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Treasury and IRS Issue Proposed “Pass-Through Deduction” Regulations

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On August 8, 2018, the U.S. Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "IRS") issued proposed regulations regarding the "pass-through deduction" for qualified trade or business income under section 199A of the Internal Revenue Code (the "Proposed Regulations").[1]

I. Background

Section 199A provides a deduction of up to 20% for individuals of the income from a domestic business that is operated as a sole proprietorship, or through a partnership, S corporation, trust or estate (the "section 199A deduction"). The section 199A deduction provides a maximum effective rate of 29.6% on an individual's domestic "qualified business income." For taxpayers with income above a threshold amount, $315,000 for joint filers and above $157,500 for other filers, the deduction with respect to income from a specified service, trade or business (“SSTB”) phases out, and is excluded completely for joint filers with income above $415,000 and above $207,500 for other filers.[2] For those taxpayers, the section 199A deduction is also limited based on the amount of the W-2 wages paid with respect to the trade or business. Additionally, section 199A allows individuals and some trusts and estates to deduct up to 20% of their combined qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership ("PTP") income, including the REIT dividends and PTP income earned from pass-through entities. Section 199A applies to taxable years ending on or before December 31, 2025.

II. Key Takeaways from the Proposed Regulations

The Proposed Regulations provide many helpful clarifications of the basic statutory language of section 199A. Some of the most significant provisions of the Proposed Regulations are:

First, the Proposed Regulations limit the catch-all provision for a business where "the principal asset is the reputation or skills of one or more of its employees or owners" to one that is receiving income in connection with endorsements, licensing of image, name, and the like, and income earned for appearances.

Second, the Proposed Regulations clarify that taxpayers will not be allowed to separate out parts of an integrated SSTB in order to qualify the separated part for a section 199A deduction. This clarification prevents the "crack-and-pack" strategy that had been considered by taxpayers engaged in an SSTB in order to avoid the SSTB exclusion.

Third, the Proposed Regulations limit the ability of an employee to become an independent contractor in order to qualify for the section 199A deduction.

Fourth, the Proposed Regulations provide that, a taxpayer can aggregate certain trades or business that are commonly owned and involve similar services. Aggregation will reduce a taxpayer's need to restructure its businesses to qualify for the section 199A deduction.

Fifth, the Proposed Regulations provide that for purposes of section 199A, the definition of trade or business relies on the definition of trade or business under section 162. As a result, taxpayers will be able to rely on case law and prior IRS's authorities applicable to section 162.

Sixth, the Proposed Regulations provide that only S corporation shareholders must receive reasonable compensation (taxable at ordinary income rates) for the services they provide. Partners (and sole proprietors) need not be paid compensation.

III. Summary of the Proposed Regulations

1. Prop. Treas. Reg. §1.199A-1: Operational Rules

The Proposed Regulations define various terms including, such as: aggregated trade or business, qualified business income ("QBI"), relevant pass-through entity ("RPE"), total QBI amount and trade or business.[3] QBI is the net amount of qualified items of income, gain, deduction, and loss with respect to a trade or business.[4] An RPE is a partnership (other than a PTP) or S corporation that is owned (directly or indirectly) by at least one individual, estate or trust.[5] The total QBI amount is the net amount of QBI from all of the taxpayer's trades or businesses.[6] Trade or business means a section 162 trade or business, other than performing services as an employee, and includes the rental of property to a related trade or business if the rental and the other trade or business are commonly controlled.[7]

For taxpayers with income above $315,000 for married individuals filing jointly, the section 199A deduction is the lesser of (A) the "QBI component" plus 20% of the taxpayer's combined qualified REIT dividends and qualified PTP income or (B) 20% of the excess (if any) of the taxpayer's taxable income (calculated without taking into consideration any deduction under section 199A) over its net capital gain.[8] The "QBI component" is the sum of amounts for each trade or business that is the lesser of (1) 20% of the taxpayer's qualified business income with respect to such qualified trade or business, or (2) the greater of (i) 50% of the W-2 wages with respect to such qualified trade or business, or (ii) the sum of 25% of the W-2 wages with respect to such qualified trade or business plus 2.5% of the unadjusted basis immediately after acquisition of qualified property ("UBIA of qualified property").[9] The Proposed Regulations clarify that if a taxpayer has multiple trades or businesses and the QBI from at least one trade or business is less than zero, the taxpayer must first offset that QBI with the QBI from businesses that produced a net positive QBI and, then use the adjusted QBI for that trade or business to compute the QBI component amount.[10]

If the total QBI amount is less than zero, then the negative number will be treated as a loss in the next succeeding taxable year for purposes of the pass-through deduction.[11] Similarly, if the combined qualified REIT dividends and qualified PTP income is less than zero, then the loss must be carried forward and can offset the combined qualified REIT dividends and qualified PTP income in the next succeeding taxable year.[12]

2. Prop. Treas. Reg. §1.199A-2: Determination of W-2 Wages and the UBIA of Qualified Property

The Proposed Regulations provide a three-step process in order to calculate the W-2 wages paid with respect to each trade or business. First, the taxpayer (individual or RPE that directly conducts the trades or business) must determine the total amount of W-2 wages paid.[13] Generally, a taxpayer can take into account W-2 wages of an employee reported on Forms W-2 issued by other parties provided that such employee is a "common law employee or officer" of the taxpayer.[14] Second, if the taxpayer conducts multiple trades or businesses, then the taxpayer must allocate its W-2 wages among its trades or businesses.[15] W-2 wages must be allocated to the trade or business that generated those wages.[16] If the W-2 wages are allocable to more than one trade or business, then the portion of W-2 wages allocable to each trade or business is equal to the same proportion to total W-2 wages as the deductions associated with those wages are allocated among the particular trades or businesses.[17] Third, the taxpayer must determine the amount of such wages that are allocable to the QBI of the relevant trade or business.[18] W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI.[19]

Qualified property generally means depreciable property which (i) is held by and available for use in the trade or business as of the end of the taxable year, (ii) is used during the taxable year in the trade or business's production of QBI and (iii) has a depreciable period that has not ended before the close of the taxpayer's taxable year.[20] Any addition to, or improvement to qualified property is treated as a separate qualified property placed in service on the date that the addition or improvement is placed in service.[21] Also, qualified property does not include property acquired within 60 days of the end of the taxable year and disposed within 120 days without having been used in a trade or business for at least 45 days.[22] Furthermore, basis adjustments under sections 734(b) and 743(b) are not qualified property for purposes of section 199A.[23]

UBIA means the basis on the date the property is placed in service.[24] A partner's or shareholder's allocable share of the UBIA of qualified property is an amount that bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the entity's total tax depreciation attributable to the property for the year.[25] In the case of an S corporation, the shareholder's share of UBIA is a share of the UBIA proportionate to the ratio of the share in the S corporation held by the shareholder over the total shares of the S corporation.[26]

3. Prop. Treas. Reg. §1.199A-3: QBI, Qualified REIT dividends and Qualified PTP income.

The Proposed Regulations provide that QBI means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer.[27] However, the following items are not taken into account when computing QBI: (i) guaranteed payments for the use of capital; (ii) net operating losses; (iii) section 1231 gains and losses; (iv) interest income; (v) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer in an S corporation; (vi) guaranteed payments described in 707(c), including a guaranteed payment paid by a lower tier partnership to an upper tier partnership; and (vii) payments described in 707(a) to a partner for services rendered with respect to the trade or business, regardless if the partners is an individual or an RPE.[28]

The term "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction or loss to the extent those items are effectively connected with the conduct of a trade or business within the U.S. (as defined in section 864(c)) and included or allowed in determining taxable income for the taxable year.[29]

The Proposed Regulations further provide that items that are attributable to one or more trade or business must be allocated among the several trades or business to which they are attributable using a reasonable method that is consistent with the purposes of 199A.[30]

A qualified REIT dividend is a dividend from a REIT received during the taxable year which is not a capital gain dividend and is not qualified dividend income.[31] Effective for taxable years ending after December 22, 2017, a REIT dividend is excluded if the stock with respect to which it is received is held for fewer than 45 days.[32]

4. Prop. Treas. Reg. §1.199A-4: Aggregation Rules

The Proposed Regulations allow a taxpayer to aggregate multiple trades or businesses and treat them as a single trade or business for purposes of applying the limitations of the section 199A deduction calculation, if the taxpayer can demonstrate that: (i) the same person, or group of persons directly or indirectly own 50% or more of each trade or business (in the case of S corporation measured by the amount of outstanding shares of the corporation and in the case of a partnership measure by capital or profits of the partnership); (ii) the ownership described in the previous clause existed for a majority of the taxable year; (iii) all of the items attributable to each trade or business are reported on returns with the same taxable year; (iv) none of the trades or businesses are an SSTB; and (v) the trades or businesses satisfy at least two of the following three factors – (1) they provide products and services that are the same or customarily offered together; (2) they share facilities or significant centralized business elements; and (3) they are operated in coordination with, or reliance on, other businesses in the aggregated group. [33]

An individual may aggregate trades or businesses that it operates directly as well as the individual's shares of trades or businesses operated through RPEs.[34] Multiple owners of an RPE do not need to aggregate in the same manner.[35] In the case of trades or businesses operated directly by an individual, the individual must compute QBI, W-2 wages and UBIA of qualified property for each trade or business before applying the aggregation rules.[36] Once an individual aggregates multiple trades or businesses, the individual must consistently report the aggregated group in subsequent years.[37] The individual may change the aggregation if there is a change in facts or circumstances that invalidates the previous aggregation.[38]

5. Prop. Treas. Reg. §1.199A-5: Specified Service Trade or Business "SSTB"

Generally, taxpayers with income above a threshold amount, $315,000 for joint filers and above $157,500 for other filers, can only take into account a certain “applicable percentage” of QBI, W-2 wages, and UBIA of qualified property from an SSTB, and cannot be taken into account at all for joint filers with income above $415,000 and above $207,500 for other filers.[39]

i. Definition of SSTBs

Generally, an SSTB includes a trade or business that performs services in the following areas: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, dealing in securities or a trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.[40] The Proposed Regulations provided additional guidance on the meaning of each of these services.

Principal Asset is the reputation or skill of one or more employees or owners. The Proposed Regulations narrow the scope of the services where the principal asset is the reputation or skills of one or more of its employees or owners to those where an individual or RPE is (a) receiving income for endorsing products or services; (b) 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; or (c) receiving appearances fees or income.[41]

Therefore, an individual receiving royalties in connection with musical performances is engaged in an SSTB but an individual receiving royalties from songwriting is not engaged in an SSTB. Moreover, if a chef who owns multiple restaurants receives endorsement fees for the use of the chef's name on a line of cooking products, the endorsement fees are from an SSTB (and therefore will not qualify for the section 199A deduction if the chef earns more than threshold amount), but the income from the restaurant businesses are not from an SSTB (and therefore will qualify for the section 199A deduction).

Health. The Proposed Regulations define the performance of services in the field of health as the provision of medical services directly to a patient.[42] These services do not include the provision of services not directly related to a medical field, even though the services may relate to the health of the service recipient. Also, services in the field of health exclude health clubs and spas, as well as research, testing, manufacture and or sales of pharmaceuticals or medical devices.[43]

Athletics. Performance of services in the field of athletics is defined as the performance by participants in athletic competitions, including the athletes, coaches, and team managers.[44] However, the term excludes services that do not require skills unique to athletic competition like the maintenance and operation of the equipment and facilities and services relating to the broadcasting, video and audio of the athletic events.[45] The Proposed Regulations specifically cover baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing.[46] The list does not include poker, horse racing or auto racing. For example, a partnership, which solely owns and operates a professional sports team, and it employs athletes and sells tickets to the public for its team sport events is engaged in an SSTB in the field of athletics.[47] As a result, its partners' share of income from such business is not eligible for the section 199A deduction.[48]

Financial Services. The field of financial services covers services typically performed by financial advisors and investment bankers, including wealth management, providing advice with respect to a client's finances, developing retirement plans and wealth transition plans, advisory services regarding valuations, mergers, acquisitions, dispositions and raising financial capital by underwriters. However, it excludes taking deposits or making loans.[49] Therefore, owners of S corporation banks may qualify for the pass-through deduction, regardless of their income.

Investing and Investment Management. Investing and investing management means a trade or business that earns fees for investment, asset management services, or investment management services, whether receiving a commission, flat fee or investment management fee based on a percentage of assets under management.[50]

Trading or Dealing in Securities. Trading means a trade or business of trading in securities, commodities, or partnership interests.[51] Dealing in securities, partnership interests and commodities means regularly purchasing securities, partnership interests or commodities from and selling securities, partnership interests or commodities to customers in the ordinary course or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities, partnership interests or commodities with customers in the ordinary course.[52]

ii. Miscellaneous SSTB's Rules

The Proposed Regulations contain de-minimis rules for SSTBs. A trade or business is not an SSTB if the trade or business had gross receipts of $25 million or less in the taxable year and less than 10% of the gross receipts of the trade or business is attributable to the performance of services in an SSTB.[53] Also, a trade or business is not an SSTB if the trade or business had gross receipts of more than $25 million in the taxable year and less than 5% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.[54]

The Proposed Regulations also contain various anti-abuse rules for SSTBs. First, an SSTB includes any trade or business (not otherwise an SSTB) with 50% or more common ownership that provides 80% or more of its property or services to an SSTB.[55] Furthermore, if a trade or business (not otherwise an SSTB) that has 50% or more common ownership with an SSTB but does not meet the 80% rule above, then any portion of the property of services provided to an SSTB will be treated as an SSTB.[56] Second, if a trade or business (not otherwise an SSTB) has 50% or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, it is treated as part of an SSTB if the trade or business represents no more than 5% of gross receipts of the combined business.[57] These two anti-abuse rules apply to taxable years ending after December 22, 2017.[58]

Under section 199A, income from the trade or business of performing services as an employee is ineligible for the section 199A deduction.[59] This includes all wages and other income earned in a capacity as an employee, including the cash value of payments made in any medium other than cash described in Treas. Reg. 1.6041-2(a)(1).[60] The Proposed Regulations provide that if an individual who was treated as an employee for federal employment tax purposes by the taxpayer and is subsequently treated as other than an employee while still providing substantially the same services directly or indirectly to the taxpayer (or a related person), such individual is presumed to be in the business of performing services as an employee with regard to such services.[61] This presumption, which is applicable to taxable years ending after December 22, 2017, can be rebutted upon showing that under the federal tax rules, the individual is performing services in a capacity other than as an employee.[62] For example, A is employed by XYZ partnership as an employee and is treated as such for federal employment tax purposes. A quits her job for PRS and enters into a contract with PRS to provide substantially the same services that A provided in her capacity as an employee. Under the Proposed Regulations, A is presumed for section 199A purposes to be engaged in the trade or business of performing service as an employee with regard to her services performed for XYZ.

6. 199A-6: Special Rules for RPEs, PTPs, Trusts and Estates

Under the Proposed Regulations, RPEs must report its QBI, W-2 wages, the UBIA of qualified property for each trade or business and whether any of its trades or businesses is an SSTB to their owners and the IRS.[63] RPEs must also report qualified REIT dividends and qualified PTP income received.[64] Additionally, PTPs must determine and report ABI for each trade and business in which the PTP is engaged and whether any of its trades or businesses are SSTBs.[65] PTPs must also report qualified REIT dividends and qualified PTP income received from another PTP.[66] However, PTPs do not need to report W-2 wages or the UBIA of qualified property for each trade or business.[67]

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[1] All section references are to the Internal Revenue Code (the "Code"), and the Treasury regulations promulgated thereunder.

[2] For purposes of this discussion, we assume that the taxpayer's income is above the threshold amount.

[3] Prop. Treas. Reg. §1.199A-1(b).

[4] Prop. Treas. Reg. §1.199A-1(b)(4).

[5] Prop. Treas. Reg. §1.199A-1(b)(9).

[6] Prop. Treas. Reg. §1.199A-1(b)(12).

[7] Prop. Treas. Reg. §1.199A-1(b)(13). For purposes of this provision, commonly controlled means that the same person, or group of persons directly or indirectly own 50% or more of each trade or business.

[8] Prop. Treas. Reg. §1.199A-1(d)(1).

[9] Prop. Treas. Reg. §1.199A-1(d)(2).

[10] Prop. Treas. Reg. §1.199A-1(d)(2)(iii)(A).

[11] Prop. Treas. Reg. §1.199A-1(c)(2)(i) and Prop. Treas. Reg. §1.199A-1(d)(2)(iii)(B). However, this carryover rule does not affect the deductibility of the loss in the current year for purposes of other provisions of the Code.

[12] Prop. Treas. Reg. §1.199A-1(c)(2)(ii) and Prop. Treas. Reg. §1.199A-1(d)(3). However, this carryover rule does not affect the deductibility of the loss in the current year for purposes of other provisions of the Code.

[13] Prop. Treas. Reg. §1.199A-2(b)(1).

[14] Prop. Treas. Reg. §1.199A-2(b)(2).

[15] Prop. Treas. Reg. §1.199A-2(b)(1).

[16] Prop. Treas. Reg. §1.199A-2(b)(3).

[17] Prop. Treas. Reg. §1.199A-2(b)(3).

[18] Prop. Treas. Reg. §1.199A-2(b)(1).

[19] Prop. Treas. Reg. §1.199A-2(b)(4).

[20] Prop. Treas. Reg. §1.199A-2(c)(1)(i).

[21] Prop. Treas. Reg. §1.199A-2(c)(2)(ii).

[22] Prop. Treas. Reg. §1.199A-2(c)(1)(iv). This is applicable for taxable years ending after December 22, 2017.

[23] Prop. Treas. Reg. §1.199A-2(c)(1)(iii).

[24] Prop. Treas. Reg. §1.199A-2(c)(3).

[25] Prop. Treas. Reg. §1.199A-2(a)(3).

[26] *Id.*

[27] Prop. Treas. Reg. §1.199A-3(b)(1).

[28] Prop. Treas. Reg. §1.199A-3(b)(1) – (2)

[29] Prop. Treas. Reg. §1.199A-3(b)(2)(i).

[30] Prop. Treas. Reg. §1.199A-3(b)(5).

[31] Prop. Treas. Reg. §1.199A-3(c)(2).

[32] *Id.*

[33] Prop. Treas. Reg. §1.199A-4(b)(1).

[34] Prop. Treas. Reg. §1.199A-4(b)(2).

[35] *Id.*

[36] *Id.*

[37] Prop. Treas. Reg. §1.199A-4(c).

[38] *Id.*

[39] Prop. Treas. Reg. §1.199A-5(a)(2).

[40] Prop. Treas. Reg. §1.199A-5(b)(1).

[41] Prop. Treas. Reg. §1.199A-5(b)(2)(xiv).

[42] Prop. Treas. Reg. §1.199A-5(b)(2)(ii).

[43] *Id.*

[44] Prop. Treas. Reg. §1.199A-5(b)(2)(viii).

[45] *Id.*

[46] *Id.*

[47] Prop. Treas. Reg. §1.199A-5(b)(3) Example 2.

[48] *Id.*

[49] Prop. Treas. Reg. §1.199A-5(b)(2)(ix).

[50] Prop. Treas. Reg. §1.199A-5(b)(2)(xi).

[51] Prop. Treas. Reg. §1.199A-5(b)(2)(xii).

[52] Prop. Treas. Reg. §1.199A-5(b)(2)(xiii).

[53] Prop. Treas. Reg. §1.199A-5(c)(1)(i).

[54] Prop. Treas. Reg. §1.199A-5(c)(1)(ii).

[55] Prop. Treas. Reg. §1.199A-5(c)(2)(i).

[56] Prop. Treas. Reg. §1.199A-5(c)(2)(ii).

[57] Prop. Treas. Reg. §1.199A-5(c)(3).

[58] Prop. Treas. Reg. §1.199A-5(e)(2).

[59] Prop. Treas. Reg. §1.199A-5(d)(1).

[60] *Id.*

[61] Prop. Treas. Reg. §1.199A-5(d)(3).

[62] *Id.*

[63] Prop. Treas. Reg. §1.199A-6(b).

[64] *Id.*

[65] Prop. Treas. Reg. §1.199A-6(c).

[66] *Id.*

[67] *Id.*

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