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Treasury Department Releases Regulations Concerning Section 199A

Summary

Recently-enacted Section 199A[1] allows individuals, trusts and estates[2] to deduct up to 20% of "qualified business income" from certain businesses operated in pass-through form (the "Section 199A Deduction"), and is intended to provide some measure of parity between the taxation of income earned with respect to businesses conducted in pass-through form and those conducted in corporate form (now eligible for a 21% federal income tax rate). As enacted, however, Section 199A left many questions as to its application unanswered.

On August 8, 2018, the Treasury Department released proposed regulations under Section 199A (the "Proposed Regulations"), providing guidance on many – though not all – of these areas of uncertainty. The Proposed Regulations generally take a taxpayer-favorable approach, with a few notable exceptions. Taxpayers may rely on the Proposed Regulations until final regulations are published. The anti-abuse provisions discussed below have retroactive effect to December 22, 2017, the date on which Section 199A was enacted.

Calculation of the Section 199A Deduction

Assuming a full 20% Section 199A Deduction (which, as discussed below, may often not be the case), an individual taxpayer would pay a top federal income tax rate of 29.6% on domestic "qualified business income" ("QBI") received from sole proprietorships, partnerships and other pass-through entities (including S corporations).[3] The Section 199A Deduction is, however, subject to a number of reductions and limitations for individuals in higher tax brackets. Generally:

- The Section 199A Deduction for taxpayers whose taxable income exceeds $157,500 ($315,000 in the case of a joint filer) (the "Threshold Amount") is subject to the "Wage/Basis Limitation," which is equal to the greater of the taxpayer's allocable share of (x) 50% of the W-2 wages paid with respect to the

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1 Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended.

2 References to "individuals" throughout include individuals, trusts and estates that are eligible for the Section 199A Deduction.

3 The Section 199A Deduction is set to expire on December 31, 2025.

qualified trade or business ("W-2 Wages")[4] and (y) the sum of (i) 25% of W-2 Wages plus (ii) 2.5% of the "unadjusted basis immediately after acquisition" of all qualified property held by the trade or business ("UBIA").[5]

- In no event may a taxpayer's deduction under Section 199A exceed 20% of the excess of the taxpayer's taxable income over such taxpayer's net capital gain for the relevant taxable year, thus ensuring that the Section 199A Deduction will not be applied to offset capital gain.

The Section 199A Deduction is also available to offset income from qualified REIT dividends and qualified publicly traded partnership income at a 20% rate, without regard to the limitations described above.

"Trade or Business"

The Section 199A deduction is available only with respect to QBI, which generally includes income that is effectively connected with a U.S. trade or business, but does not include investment income, amounts paid as reasonable compensation to S corporation shareholders, amounts received for the performance of services as an employee and guaranteed payments received for services rendered to a partnership. Income earned with respect to a business that constitutes a "specified service trade or business" (an "SSTB") is also excluded from treatment as QBI, except for taxpayers whose taxable income falls below the Threshold Amount. The Proposed Regulations resolve prior uncertainty regarding the treatment of gain characterized as ordinary income under Section 751 or Section 1231, providing that such amounts constitute QBI.

The Proposed Regulations clarify that the term "trade or business" as used in Section 199A generally has the same meaning as under Section 162, the Code provision governing trade or business expenses, for which there is significant existing authority (excluding the provision of services as an employee), with one notable extension: the rental or licensing of tangible or intangible property to a related trade or business will be treated as a "trade or business" for purposes of Section 199A if the businesses are commonly controlled, even if the rental or licensing business might not otherwise rise to the level of a "trade or business" for purposes of Section 162.

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4 For purposes of calculating W-2 Wages for a business, the Proposed Regulations clarify that a pass-through entity may include wages paid to a common-law employee of the entity by a third-party payor, provided that the wages were paid to the employee for employment by the pass-through entity.

5 "Qualified Property" held by the trade or business generally includes tangible property used for the production of QBI that is held at the end of the taxable year and for which the depreciable period has not ended at the close of such year. For this purpose, "depreciable period" means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (x) 10 years after such date or (y) the end of the applicable tax recovery period (potentially subject to certain adjustments).

The Proposed Regulations also clarify that the reference to "reasonable compensation" that is ineligible for the Section 199A Deduction refers only to existing standards applicable to S corporations, and does not impose a new requirement on partnerships to treat any portion of income allocated to its owner as "reasonable compensation."

Specified Service Trade or Business

The Proposed Regulations provide welcome guidance with respect to whether certain business activities constitute SSTBs, operational guidance and a significant anti-abuse rule. The Proposed Regulations also make clear that the determination of whether a business constitutes an SSTB is made at the entity level. Pass-through entities are required to report this determination to their owners.

Covered Businesses

Section 199A includes trades or businesses involving the performance of services in the following fields as SSTBs:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners
- Investing and investment management
- Trading

- Dealing in securities, partnership interests or commodities

The Proposed Regulations clarify the following with respect to the scope of certain businesses constituting SSTBs:

- "Services Performed in the field of health" include only the provision of services directly related to the medical services field (i.e., providing medical services directly to a patient), and do not include the operation of health clubs or spas, or the research, testing and manufacture and/or sales of pharmaceuticals or medical devices.

- "Services Performed in the field of consulting" include the provision of professional advice and counsel to clients to assist in achieving goals and solving problems, but do not include the performance of such services ancillary to the sale of goods or performance of services on behalf of a trade or business that is not an SSTB if there is no separate payment for the consulting services. Owners of businesses with ancillary consulting functions may reconsider pricing structures to avoid characterization of their income as SSTB income (taking into account the "cliff" de minimis exception described below).

- "Services performed in the field of athletics" includes the performance of services by individuals who participate in all types of athletic competition, including athletes, coaches and team managers, but do not include the provision of services by persons who operate athletic facilities or broadcast athletic events. The Proposed Regulations make clear that in addition to athletes, coaches, managers and owners of teams are also covered by this category and income earned with respect to a partnership that owns a professional sports team is not eligible for the Section 199A Deduction.

- "Services performed in the field of financial services" do not include customary commercial banking services.

- "Services performed in the field of brokerage services" do not include services provided by insurance and real estate agents and brokers.

- "Trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners" is narrowly drafted to include only those trades or businesses involving receipt of compensation by a person for (a) endorsement, (b) use of such person's image or other symbol associated with such person's identity or (c) appearances at a live or broadcast event. This clarification is particularly helpful as previously there had been concern that this "catch-all" category of SSTB could encompass any service industry where clients are attracted by the reputation of the service provider.

W-2 Wages and UBIA

- The Proposed Regulations take certain positions which may be adverse to taxpayers regarding the calculation of UBIA. In the case of nonrecognition transfers, such as a transfer to a partnership or a Section 1031 like-kind exchange, the UBIA of the qualified property will equal the adjusted (i.e., depreciated) basis of the transferred property. In addition, basis adjustments under Section 734(b) and 743(b) are not treated as separate qualified property for purposes of calculating UBIA, and thus no benefit is available under Section 199A for special basis adjustments made by a partnership with a Section 754 election in place.

- To comply with the new rules, pass-through entities are required to determine and report W-2 Wages and UBIA for each separate trade or business, or such amounts are presumed to be zero. Entities that operate more than one trade or business may need to adjust internal reporting systems in order to compile the information needed to comply with these new requirements.

QBI Calculation

Netting Required; Loss Carryover

In calculating QBI for a taxable year, individuals must net losses from eligible businesses against QBI from other businesses before applying the Section 199A Deduction. Any net loss ("negative QBI") for a taxable year is carried forward and used to offset QBI in future years before application of the Section 199A Deduction.

If a taxpayer has an overall loss from combined qualified REIT dividends and qualified publicly traded partnership income for any taxable year, such loss is not netted against QBI, and is instead carried over for offset against combined qualified REIT dividends and qualified publicly traded partnership income in subsequent taxable years.

Aggregation Permitted

Individuals are permitted, but not required, to aggregate income from multiple eligible businesses (excluding businesses that constitute SSTBs) for purposes of applying the Wage/Basis Limitation, if the businesses are commonly controlled and meet certain requirements demonstrating that the multiple businesses are functionally related. An individual must disclose an election to aggregate income from multiple businesses on the individual's tax return, and an electing individual must continue to report such income on an aggregated basis in subsequent years. Because aggregation of business income is permitted at the individual – and not entity – level, however, owners of the same pass-through entity need not take a consistent approach with respect to aggregation.

De Minimis Exception

A *de minimis* exception provides that a trade or business will not be treated as an SSTB if the percentage of gross receipts of the business attributable to the performance of specified service activities is less than (a) 10% for any business generating $25 million or less in gross receipts annually, or (b) 5% for any business generating more than $25 million in gross receipts annually.

Anti-Abuse Rules

No "Crack and Pack"

Following enactment of Section 199A, many taxpayers engaged in SSTBs considered whether segregation of non-SSTB activities in entities separate from those conducting SSTB activities (a planning technique commonly referred to as "crack and pack") could render the non-SSTB activity income eligible for the Section 199A Deduction. The Proposed Regulations preclude the use of such a structure by including as an SSTB any business that shares 50% common ownership (direct or indirect) with an SSTB and provides 80% or more of its services to such SSTB.

Even if the 80% threshold is not met, the Proposed Regulations treat any income derived by a business from the provision of services to a commonly-controlled SSTB as income from an SSTB ineligible for the deduction. For example, if a dentist owns both a dental practice and an office building, and rents 50% of the building to the dental practice and 50% of the building to an unrelated party, rental income from the dental practice will constitute SSTB income.

Change in Employment Status

As noted above, amounts received for the performance of services as an employee are not eligible for the Section 199A Deduction. To prevent employees from changing employment status to take advantage of the new deduction, the Proposed Regulations provide that if an employee changes employment status but continues to provide substantially the same services to the former employer, the individual is presumed to be providing such services as an employee, and thus cannot offset any compensation income by the Section 199A Deduction.

Anti-Avoidance Rule for Trusts

On August 8, 2018, the Treasury Department also issued a new proposed regulation under Section 643(f), which has long authorized the issuance of regulations providing for the treatment as a single trust any two or more non-grantor trusts that have substantially the same grantor(s) and beneficiary/ies where a principal purpose for establishing the trusts is the avoidance of federal income tax. Although this new regulation was issued at the same time as the Proposed Regulations and clearly will apply to structures intended to circumvent the Section 199A limitations, it also will have broad application beyond Section 199A, including the creation of multiple trusts to attempt to multiply the $10,000 deduction for state and local income taxes.

REIT Holding Period

The Proposed Regulations exclude from treatment as a "qualified REIT dividend" eligible for the Section 199A Deduction any dividend received with respect to stock that has been held for less than 45 days, taking into account applicable rules under Section 246 that suspend holding periods for stock with respect to which the holder has a diminished risk of loss due a hedge or straddle.

Additional Considerations

Credit Agreements and Operating Agreements

The Section 199A Deduction may factor into the negotiation of tax distribution provisions contained in credit agreements and operating agreements. The availability and amount of the Section 199A Deduction for each individual owner will vary – in part based on the performance of other businesses and individual elections – and it may be difficult to estimate at the time of agreement the likely effect of the Section 199A Deduction on the ultimate tax liability of each individual owner. Ignoring potential Section 199A Deductions, however, could result in tax distributions significantly in excess of the owners' tax liabilities. Lenders may take issue with disregarding the Section 199A Deduction altogether.

Reporting and Computational Complexities

Application of the Section 199A rules requires numerous complex calculations and extensive recordkeeping and reporting, at the level of both the pass-through entity and the individual taxpayer, some of which are noted above. Pass-through entities should prepare to update their systems of recordkeeping and reporting to meet these new, burdensome requirements.

Structuring Partnership Purchases – Assets vs. Interests

Rules preventing inclusion of Section 754 basis adjustments in the calculation of UBIA may affect structuring of partnership acquisitions where the partnership holds significant tangible assets, such as a partnership operating a real estate or manufacturing business. Before the enactment of Section 199A, a buyer of an interest in such a pass-through entity generally would have been indifferent from a tax perspective between structuring the acquisition as a purchase of the partnership assets followed by contribution to a partnership vs. structuring as a purchase of partnership interests, because the buyer would get the benefit of a basis step-up under either alternative. Because special basis adjustments under Section 754 are disregarded for purposes of Section 199A, however, in acquisitions of such a business where the Wage/Basis Limitation applies, the Section 743(b) basis step-up benefit in an acquisition of partnership interests may be offset by paying a higher tax rate on earnings as compared to a direct purchase of assets, potentially making the two alternatives economically different for the buyer from a tax perspective.

We will continue to monitor these developments. If you have questions, please contact any of the undersigned.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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