Proposed IRS Regulations Could Affect Your Ability to Take The New 20% Pass-Through Income Deduction

By Russell J. Stein

Overview

On Wednesday August 8, 2018, the IRS issued proposed regulations under Section 199A of the Income Tax Code (the "Proposed Regulations") governing the new 20 percent deduction from income from certain pass-through entities enacted as part of the Tax Cuts and Jobs Act of 2017. The Proposed Regulations add some much needed clarity to the deduction's eligibility rules but also add anti-abuse provisions that may prevent some businesses from reorganizing for the purposes of taking advantage of the new deduction.

Background to the 20 percent Deduction

Section 199A of the Income Tax Code generally allows non-corporate taxpayers a deduction of up to 20 percent of qualified business income ("QBI") from a domestic business operating as a pass-through entity (such as a sole proprietorship, S corporation, partnership or limited liability company). The deduction is also available for certain REIT dividends and qualified publicly traded partnership income.

Not all owners of pass-through businesses can take full advantage of this new deduction though. The deduction is generally limited to the lesser of 20 percent of QBI or the greater of (a) 50 percent of the businesses' W-2 wages or (b) 25 percent of wages plus 2.5 percent of the basis of certain property acquired by the business ((a) and (b) collectively, the "W-2 Limitation"). Additionally, owners of certain "specified trade or business activities" ("SSTB Activities") are ineligible to take the new deduction once their taxable income surpasses a certain level.

The deduction is phased out for SSTB Activities (generally businesses in the fields of health, law, accounting, consulting, and finance) once the taxpayer's income exceeds a certain level ($157,500 for single individuals, $315,000 for joint returns). For those taxpayers the deduction is completely disallowed once taxable income exceeds either $207,500 for single taxpayers or $415,000 for joint returns (the "SSTB Threshold"). These thresholds are measured on the taxpayer's 1040 tax return not the business tax return.

Proposed Regulations

The preamble and the Proposed Regulations are quite extensive, coming in at 183 pages, and provide some welcome clarifications in some areas as well as restrictions in other areas.

Some of the highlights of the Proposed Regulations include:

• *Clarifying the Definition of SSTB Activities*

1. *Insurance and Banks get favorable treatment.*

The preamble to the Proposed Regulations clarifies that Insurance Brokers, Insurance Agents, and Banks organized as pass-through businesses are not SSTB Activities, therefore the owners of such businesses will not have their deductions limited by the SSTB Threshold.

2. *Field of Health definition clarified.*

For purposes of the SSTB limitations, "field of health" services are defined as primarily the provision of medical services directly to patients. Accordingly, businesses providing services to health care professionals appear to

be excluded from this definition and not subject to the more restrictive SSTB Threshold. There is still some uncertainty as to whether pharmacy services are considered SSTB Activities. The Proposed Regulations indicate pharmacist services provided directly to a patient are SSTB Activities, but the manufacture and sale of pharmaceuticals are not SSTB activities. Presumably this means that pharmacies are SSTB Activities since the services are provided directly to patients, but drug manufacturing companies are not SSTB Activities.

3. Consulting services definition clarified for purposes of SSTB limitations.

Consulting services classified as SSTB Activities are generally limited to services providing professional advice and counsel to assist clients in achieving goals and solving problems including traditional lobbying type activities. The Proposed Regulations specifically indicate that consulting does not include sales or the provision of training and educational courses.

4. The catch-all category for SSTB Activities where "the principal asset of such trade or business is the reputation or skill of its employees or owners" is narrowed in the Proposed Regulations to just individuals or businesses (1) receiving income for endorsing products or services; (2) licensing or receiving income for the use of an individual's image, likeness, etc.; or (3) receiving appearance fees or income.

5. A *de minimis* rule is added where a trade or business will not be considered an SSTB Activity merely because it provides a small amount of services in a specified service activity.

• *Certain Trusts are eligible to take the deduction.*

The Proposed Regulations provide that Electing Small Business Trusts (certain trusts that hold S corporation stock) are eligible to take the deduction on any S corporation income.

• *New Aggregation Rules permitting aggregation of separate trades or businesses.*

Generally the W-2 Limitation is calculated on an activity by activity basis in determining the deduction. If a business has minimal wages expenses the deduction could be limited. The Proposed Regulations permit a taxpayer to aggregate its activities in order to combine W-2 expenses and income from separate trades or businesses into one calculation. Among the requirements for aggregation are that the same person or group of persons own 50 percent or more of each business and at least two of the following three factors are satisfied: the businesses provide products and services that are the same or customarily offered together, the businesses share facilities or "significant centralized business elements", or the businesses are operated in coordination with or reliance upon the other businesses in the group.

• *Anti-abuse rules for businesses providing services to SSTBs.*

If a business with SSTB Activities has common ownership with an entity that does not have SSTB Activities, the Proposed Regulations have an anti-abuse provision that reclassifies an activity as an SSTB Activity if there is common ownership and if the business provides services primarily to an SSTB Activity. As an example, if partners in an accounting firm (an SSTB Activity) also own a real estate partnership that just owns the building housing the accounting firm, and there is 50 percent or more common ownership between the accounting firm and the real estate partnership, such real estate partnership will now be classified as an SSTB and subject to those threshold limitations. Companies with SSTB Activities that are considering spinning out certain business lines to take advantage of the new deduction should carefully review the Proposed Regulations to determine the feasibility of any restructuring.

• *No effect on self-employment taxes or net investment income taxes.*

The Proposed Regulations clarify that the 20 percent deduction from income does not affect either the calculation of a taxpayer's self-employment income or the calculation of a taxpayer's net investment income, so the deduction will not affect the calculation of either self-employment taxes or net investment income taxes.

• *Documentation rules regarding W-2 reporting.*

If W-2 wages are not reported to the Social Security Administration on or before the 60th day after the due date for such returns (including extensions), the W-2 wages are disallowed for purposes of calculating the Section 199A deduction. In addition, if W-2 wages are not determined and reported to the taxpayer for each trade or business, a presumption exists that such amounts are zero for purposes of calculating the Section 199A deduction. Accordingly, pass-through entities should report each partner or shareholder's allocable share of such expenses each year.

What does this mean for your business?

The Proposed Regulations add some clarity to the rules, but are still quite extensive and complex in nature, and this Client Alert highlights just a few of the provisions. If your business is organized as a pass-through entity, or you are considering starting a new venture or restructuring a current venture, the Proposed Regulations provide some useful guidance on whether or not income generated from your business will be eligible for this new 20 percent deduction. Although the Proposed Regulations will not be effective until published in final form in the Federal Register, and the Proposed Regulations may be revised prior to finalization, taxpayers may rely on them now for planning purposes.

Please contact Russell J. Stein at Partridge Snow & Hahn if you have questions about these Proposed Regulations.

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