TAX REFORM: CONSIDERATIONS FOR PASS-THROUGH DEDUCTIONS

How will you be affected?

February 5, 2019
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Agenda

• A brief review of section 199A – the pass-through deduction

• Guidance available – statute, proposed and final regulations

• Questions answered, and those left unanswered, by the final regulations

• Actions that taxpayers might take to maximize the benefit of this deduction
A BRIEF REVIEW OF SECTION 199A – THE PASS-THROUGH DEDUCTION
The section 199A deduction

- A 20 percent deduction that effectively reduces the top rate on certain business income from 37 percent to 29.6 percent
- Limitations apply to taxpayers with taxable income in excess of thresholds
  - ‘Specified service’ businesses become ineligible
  - Additional limitations based on wages paid or tangible assets
- Only applies to income taxes (not self employment or net investment income tax)
Who is eligible for the section 199A deduction?

- Individuals and trusts with qualifying income from:
  - Sole proprietorships (Schedule C)
  - Rental businesses (Schedule E)
  - Farming businesses (Schedule F)
  - S corporations
  - Partnerships (including PTPs)
  - Trusts and estates (K-1 income)
  - REITs (Real estate investment trusts)
  - Qualified cooperatives

- C corporations are NOT eligible for the deduction
Wage and asset limits

- Applies to taxpayers with taxable income > $157,500/$315,000
- Pass-through deduction limited to the owner’s share of the greater of:
  - 50 percent of W-2 wages (employees and owners), or
  - 2.5 percent of original cost of depreciable, tangible property plus 25 percent of wages
- Owner’s share of:
  - W-2 wages is the same as share of wage expense,
  - Cost of assets is generally determined based on end of year ownership (unless relying on proposed regulations for 2018)
Specified service businesses limitations

- Applies to taxpayers with taxable income > $157,500/$315,000

- 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

  OR

- A trade or business that involves the performance of services that consist of investing and investment management, trading or dealing in securities (section 475(c)(2)), partnership interests, or commodities (section 475(e)(2))
Section 199A deduction

• Does not apply to:
  - Investment income
  - Foreign source income
  - Wages paid to shareholders
  - Guaranteed payments for services
  - Guaranteed payments for the use of capital
  - Capital gain from the sale of business assets
WHICH RULEBOOK APPLIES?

Statute, proposed and final regulations
What guidance can I apply?

• Years ended on or before publication of the final regulations (i.e., calendar year 2018)
  - Reliance on a reasonable interpretation of statute and anti-abuse provisions of the final regulations, or
  - Reliance on proposed regulations in their entirety, or
  - Reliance on final regulations in their entirety
  - Disclosure may be required if position violates anti-abuse provisions of the final regulations

• Years ended after final regulations are published (i.e., calendar 2019)
  - Disclosure required if position violates the final regulations
WHAT IS IN THE FINAL REGULATIONS?

Questions answered and unanswered
WHAT IS A TRADE OR BUSINESS, AND HOW MANY DO WE HAVE?

Uncertainties remain
Uncertainty related to ‘trade or business’ definition remains

- The proposed regulations contained little guidance related to the definition of a ‘trade or business’

- Although many commenters sought additional direction, the IRS generally declined to offer it
  - A notice of a proposed safe harbor was released for certain real estate activities

- Taxpayer must analyze facts and circumstances to determine whether activities rise to the level of a trade or business
How many trades or businesses do I have?

• All computations and determinations under section 199A are made at the trade or business level – not at the entity level

• Whether a taxpayer is conducting one, or several businesses can dramatically impact qualification for the deduction and complexity of reporting items related to it
The de minimis ‘cliff’ remains

• The IRS confirmed in the preamble to the final regulations its belief that the statute indicates that any amount of specified service activity will render the entire business a specified service trade or business (SSTB)
  - “…the word ‘involving’ suggests that any amount of specified service activity causes a trade or business to be an SSTB.”

• However, an otherwise qualified business will not be a SSTB if:
  - less than 5 percent of its gross receipts are attributable to the performance of service in a field that would normally be considered an SSTB, or
  - less than 10 percent of its gross receipts are so attributable if gross receipts < $25 million for the taxable year

• Cliff effect applies if a trade or business exceeds the de minimis threshold
SPECIFIED SERVICES
• The proposed regulations required that health services be provided “directly to the patient”
• The final regulations remove this requirement – potentially expanding SSTB status to more in the medical field
• The final rules also added new examples related to application of the deduction to surgery centers and assisted living facilities
Lending

• Language in the proposed regulations created uncertainty for lenders concerned that they may be considered to be dealing in securities and thus ineligible for the deduction

• The final regulations added language providing that the origination of a loan is not treated as a purchase of a security
Anti-abuse provisions – segregating activities

• The proposed regulations provided that all income of a trade or business that shared common ownership (50 percent or more) with an SSTB and that provided 80 percent or more of its property or services to that commonly owned SSTB was itself an SSTB
  - If less than 80 percent, an allocable portion of the income was considered to be from an SSTB

• The final regulations eliminated this 80 percent rule, and instead require that taxpayers apply the allocation rules to all income
Anti-abuse provisions – segregating activities (cont.)

• The proposed regulations provided that a trade or business that shared expenses with an commonly controlled SSTB, and whose gross receipts are no more than 5 percent of the combined business, was itself an SSTB

• The final regulations eliminate this rule
AGGREGATING BUSINESSES
Aggregation at the ultimate taxpayer level

- Under the proposed regulations, partnerships and S corporations could not aggregate separate trades or businesses
  - This could increase reporting requirements for many entities that have more than one business activity

- The final regulations allow entity-level aggregation – if requirements are satisfied
Taxpayers can generally aggregate businesses if:

- The same person, or group of persons, directly or indirectly owns a majority interest (at least 50 percent) in each of the distinct trades or businesses for a majority of the taxable year.

- None of the aggregated trades or businesses can be an SSTB.

- Each of the trades or businesses to be aggregated must meet at least two of the following three factors:
  - The trades or businesses provide products and/or services that either are the same or are customarily provided together.
  - The trades or businesses share facilities or share significant centralized business elements (accounting, legal, purchasing, HR, IT, manufacturing, etc.).
  - The businesses are operated in coordination with or are reliant upon other businesses in the aggregated group.
### Aggregating businesses – wages paid

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<thead>
<tr>
<th>ABC, LLC</th>
<th>XYZ, INC. (S)</th>
<th>Aggregated</th>
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<tr>
<td>QBI $500,000</td>
<td>QBI $500,000</td>
<td>QBI $1,000,000</td>
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<tr>
<td>20% Limit - $100,000</td>
<td>20% Limit - $100,000</td>
<td>20% Limit - $200,000</td>
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<td>Wages paid $350,000</td>
<td>Wages paid $100,000</td>
<td>Wages paid $450,000</td>
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<tr>
<td>50% Limit – $175,000</td>
<td>50% Limit – $50,000</td>
<td>50% Limit – $225,000</td>
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<tr>
<td>QBI Deduction = $100,000</td>
<td>QBI Deduction = $50,000</td>
<td>QBI Deduction = $200,000</td>
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- Taxpayers may carry on multiple, related trades or businesses that would otherwise be limited if viewed independently.
- The regulations provide a mechanism to aggregate businesses, if certain tests are met.
COMPUTING UBIA

Final regulations provide several beneficial changes
Unadjusted basis immediately after acquisition (UBIA) of qualified property

• Carryover transactions
  - Under the proposed regulations, like-kind exchanges, along with contributions to partnerships or S corporations reset UBIA to adjusted basis immediately after the transaction
  - Under the final regulations, UBIA carries over

• Step-up transactions
  - Under the proposed regulations, basis adjustments due to sales or exchanges of partnership interests did not impact UBIA
  - The final rules provide that some portion of these amounts may be included in UBIA
Reporting UBIA and W-2 Wages

• Under the proposed regulations, failure to report any required item could cause all items - and therefore the deduction itself - to be deemed to be $0

• The final regulations relax this requirement, and only require that the omitted item be treated as $0
  - This may cause some with sufficient wages to bypass calculation of UBIA (or vice versa)
WHAT NEXT?

Actions that taxpayers may need to take
Does my business qualify?

• Am I engaged in a single, or in multiple, trades or businesses?
• Does each activity rise to the level of a trade or business?
• Do my businesses earn foreign income?
• Does my business, or do my investors, earn income that does not qualify?
  - Investment income, interest on loans to the business, guaranteed payments, wages, etc.
Does my business qualify? (cont.)

• If my investors’ taxable income exceeds key thresholds:
  - Does my business:
    • provide any services in an SSTB field?
    • pay sufficient wages?
    • hold sufficient depreciable assets?
  - Can I aggregate my businesses for wage and asset testing purposes?
THANK YOU FOR YOUR TIME AND ATTENTION
Thank you

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