable to taxpayers. However, case law and IRS guidance have not been favorable regarding whether triple-net leases are trades or businesses,

so taxpayers who rent out commercial property on this basis may not be eligible for the deduction.

It is not uncommon for taxpayers to separate rental property from operating businesses for legal or other non-tax reasons. Therefore, the proposed regulations do include a safe harbor rule providing that a rental activity will be treated as a trade or business for purposes of Section 199A, whether it rises to the level of a trade or business, if the property is rented to a commonly controlled trade or business.

The guidance provided by the proposed regulations was much needed and over-due. The new rules are generally favorable to taxpayers, particularly because they attempt to narrow the scope of specified service businesses ineligible for the pass-through deduction. While there are still open issues, the rules better enable taxpayers to plan for the 2018 tax year and beyond. Given the significance of the new 20 percent pass-through deduction and the choice of entity issues created by the Tax Cuts and Jobs Act's permanent reduction in the corporate tax rate, taxpayers were entitled to be assured that their activities do or do not qualify for the deduction, and to understand how the deduction is calculated. Although the rules generally are proposed to apply to taxable years ending after the date the regulations are finalized, taxpayers may rely on the proposed regulations until that date. Therefore, taxpayers need to understand these rules to ensure that they maximize any potential benefit provided by this new deduction.

If you have questions about how the pass-through deduction under Section 199A and the recently issued guidance might affect you and your business, please contact your Bennett Thrasher tax advisor by calling 770.396.2200.