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IRS Publishes Proposed Section 199A Regulations

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Summary

The IRS recently issued proposed regulations under Section 199A, a provision enacted as part of tax reform to allow individuals and certain other non-corporate taxpayers to deduct up to 20 percent of qualified business income. The proposed regulations provide operational rules on calculating this deduction, an aggregation rule, detail on the scope of trades or businesses that are not eligible for this deduction and rules applying this deduction to trusts and estates.

In Depth

Section 199A Deduction: In General

Section 199A, enacted at the end of 2017 as part of tax reform, allows individuals and certain other non-corporate taxpayers to deduct up to 20 percent of qualified business income (QBI) beginning this year. QBI includes certain income from a partnership, S corporation or sole proprietorship, as well as 20 percent of the total qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income of the non-corporate taxpayer. Subject to limitations, QBI generally is taxable income (*i.e.*, the net amount of items of income, gain, deduction and loss) with respect to a US trade or business. Passive investment income such as capital gains, dividends and interest income does not qualify as QBI (unless the interest is received in connection with a lending business).

Taxpayers with income in excess of certain threshold amounts are not eligible for the section 199A deduction if the income is attributable to a specified service trade or business, or an “SSTB.” The SSTB exclusion phases in for (a) individuals filing joint returns with taxable income in excess of $315,000 and (b) for other individual taxpayers and non-grantor trusts with taxable income, in each case in excess of $157,500. These threshold amounts are indexed for inflation.

Even if a taxpayer earns QBI that is eligible for the section 199A deduction, the amount of the deduction may be limited if the taxpayer earns income in excess of the threshold amounts. The section 199A deduction, otherwise allowable, cannot exceed the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the tax basis of certain tangible depreciable property used in the qualified trade or business.

On August 8, the Internal Revenue Service (IRS) and US Department of the Treasury (Treasury) published proposed regulations under section 199A. The stated purpose of the proposed regulations is to "provide taxpayers with computational, definitional and anti-avoidance" guidance under section 199A.

Definition of Specified Service Trade or Business

Income exceeding the threshold amounts stated above that is from a SSTB is not eligible for the section 199A deduction because a SSTB is not a "qualified" trade or business under section 199A.

Under section 199A, an SSTB is defined as "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." Section 199A provides that 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 take further steps to define each field that is an SSTB. While questions remain, the definitions in the proposed regulations appear to be narrowly tailored to address specific lines of services in what could otherwise be viewed as broad categories. For example, the proposed regulations define the performance of services in the field of:

1. "Health" as "the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient)";

   The proposed regulations exclude services "not directly related to the medical services field" such as the operation of health clubs or health spas and "payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical services";

2. "Law" as "the performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such" but exclude ancillary services that "do not require skills unique to the field of law";
3. "Accounting" as "the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such";
4. "Consulting" as "the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems" but states that 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";
5. "Athletics" as "the performance of services by individuals who participate in athletic

competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing";

6. "Financial services" as "the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services";

   Notably absent from the definition of financial services is a traditional banking business.

7. "Investing and investment management" as "a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments" but excluding the business of "directly managing real property";
8. "Trading" as "a trade or business of trading in securities (as defined in section 475(c)(2)), commodities (as defined in section 475(e)(2)), or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof";
9. "Dealing in securities" as "regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business"; or
10. 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.

    The proposed regulations provide that a business is an SSTB under this rule if it is a business in which a person receives fees, compensation or other income, including receipt of a partnership interest or S corporation stock, for: (a) endorsing products or services; (b) the use of a person's image, likeness, name, signature, voice, trademark or any other symbols associated with the individual's identity; or (c) appearing on radio, television or another media format.

Other SSTB services specifically listed in the proposed regulations are actuarial science, performing arts and brokerage services. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment and facilities for use in the performing arts. Brokerage services do not include services provided by real estate agents and brokers, or insurance agents and brokers.

The definition of SSTB, like many other provisions in the proposed regulations, become effective only when the Treasury publishes final regulations. Taxpayers may, however, rely on these definitions (and certain other specified provisions) until the Treasury publishes final regulations.

Definition of Trade or Business

“Trade or business” is a key term in section 199A; only amounts earned in a qualified *trade or business* are eligible for the full benefit of the deduction. However, neither section 199A nor its legislative history defines trade or business.

The proposed regulations adopt the definition of trade or business elsewhere in the Code, with modifications. The proposed regulations also aggregate certain related entities into a single trade or business. This extension of the trade or business definition allows more than one legal entity to be treated as conducting a single trade or business for purposes of the section 199A deduction, potentially increasing the amount of a taxpayer’s deductible QBI.

The proposed regulations extend the definition of trade or business to include the rental or licensing of tangible or intangible property to a commonly controlled trade or business even if such rental or licensing business does not itself constitute a trade or business under general principles under the Code. Treasury stated that the purpose of this extension is to allow taxpayers that segregate legal ownership of rental or other property from an operating business to aggregate the operating business with such property for purposes of qualifying for the section 199A deduction.

SSTB Related Party Rules

The proposed regulations adopt three rules intended to address arrangements between separate but commonly owned entities engaging in purportedly distinct businesses, one of which includes an SSTB (the SSTB Related Party Rules). Each of the SSTB Related Party Rules applies only if an SSTB and an otherwise qualifying trade or business are “related.” Businesses are related for this purpose if they share 50 percent or more common ownership. Ownership is determined under special constructive ownership rules under the Code. Under the SSTB Related Party Rules:

1. Any trade or business that provides 80 percent or more of its property or services to a related SSTB is itself treated as an SSTB;
2. A trade or business is treated as an SSTB if (1) it shares expenses (including wages or overhead) with a related SSTB and (2) the trade or business’s gross receipts represent 5 percent or less of the total combined gross receipts of the trade or business and the related SSTB during a taxable year; and
3. Even if a trade or business is not treated as an SSTB in its entirety under either of the prior two rules, any portion of a trade or business providing property or services to a related SSTB is treated as part of the SSTB.

Any income earned by a trade or business that is treated as an SSTB (under either of the first two SSTB Related Party Rules) or as part of the related SSTB (under the third SSTB Related Party Rule) will not be QBI. Such income therefore will not be eligible for the section 199A deduction unless the taxpayer’s taxable income is less than the previously mentioned applicable threshold.

The SSTB Related Party Rules are effective for any tax year ending after December 22, 2017, the date tax reform was enacted.

Exception for *de minimis* SSTB

The proposed regulations add a *de minimis* exception to the definition of SSTB, which was not included in section 199A. Under the exception, a business that generates $25 million or less gross receipts for a taxable year will not be an SSTB if less than *10 percent* of its gross receipts are

attributable to the performance of services in the fields that are SSTBs. A business that generates more than $25 million of gross receipts for a taxable year will not be an SSTB if less than *5 percent* of its gross receipts are attributable to the performance of services in the fields that are SSTBs.

Anti-Abuse Provisions for Trusts

Certain limitations on the section 199A deduction, including the preclusion of the deduction for SSTBs, apply only to taxpayers with taxable income in excess of $315,000 for joint filers and $157,500 for other taxpayers. A non-grantor trust is treated as a taxpayer and is subject to the section 199A limitation only if its income exceeds is $157,500.

The grantor of a grantor trust is treated as directly receiving any QBI received by the grantor trust. The threshold income amounts for a non-grantor trust, on the other hand, are determined at the trust level (without taking into account deductions for trust distributions). Absent an anti-abuse rule, taxpayers could circumvent the income thresholds by creating multiple trusts, each of which would take advantage of its own threshold income amount.

The proposed regulations utilize the authority granted by section 643(f) to prevent taxpayers from establishing or funding multiple non-grantor trusts in order to increase the section 199A deduction. Section 643(f), enacted in 1984, grants Treasury authority to issue regulations treating two or more trusts as a single trust if (1) the trusts "have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries" and (2) "a principal purpose" of the trusts is the avoidance of income tax. For purposes of applying this section, spouses are treated as one person.

The proposed regulations provide a presumption that two or more trusts were formed for a principal purpose of avoiding tax if the establishing or funding of a trust "results in a significant tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation" of the separate trusts. This rule is illustrated in two examples. One example clarifies that two trusts established by the same grantor for the primary of two different children would be respected as two separate trusts. However, another example provides that three separate trusts for four potential beneficiaries would be aggregated as one trust if the separate trusts were for the benefit of more than one beneficiary without further explanation.

The proposed regulations apply to arrangements involving multiple trusts that are entered into or modified after the date that final regulations are published. The proposed regulations take the position, however, that section 643(f) is self-executing and therefore section 643(f) would apply to arrangements entered into prior to the date final regulations are published if appropriate under the statute, guidance and legislative history of section 643(f).

These anti-abuse rules are effective for any tax year ending after December 22, 2017, the date tax reform was enacted.

Electing Small Business Trusts

An electing small business trust (ESBT) is a special type of trust that is eligible to own stock in an S corporation. Because of language in the statute governing the taxation of ESBTs, some practitioners were concerned that ESBTs might not be entitled to the section 199A deduction. The proposed regulations clarify that an ESBT is entitled to the section 199A deduction in connection with its share of an S corporation's QBI.

Non-Application of SSTB Definitions to Section 1202

Section 199A defines an SSTB, in part, by cross-reference to section 1202(e)(3)(A) (with certain modifications). Section 1202 allows taxpayers to exclude all or part of gain recognized from the sale of certain “qualified small business stock.” Similar to section 199A, certain service businesses are not treated as “qualified” for purposes of section 1202. Many practitioners expected that because section 199A defines SSTB, in part, by cross-reference to the section 1202(e)(3)(A) definition of a qualified trade or business, the content of the section 199A regulations would be useful to also provide guidance regarding the application of section 1202. However, Treasury makes clear that the definition of SSTB in the proposed regulations provides “[d]istinct guidance for section 199A” that “applies only to section 199A” and not section 1202.

Adjusted Tax Basis in Pass-Through Entities

Shareholders and partners that are allocated deductions from an S corporation or partnership typically must reduce their tax basis in their shares or partnership interests by the amount of the deduction. Section 199A provides that the section 199A deduction is applied at the shareholder level (for S corporations) or partner level (for entities classified as partnerships). The proposed regulations clarify that the section 199A deduction does not affect a shareholder’s or partner’s tax basis in an S corporation or partnership.

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