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Practice Update

U.S. Issues Proposed Tax Regulations for Section 199A Qualified Business Income Deduction

September 10, 2018

On August 8, 2018, the Treasury Department and Internal Revenue Service released Proposed Regulations clarifying issues that arise under Section 199A of the Internal Revenue Code of 1986, as amended (the "Code"). This Practice Update analyzes certain salient aspects of Section 199A and the new Proposed Regulations, which could be relevant to an individual's 2018 income tax return.

An Overview of Section 199A

The 2017 Tax Cuts and Jobs Act (Pub. L. 115-97) added Section 199A to the Code. Section 199A grants taxpayers other than corporations, such as individuals, up to a 20 percent deduction of net qualified business income ("QBI") earned either directly or indirectly through a pass-through entity (a "PE") such as a partnership (or limited liability company taxed as a partnership) or an S corporation. For example, for individual taxpayers in the highest marginal income tax bracket, this deduction can effectively reduce their federal income tax rate on QBI from 37 percent to as low as 29.6 percent. Section 199A is effective for taxable years beginning after 2017, and before 2026.

Generally, the amount of the QBI deduction is the lesser of:

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(i) 20 percent of the QBI from the individual's trades or businesses (plus 20 percent of the individual's combined qualified dividends from a real estate investment trust ("REIT") and qualified income from a publicly-traded partnership ("PTP")), or

(ii) 20 percent of the excess, if any, of the individual's taxable income (determined without regard to any deduction under Section 199A) in excess of the individual's net capital gain.

QBI is calculated at the individual level with respect to each separate qualified trade or business of the individual (including the individual's share of QBI as a partner or shareholder of a PE). Special rules to compute the final Section 199A deduction may apply when multiple trades or businesses are involved. Those rules include aggregation of the businesses (as discussed below) and the reduction of an individual's net income from one trade or business by the net loss of another trade or business, even in the absence of aggregation.

What Constitutes QBI?

QBI is generally defined as the net amount of items of qualified income, gain, deduction and loss from the conduct of a qualified trade or business. A qualified trade or business does not include a "specified service trade or business" (an "SSTB") except for taxpayers having taxable income below certain threshold amounts, nor does it include the trade or business of performing services as an employee (and thus does not apply to W-2 wages earned by an employee). QBI also does not include capital gains or losses, dividends, interest (other than interest properly allocable to a trade or business) and certain other forms of portfolio income along with deductions allocable to these excluded terms, nor does it include a "guaranteed payment" paid to a partner for services rendered with respect to the trade or business.

The QBI Deduction Limitations

The deduction of 20 percent of net QBI is referred to as the "basic QBI deduction." It is available to all eligible taxpayers whose taxable income does not exceed $157,500 (or $315,000 for joint returns). If taxable income exceeds those amounts plus $50,000 (or $100,000 for joint returns), i.e., $207,500 (or $415,000 for joint returns), the basic QBI deduction cannot exceed what is referred to as the "QBI deduction limitation." If the taxable income amounts are between $157,500 and $207,500 (or $315,000 and $415,000 for joint returns), the basic QBI deduction is reduced on a phased-in basis. These dollar amounts are increased for tax years after 2018 by cost-of-living adjustments. Special rules apply to an SSTB as discussed below.

Under the QBI deduction limitation, the QBI deduction for a trade or business cannot exceed the greater of:

> (i) the taxpayer's share of 50 percent of the W-2 wages paid in connection with the business, or
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> (ii) the taxpayer's share of the sum of 25 percent of such W-2 wages and 2.5 percent of the unadjusted basis of qualified business property immediately after its acquisition ("UBIAP") and used in the business.

Aggregating Multiple Trades or Businesses

The Proposed Regulations allow individuals to aggregate trades or businesses in computing their Section 199A deduction. This can be advantageous for a taxpayer because the W-2 wages and UBIAP in a business whose basic QBI deduction is less than the QBI deduction limitation can be combined with the W-2 wages and UBIAP of another business whose basic QBI deduction exceeds the QBI deduction limitation.

Aggregation of multiple qualified trades or businesses, other than SSTBs, under common control is permissible under the Proposed Regulations on an elective basis if the businesses are related to each other and satisfy at least two of the following three factors:

1. the businesses provide products or services that are the same or that are customarily provided together;
2. the businesses share facilities or significant business elements such as personnel, accounting, legal, manufacturing, purchasing, HR or IT resources; and
3. the businesses are operated in coordination with, or reliance upon, one or more businesses in an aggregated group.

If businesses are aggregated, an individual combines the QBI, W-2 wages and UBIAP of the businesses.

Specified Service Trade or Business (SSTB) Restrictions

Generally, income from an SSTB cannot qualify for the basic QBI deduction. However, if an individual's taxable income is below a threshold amount, i.e., $157,500 (or $315,000 for joint returns), the basic QBI deduction is allowed in full as if the SSTB was a qualified trade or business. If an individual's taxable income exceeds the threshold amount plus $50,000 (or $100,000 for joint returns), i.e., $207,500 (or $415,000 for joint returns), no basic QBI deduction from SSTBs is allowable. If an individual's taxable income is greater than the threshold amount but within the phase-in range, i.e., $157,500-$207,500 (or $315,000 - $415,000 for joint returns), only a percentage of an SSTB's QBI, W-2 wages and UBIAP is used to calculate the basic QBI deduction and QBI deduction limitation as if the SSTB was a qualified trade or business.

An SSTB is defined as a business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. An SSTB also includes the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.

The Proposed Regulations contain definitions for the various classes of businesses that constitute SSTBs. As a general rule, the definitions are narrowly drawn and therefore benefit taxpayers. They generally focus on the performance of services directly to customers requiring unique skills or limit the category of services to a specific industry.

The Proposed Regulations provide that the performance of services in the field of health means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient. Therefore, a lab that analyzes blood for medical providers should not be an SSTB. Services not directly related to a medical field, such as health clubs or spas or the manufacture and sale of pharmaceuticals and medical devices, are also not SSTBs.

In similar fashion, the Proposed Regulations provide that the performance of services in the field of athletics is limited to the performance of services by individuals who participate in athletic competition and not, for example, the maintenance and operation of facilities used in athletic events or the broadcast of those events. A professional sports franchise is an SSTB. A similar rule applies to the field of performing arts.

Financial services is limited to services commonly provided by financial advisors, investment bankers, wealth planners and retirement advisors and does not include the primary activity of a bank in taking deposits and making loans, although certain services offered by a bank could fall into the financial services category or another category that is an SSTB. The performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management or investment management services including advice with respect to buying and selling investments. It does not include directly managing real property.

Brokerage services include only services for arranging transactions between a buyer and seller of securities (such as services provided by stock brokers and other similar professionals). Brokerages services do not encompass services of a real estate agent or broker or insurance agent or broker.

Perhaps the broadest category is consulting. Under the Proposed Regulations, consulting services means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. It includes lobbying a government or governmental agency. It does not include services performed that are ancillary to the sale of goods, such as the sale and installation of software, or performance of services on behalf of a trade or business that is not an SSTB such as typical services performed by a building contractor, provided there is not a separate payment for the consulting services.

The Proposed Regulations also limit the activities which can constitute an SSTB because of the skill of one or more of its employees or owners. In this situation, it is limited to an individual's conduct of a trade or business of (1) receiving endorsement income; (2) licensing or receiving income for the use of an individual's image, likeness, name, signature, voice trademark or any symbols associated with the

individual's identity; or (3) receiving appearance fees or income.

Certain Anti-Abuse Rules

The Proposed Regulations contain several anti-abuse rules. One such rule is designed to prevent the division of activities that would constitute an SSTB as a whole into separate activities where one or more businesses are not SSTBs. For example, a legal partnership may transfer its office building and administrative staff to another partnership, with such other partnership renting the building back to the legal partnership and receiving fees from the legal partnership, with the hope that such other partnership can have a qualified trade or business. However, the Proposed Regulations provide that an SSTB includes any trade or business that provides 80 percent or more of its property or services to an SSTB if there is 50 percent or more common ownership of the trades or businesses. If the level is less than 80 percent, then the portion of the trade or business providing the property or services to the 50 percent or more commonly-owned SSTB is treated as part of the SSTB. Presumably, this simply means that only the portion of the income and deductions attributable to the property or services provided to the SSTB will be the income and deductions of an SSTB, and therefore not QBI eligible. Fifty percent or more common ownership includes direct and indirect ownership by related parties. This anti-abuse rule appears to apply to trades or businesses which have been divided for non-tax business reasons before Section 199A was enacted.

Another notable anti-abuse rule deals with non-grantor trusts. The Proposed Regulations under Section 199A provide that trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected. Commentators suggested one could set up multiple trusts to take advantage of multiple threshold amounts. This anti-abuse rule restricts such planning.

Looking Forward

Because Section 199A is effective for taxable years beginning after 2017, and before 2026, this means that Section 199A could be relevant to an individual's 2018 income tax return. Taxpayers should plan ahead to qualify for the benefits of the rules in the Proposed Regulations. For example, taxpayers may need to take action in the remaining months of 2018 in order to meet (or not meet) certain provisions or tests contained in the Proposed Regulations. The Proposed Regulations are proposed to be effective for taxable years ending after publication of the final Regulations, although taxpayers may rely on the Proposed Regulations before they are finalized.
