SQUIRE PATTON BOGGS

Treasury and IRS Release Proposed 199A Regulations on the 20% Pass-Through Deduction

The US Department of the Treasury and the Internal Revenue Service (IRS), after having received sign-off from the Office of Management and Budget, released a Notice of Proposed Rulemaking (NPRM) with proposed regulations (Proposed 199A Regulations) on the 20% pass-through deduction under Section 199A of the Internal Revenue Code (Code) as added by the Tax Cuts and Jobs Act (TCJA). In conjunction with the release of Proposed 199A Regulations, the IRS also issued a notice describing the methods for calculating W-2 wages for purposes of determining the deduction, as well as a series of Frequently Asked Questions.

While Section 199A added numerous definitions and special rules for application of the Section 199A deduction to the Code, it left taxpayers and tax advisors with many questions as to its application and as to whether some of its limitations could be circumvented. The Proposed 199A Regulations provide comprehensive guidance on how the US Department of the Treasury and the IRS (collectively, Treasury) propose to implement the deduction, including anti-abuse rules.

This client update highlights some of the guidance provided by the Proposed 199A Regulations in the areas where the statute was most unclear and the areas in which taxpayers and tax advisors were pressing Treasury for guidance so they could proceed with tax planning or estimating tax liability.

Background

Section 199A generally provides individuals with a deduction of 20% of their qualified business income (QBI) for 2018 through 2025. Legislators developed the deduction to provide parity for pass-through businesses in light of the significant cut in the tax rate (35% to 21%) for corporations.

The Section 199A deduction is generally equal to the combined "QBI amount" of the taxpayer. The combined QBI amount consists of (i) 20% of the taxpayer's QBI with respect to each qualified trade or business of the taxpayer (subject to limits in certain cases) and (ii) 20% of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income. The portion of the deduction attributable to qualified trades or businesses is subject to two key limitations. First, for individual taxpayers with income above certain thresholds, the deductible amount for each qualified trade or business is limited to the greater of (i) 50% of the "W-2 wages" with respect to the qualified trade or business or (ii) the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis of all "qualified property." Second, the term "qualified trade or business" excludes a "specified service trade or business" (SSTB) for individuals above the income threshold and the trade or business of performing services as an employee. In applying these limitations, the threshold amounts in 2018 are US$157,500 for an individual return and US$315,000 for a joint return, with a phase-out range of US$50,000 for individuals and US$100,000 for a joint return. The thresholds are based on an individual's or couple's taxable income, taking into account income from all sources and all deductions other than the Section 199A deduction. After a technical correction enacted earlier this year, special rules apply to the qualified trade or business of a patron of a specified agricultural or horticultural cooperative.

In the case of an activity conducted through a pass-through entity, such as a partnership or S corporation, Section 199A applies at the partner or shareholder level, taking into account the partner's or shareholder's allocable share of items of qualified income and loss, W-2 wages and unadjusted basis of the partnership or S corporation.

Highlights of the Proposed 199A Regulations

Trade or Business

The Proposed 199A Regulations generally follow the definition of "trade or business" that is applicable for Code Section 162. However, the Proposed 199A Regulations expand the definition to cover the rental or licensing of tangible or intangible property that does not rise to the level of a Section 162 trade or business if the property is rented or licensed to a trade or business that is under common control. This allows taxpayers to aggregate their trades or businesses with the associated rental or intangible property under the aggregation rules described below.

Aggregation of Trades and Businesses

The W-2 wage and unadjusted basis limitations are applied separately for each trade or business of the taxpayer. Taxpayers sought authority to aggregate related trades or businesses for this purpose. The Proposed 199A Regulations permit, but do not require, aggregation if:

- Each trade or business is a trade or business for purposes of Section 199A
- The same person or group of persons directly or indirectly own a majority interest in each of the businesses to be aggregated and all of the items attributable to the trades or businesses are reported on returns with the same taxable year
- None of the aggregated trades or businesses are an SSTB

- The taxpayer establishes that the trades or businesses meet at least two of three factors demonstrating integration:
  - The businesses provide products and services that are the same or they provide products and services customarily provided together
  - The businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal or information technology resources
  - The businesses are operated in coordination with or reliance on other businesses in the aggregated group

The Proposed 199A Regulations allow individuals to aggregate (under the preceding rules) trades or businesses operated directly and trades or businesses operated through pass-through entities. The NPRM seeks comments on whether a pass-through entity should be able to aggregate its trades or businesses.

Third-Party Payors and Wages Allocable to Multiple Trades or Businesses

Some businesses use arrangements under which their workers are paid by third-party payors, such as professional employer organizations, certified professional employer organizations, and agents under Code Section 3504. The Proposed 199A Regulations allow a person to take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 if the wages are paid to common law employees or officers of the person for employment by the person.

The Proposed 199A Regulations provide guidance on allocating W-2 wages attributable to more than one trade or business. Generally, W-2 wages are allocated in the same proportion as the deductions attributable to the wages.

Specified Service Trade or Business

Through use of cross references, Section 199A defines an SSTB as (1) any trade or 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, and (2) any trade or business that involves the performance of services that consist of investing and investment management, trading or dealing in securities (as defined in section 475(c)(2)), partnership interests or commodities (as defined in section 475(e)(2)).

Taxpayers were concerned that the "performance of services in fields" provisions could pick up services beyond direct services in the field. Through discussions, rules and examples, the NPRM clarifies that the scope of coverage is relatively narrow. For example, it indicates that 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. Operation of health clubs or health spas, payment processing or research, testing and manufacture and/or sales of pharmaceuticals or medical devices are not considered performance of services in the field of health.

The Proposed 199A Regulations provide that the performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. The NPRM states that consulting includes all attempt to influence legislators and other government officials on behalf of a client by lobbyists. The Proposed 199A Regulations provide that consulting does not include consulting that is embedded in, or ancillary to, the sale of goods if there is no separate payment for the consulting services.

Tax advisors who studied Section 199A had great concerns about the possible breadth of what seemed like a catchall for a trade or business the principal asset of which is "the reputation or skill of one or more of its employees or owners." Treasury opted for a narrow reading of this, essentially limiting it to activities in which individuals or pass-through entities are receiving income from the sale of an individual's reputation or image. The Proposed 199A Regulations limit the meaning of "reputation or skill" to situations in which an individual or pass-through entity is engaged in one or more of the following businesses:

(i) Receiving income for endorsing products or services

(ii) Licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark or any other symbols associated with the individual's identity

(iii) 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, and video game players)

The Proposed 199A Regulations treat a direct or indirect owner of a trade or business engaged in an SSTB as engaged in the SSTB, regardless of whether the owner participated in the SSTB. For example, an owner of a baseball team treats the business as an SSTB even though the owner does not play baseball.

Under a proposed *de minimis* rule, a trade or business (determined before the application of the aggregation rules) is not an SSTB if the trade or business has gross receipts of US$25 million or less in a taxable year and less than 10% of the gross receipts are attributable to the performance of services in an SSTB. A trade or businesses with gross receipts greater than US$25 million is not an SSTB if less than 5% of its gross receipts are attributable to the performance of services in an SSTB.

The NPRM notes that Treasury is aware that some taxpayers have considered separating parts of what would be an integrated SSTB in an attempt to qualify a separated part for a Section 199A deduction (e.g., so-called "crack and pack" strategies). The Proposed 199A Regulations provide that an SSTB includes another trade or business with 50% or more direct or indirect common ownership that provides 80% or more of its property or services to an SSTB. In addition, if a trade or business that is not an SSTB (the non-SSTB) has 50% or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, then the non-SSTB is treated as part of the SSTB if 5% or less of the gross receipts of the combined business is attributable to the non-SSTB.

The Proposed 199A Regulations also include anti-abuse rules to prevent taxpayers from circumventing the threshold amounts by dividing assets among multiple trusts.

Qualified Property

For taxpayers above the income thresholds, QBI amounts will be limited to the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis of all "qualified property" if such sum is greater than 50% of the W-2 wages. Property is "qualified property" only during the period beginning on the date that the property is first placed in service by the taxpayer and ending on the later of the date that is 10 years after that date, or the last day of the last full year in the applicable recovery period that would apply to the property under Code Section 168(c) (as determined without regard to Code Section 168(g)). The Proposed 199A Regulations provide extensive guidance on what is qualified property and when qualified property is placed in service, including guidance on the application of special partnership basis adjustments, property received in like-kind exchanges, and property transferred in other non-recognition transactions. The Proposed 199A Regulations include an anti-abuse provision to prevent transfers with the principal purpose of increasing the Section 199A deduction: Property is not qualified property if it is acquired within 60 days of the end of the tax year and disposed of within 120 days of acquisition without having been used in the trade or business for at least 45 days.

Reasonable Compensation and Payments for Services

Section 199A provides that QBI does not include "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered." The Proposed 199A Regulations clarify that this provision applies only to S corporation shareholder-employees. Thus, a partner who is compensated for services provided to a partnership by receiving a share of the profits of the partnership does not have to subtract an amount for reasonable compensation from his or her share of the profits to determine QBI from the partnership.

Section 199A excludes guaranteed payments under Code Section 707(c) from QBI (i.e., amounts paid to partner in its capacity as a partner that are determined without regard to the income of the partnership, such as fixed salary paid to a lawyer in a law firm), but Congress left for Treasury to determine whether amounts paid by a partnership to partners under Section 707(a) (payments to a partner other than in a capacity as a partner) are excluded. The Proposed Regulations exclude from QBI Section 707(a) payments for services rendered, but the NPRM specifically invites comments on whether there are situations in which it is appropriate to include Section 707(a) payments in QBI. For example, an electrician who provides services to a variety of businesses in a town might argue that his income from electrical repairs for a franchise coffee shop in which he holds a 1% partnership interest should not be treated differently than his income from a hardware store in which he holds no interest or from a car dealership in which he is a 2% shareholder.

Conversion to Independent Contractor Status

An independent contractor may claim the 20% deduction with respect to its QBI, but an employee cannot have QBI attributable to his or her employment. Treasury feared that individuals who are employees under existing federal income tax principles would seek to label themselves as independent contractors without making any substantive changes in their economic or legal relationship with their "employer." The Proposed 199A Regulations include a rebuttable presumption that an individual who was treated as an employee by the person for whom he or she provided services and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services, directly or indirectly to the person, is in the trade or business of performing services as an employee with regard to such services. The individual may rebut the presumption only by showing that, under Federal tax rules, regulations and principles, the individual is performing services in a capacity other than as an employee.

Effect of Section 199A Deduction

The Proposed 199A Regulations clarify the effect of the Section 199A deduction on some other tax calculations. The deduction does not affect a taxpayer's adjusted basis in a partnership interest or shares of an S corporation and does not reduce net earnings from self-employment. The Section 199A deduction as calculated for regular tax purposes is also the deduction used in determining alternative minimum taxable income.

Reliance Regulations

The Proposed 199A Regulations generally apply to taxable years ending after the date of publication in the Federal Register of the Treasury decision adopting them as final regulations, but the Proposed 199A Regulations state that taxpayers may rely on the Proposed 199A Regulations until Treasury promulgates final regulations. The NPRM states that to prevent abuse of Section 199A, various anti-abuse rules are proposed to apply to taxable years ending after the December 22, 2017, date of enactment of the TCJA.

What's Next?

The NPRM calls for written or electronic comments to be submitted in time to be received by 45 days after its publication in the *Federal Register*. Additionally, Treasury scheduled a hearing on the Proposed 199A Regulations for October 16, 2018. The NPRM specifically invites comments on a variety of topics, ranging from the regulatory burden of the regulations to specific complicated matters that the Proposed 199A Regulations address. The scheduling of a hearing and the short time frame for submitting comments appears to indicate a desire on the part of Treasury to move quickly to finalize regulations.

While the Proposed 199A Regulations are generally favorable to many taxpayers, they provide the "wrong" answer for other taxpayers and do not answer all technical questions that individuals and pass-through entities are likely to have. Some of the proposed rules or discussion of the proposed rules in the NPRM will prompt new questions from taxpayers who may benefit from the Section 199A deduction.

Taxpayers and pass-through entities that could benefit from the pass-through deduction should consider submitting comments and outlines of topics for the hearing, as this is an important opportunity to help refine the regulations before they are finalized or to get answers to questions in a preamble to final regulations. Comments may challenge positions taken, offer alternative positions, flag important issues that the Proposed 199A Regulations do not address, or support provisions of the Proposed 199A Regulations. The NPRM references comments that Treasury received from persons who were concerned about loopholes and potential abuse. Therefore, it may be important to convey support for provisions that address favorably matters on which taxpayers were hoping to see guidance.

For our current views on the prospects for the enactment of additional tax reform legislation this year (including technical corrections to the TCJA), see our update, "Here Come the Regulations: Treasury Releases Proposed Regulations on Repatriation Tax," which explores the Section 965 proposed regulations.

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