Steptoe

Proposed Regulations Released Regarding Section 199A Deduction

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On August 8, Treasury and the IRS issued a notice of proposed rulemaking containing proposed regulations concerning the deduction for qualified business income under section 199A, enacted by P.L. 115-97, commonly known as the Tax Cuts and Jobs Act. The proposed regulations are intended to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 199A.

Big Picture on Section 199A Proposed Regulations

The proposed section 199A regulations generally reflect an effort by Treasury to provide a broad interpretation (with exceptions) of the types of business income and activities that business owners can take into account for the 20 percent deduction provided under section 199A.

Unlike other recent proposed regulations implementing P. L. 115-97, the section 199A proposed regulations include a significant amount of interpretive rules (as opposed to merely restating much of the statute in the regulations). The regulations provide interpretive rules along with illustrative examples to:

(i) aggregate trades or businesses (but not via the section 469 rules and not merely when common ownership is present);

(ii) ameliorate the third-party-payor issue for the W-2 wages limit (by adopting much of the former section 199 rules);

(iii) define somewhat narrowly many (but not all) of the specifically-listed activities in the specified service trades or businesses (SSTB) definition (generally helpful for banks, insurance, and real estate agents and brokers, although the somewhat broad definitions of consulting and financial services create some uncertainty, and generally unhelpful for financial advisors and veterinarians);

(iv) define narrowly the skills and reputation definition of a SSTB (helpful to local plumbers and HVAC specialists but not as helpful for celebrity endorsers and reality TV stars); and

(v) provide de minimis exceptions for SSTB activities (e.g., the legal department in the manufacturing company or consulting embedded within the sale of goods or non-SSTB services).

As expected, the proposed regulations also include a number of anti-abuse rules aimed at preventing taxpayers from transacting into section 199A, such as through (i) “crack” or “pack” transactions (e.g., the law firm spinning off its real property and administrative functions), (ii) converting employees to independent contractors only in form, and (iii) using non-grantor trusts to multiply the available taxable income thresholds. The effective date provisions also contain helpful rules that permit taxpayers to rely immediately on the regulations for the entire 2018 year and, in certain fiscal-year scenarios, to include qualified business income

(QBI) from pre-2018 periods. However, there also are significant annual reporting obligations imposed on partnerships, S corporations, their owners, non-grantor trusts, and estates, with presumptions against owners/beneficiaries for failures to report.

An outline summary of how the proposed regulations address certain significant issues follows.

Certain Significant Issues Addressed by the Proposed Regulations

- **Definition of Trade or Business**
    - **Section 162 standard adopted:** The proposed regulations adopt the definition of trade or business from section 162(a), since (according to the preamble) it is derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries, which will reduce compliance costs, burden, and administrative complexity.
    - **Rental activities:** However, the proposed regulations extend the definition of trade or business for purposes of section 199A beyond section 162 in one circumstance: the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business itself if the rental or licensing and the other trade or business are commonly owned (same group of persons, directly or indirectly, owns 50 percent or more of each business).
- **W-2 Wages Issues Addressed in Taxpayer-Friendly Manner**
    - **Follow former section 199 rules:** The proposed regulations on defining W-2 wages largely follow the rules for the domestic production activities deduction of former section 199. In addition, Notice 2018-64, issued concurrently with the proposed regulations, proposes a revenue procedure providing three methods for calculating W-2 wages. The three methods in the notice are substantially similar to the methods provided in Rev. Proc. 2006-47, which were used for purposes of former section 199.
    - **Third-party payor wages qualify:** The proposed regulations also address the third-party payor issue in a taxpayer-friendly manner. Under the proposed regulations, in determining W-2 wages, a person (Q) may take into account any W-2 wages paid to an individual by another person (P) and reported by P on Forms W-2 with P listed as the employer in Box C of the Forms W-2, provided that the W-2 wages were paid to an individual who was a common law employee or officer of Q for employment by Q.
- **Reasonable Compensation Exclusion**
    - **Reasonable compensation exclusion not extended beyond S corporation shareholders:** The proposed regulations clarify that the statutory exclusion from QBI of reasonable compensation paid from a trade or business in exchange for services will be limited only to the S corporation context. The preamble also explains that, even though employee compensation is expressly excluded from QBI, this reasonable compensation rule is intended to cause employee-shareholders to exclude

from their QBI from an S corporation an amount constituting reasonable compensation (if not already actually paid).

- **SSTB–Operating Rules; Narrowing Definition for Many**
    - **SSTB of partnership and S corporation determined at entity level:** The proposed regulations require each partnership or S corporation to determine whether it conducts an SSTB and provide that information to its owners, regardless whether the entity or any owner may have taxable income below the taxable income thresholds. Once determined, such SSTB remains an SSTB and cannot be aggregated with other trades or businesses.
    - **De minimis exceptions:** Taxpayers were concerned that the SSTB exclusion also could capture an otherwise non-SSTB if such trade or business included only a small amount of SSTB activity (e.g., the legal department in a manufacturing company). The proposed regulations attempt to address this concern with two de minimis rules.
        - **$25M or less gross receipts:** A trade or business (before aggregating) is not an SSTB if it has gross receipts of $25M or less in a year **and** less than 10 percent of the gross receipts of the business is attributable to the performance of services in an SSTB.
        - **Over $25M gross receipts:** A trade or business (before aggregating) is not an SSTB if it has gross receipts of over $25M in a year **and** less than five percent of the gross receipts of the business is attributable to the performance of services in an SSTB.
    - **Objective interpretations of specifically-listed SSTBs:**
        - **In general:** Under section 199A, the definition of an SSTB (via cross-reference to section 1202(e)(3)(A)) is: (i) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services; (ii) 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 reputation or skill prong); or (iii) 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)). The proposed regulations provide guidance regarding the interpretation of each of these specifically-listed SSTBs, some of which are discussed below.
        - **Consulting:** The proposed regulations provide that the term 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. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals

performing services in their capacity as such. The performance of services in the field of 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 or educational courses. This determination is made based on all the facts and circumstances of a person's business, including how such person is compensated for the services (i.e., fee (consulting) versus commission (sales)).

- To address concerns about the customary provision of consulting services in connection with the purchase of goods by customers (or the performance of services that is otherwise not a SSTB), the proposed regulations also provide that the field of consulting does not include consulting that is embedded in, or ancillary to, the sale of such goods (or services), if there is no separate payment for the consulting services.

- **Financial services:** The proposed regulations provide that financial services mean services typically performed by financial advisors and investment bankers and provides that the field of financial services includes the provision of financial services to clients, including: managing wealth; advising clients with respect to finances; developing retirement plans; developing wealth transition plans; providing 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 the client's agent in the issuance of securities, and similar services. This definition includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals, but does not include taking deposits or making loans.

- **Brokerage services:** The proposed regulations provide that the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

- **Reputation and skill prong:** The preamble indicated that Treasury considered and rejected several conceptual approaches to defining the reputation and skill prong of the SSTB definition due to its view that such prong must be interpreted in a manner that is both objective and administrable. The proposed regulations limit the meaning of the reputation or skill prong to fact patterns in which the individual or entity is engaged in the trade or business of: (i) receiving income for endorsing products or services, including a taxpayer's distributive share of income or distributions from an entity for which the taxpayer provides endorsement services; (ii) licensing or receiving income for the use of a taxpayer's image, likeness, name, signature, voice, trademark, or any other symbols associated with the taxpayer's identity, including a taxpayer's distributive share of income or distributions from

an entity to which a taxpayer contributes the rights to use the taxpayer's image; or (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).

- **Investing and investment management:** The proposed regulations provide that any trade or business that involves the performance of services that consist of investing and investment management means a trade or business that involves the receipt of fees for investment, asset management services, or investment management services, including providing advice with respect to buying and selling investments. The performance of services that consist of investing and investment management would include a trade or business that receives either a commission, flat fee, or investment management fee calculated as a percentage of assets under management. However, the performance of services of investing and investment management does not include directly managing real property.

- **Trading:** The proposed regulations provide that any trade or business involving the performance of services that consist of trading means a trade or business of trading in securities, commodities, or partnership interests. Whether a person is a trader is determined taking into account the relevant facts and circumstances, and relevant factors include the source and type of profit generally sought from engaging in the activity regardless of whether the activity is being provided on behalf of customers or for a taxpayer's own account.

- **Dealing in securities, partnership interests, and commodities:** The proposed regulations provide that the performance of services that consist of dealing in securities (as defined in section 475(c)(2)) means 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. However, a taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities for this purpose. The proposed regulations provide analogous definitions for the performance of services that consist of dealing in partnership interests and the performance of services that consist of dealing in commodities (as defined in section 475(e)(2)).

- **Rules Permit Aggregation of Trades or Businesses Within Functional and Ownership Limits**

  - **Aggregation permitted (not required):** A significant concern was that a taxpayer that conducted multiple trades or businesses would have its section 199A deduction limited due to the application of the W-2 limit or unadjusted basis (UBIA) of qualified property limit on a business-by-business basis. The proposed regulations permit, but do not require, taxpayers to aggregate if they meet

certain requirements focused on the relatedness of the owners of the businesses and of the activities conducted or services or products provided by the businesses.

- **Four requirements:** The section 469 activity grouping rules were not used. Instead, the proposed regulations create a new aggregation regime, where aggregation is permitted if four requirements are met: (i) each trade or business must be a section 162 trade or business for purposes of section 199A; (ii) the same group of persons must directly or indirectly own a majority interest (50 percent or more) in each of the businesses for the majority of the relevant taxable year; (iii) no trade or business is an SSTB; and (iv) the taxpayer can establish that the businesses are part of a larger, integrated trade or business (i.e., they provide similar products and services or ones that are customarily provided together (e.g., restaurant and food truck, gas station and car wash), they share common facilities or significant business elements (e.g., common accounting, legal, manufacturing, human resources, IT resources, etc.), or they operate in coordination with each other (e.g., supply chain interdependencies)).
- **No entity-level aggregation by partnerships or S corporations:** The proposed regulations provide that aggregation is permitted only at the taxpayer level. Partnerships and S corporations will need to compute and provide its owners with information regarding QBI, W-2 wages, and UBIA of qualified property for each trade or business.

- **Several Anti-Abuse Rules**
  - **Non-grantor trust anti-abuse rule:** The proposed regulations establish anti-abuse rules under section 199A and section 643(f) to prevent taxpayers from establishing multiple non-grantor trusts or contributing additional capital to multiple existing non-grantor trusts in order to avoid federal income tax. This is aimed at taxpayers trying to multiply their otherwise single threshold amount by spreading interests in businesses generating QBI among several non-grantor trusts.
  - **Qualified property anti-abuse rule:** The proposed regulations include an anti-abuse rule that disregards property as qualified property for purposes of the UBIA of qualified property limit if the property is acquired within 60 days of the end of a taxable year and disposed of within 120 days without having been used in a business for at least 45 days, unless the taxpayer can demonstrate that the principal purpose of acquisition and disposition was a purpose other than increasing the section 199A deduction.
  - **Qualified REIT dividend anti-abuse rule:** The proposed regulations include an anti-abuse rule to prevent dividend stripping and similar transactions related to qualified REIT dividends where the taxpayer does not have economic exposure to the REIT stock for a meaningful period of time.
  - **SSTB anti-abuse rules:** The proposed regulations include another set of anti-abuse rules for purposes of defining an SSTB in an effort to prevent taxpayers from separating out parts of what otherwise would be an integrated SSTB, such as administrative functions, in an attempt to qualify those separated parts for the section 199A deduction.

- **Commonly-owned non-SSTB substantially serving an SSTB:** The proposed regulations provide that an SSTB includes any trade or business with 50 percent or more common ownership (directly or indirectly) that provides 80 percent or more of its property or services to an SSTB.
    - The proposed regulations also provide that, if a trade or business has 50 percent or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (causing the related income to be treated as income from an SSTB).
- **Commonly-owned small non-SSTB supported by SSTB:** The proposed regulations also provide that, if a trade or business (that would not otherwise be treated as an SSTB) has 50 percent or more common ownership with an SSTB and shared expenses (including wages or overhead expenses) with the SSTB, it is treated an SSTB if the trade or business represents no more than five percent of gross receipts of the combined business.

- **Employee status anti-abuse rules**
    - **Employees converting to independent contractors while providing substantially similar services:** The proposed regulations provide that, if an employer improperly treats an employee as an independent contractor or other non-employee, the improperly classified employee is in the trade or business of performing services as an employee notwithstanding the employer's improper classification. The preamble states that this issue is particularly important in the case of individuals who cease being treated as employees of an employer, but subsequently provide substantially the same services to the employer (or a related entity) but claim to do so in a capacity other than as an employee.
    - **Rebuttable presumption against independent contractor status for former employees:** The proposed regulations provide that an individual who was treated as an employee for federal employment tax purposes by the person to 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 (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted only upon a showing by the individual that, under federal tax rules, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

- **Effective Date and Reliance Issues**
    - **General:** The regulations generally are proposed to apply to taxable years ending after the date of publication of final regulations. However, taxpayers may rely on the proposed regulations, in their entirety, until that date.
    - **Anti-abuse rules:** The anti-abuse rules of the regulations, however, are proposed to apply to taxable years ending after December 22, 2017, the date of enactment of the 2017 Tax Act.
    - **Fiscal year partnerships and S corporations:** The proposed regulations provide that, for purposes of determining QBI, W-2 wages, and UBIA of qualified property, if a taxpayer takes into account QBI, W-2 wages, or UBIA of qualified property from a partnership or S corporation with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the taxpayer during the taxpayer's taxable year during which such partnership or S corporation taxable year ends. This rule could permit taxpayers to include in their section 199A deduction computations QBI, W-2 wages, and UBIA of qualified property arising prior to the general effective date of section 199A (taxable years beginning after December 31, 2017).

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