Tax Flash

New Federal Tax Developments

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Proposed rules on pass-through deduction provide flexibility for wage and asset tests

The IRS has released highly anticipated proposed regulations (REG-107892-18) on the new deduction for pass-through income that pair flexibility in some areas with strict anti-abuse rules in others.

Section 199A was added by the Tax Cuts and Jobs Act (TCJA) and offers a deduction of up to 20% for qualifying income of pass-throughs and sole proprietorships, but can be limited for taxpayers with income over certain thresholds if they participate in disqualified activities or fail complex wage and asset tests. The proposed rules provide taxpayers with much-needed flexibility to combine trade or business activities for the wage and asset tests. Wages must be assigned to the common-law employer. But anti-abuse rules can deny deductions to taxpayers with even small amounts of disqualified activities unless they qualify for strict de minimis exceptions. The list of disqualified activities is interpreted fairly narrowly with some exceptions.

The proposed regulations offer taxpayers some interim guidance for planning their activities for 2018, but areas of uncertainty remain. The IRS is expecting to receive extensive comments and has scheduled a regulatory hearing on Oct. 16. Taxpayers may rely on the proposed regulations until final regulations are published in the *Federal Register*, but the IRS is proposing that final rules be effective for tax years ending after their publication. This means if the regulations are finalized before the end of 2018, individuals would generally be permitted to rely on the final version for their 2018 returns. In addition, several of the anti-abuse rules are proposed to be effective retroactively for tax years ending after Dec. 22, 2017, the date of enactment of TCJA.

More details on the regulations follow below.

Background

Section 199A provides a deduction of up to 20% for qualifying pass-through income. If fully allowed, the deduction provides a top effective rate of 29.6% against the new top individual federal tax rate of 37%. But the deduction is subject to two strict limits: It is not available for income from a list of disqualified activities, which the statute and proposed regulations define as specified service trades or businesses (SSTBs), and it is limited if the taxpayer (or the taxpayer's pass-through business) does not pay sufficient wages or invests in sufficient tangible depreciable property used in the business. Neither of these limits apply for taxpayers with taxable income less than $157,500 if single or $315,000 if filing jointly. The limitations phase in over the next $50,000 and $100,000 in income over these thresholds, respectively.

The pass-through deduction does not affect an owner's basis in an S corporation stock or partnership interest and does not affect an S corporation's accumulated adjustment account. In addition, the proposed regulations confirm that the deduction does not apply to reduce net investment income under Section 1411 of self-employment income under Section 1402.

The proposed regulations also provide that the same Section 199A deduction used in calculating regular taxable income is to be used in calculating alternative minimum taxable income. As a result, taxpayers with preferences and adjustments do not have to recalculate either qualified business income or taxable income used for the phase-in of the limitations on the deduction. Net operating losses (NOLs) generally are not included in qualified business income (QBI) because the items that created the loss would have been included in QBI in a previous year. However, NOLs arising from suspended losses under the new rules in Section 461(l), which disallow an owner's share of a net loss over $250,000 in an unincorporated business for a tax year, can reduce QBI in the tax year that the NOL is used to compute the owner's taxable income.

Qualifying income

Income qualifying for the deduction is limited to dividends from real estate investment trusts (REITs), income from publicly traded partnerships (PTP) and QBI.

QBI generally includes items of income, gain, deduction, and loss, including rental income, from a trade or business conducted in the United States that is not an SSTB. It specifically excludes dividends and capital gain and loss, and annuities and interest only qualify to the extent they are allocable or received in connection with a trade or business. With respect to this definition, the proposed regulations provide:

- Interest income on working capital, reserves and similar accounts does not qualify, but interest income on account receivables for goods or services provided by a qualifying trade or business does qualify.

- Gain or loss on an asset held in a business under Section 1231 does not qualify as QBI because the IRS determined there is no exception for the exclusion for capital gain or loss (net Section 1231 losses treated as ordinary income, on the other hand, reduce QBI).

QBI from multiple trades and businesses is calculated separately for each trade or business and then netted when used to determine the pass-through deduction, but the proposed regulations segregate the calculation of QBI from the calculation of REIT dividends and PTP income or loss. If QBI results in a loss, it is carried forward separately to be used against QBI in future years and is not netted against any REIT dividends or PTP income. If PTP loss exceeds REIT and PTP income, then this negative amount is also carried forward separately to be used against future REIT dividends and PTP income.

Section 199A specifically excludes from QBI the reasonable compensation paid by an S corporation to a shareholder and the guaranteed payments for services paid by a partnership to a partner. Taxpayers are to rely on existing guidance and case law in determining what is reasonable compensation for an S corporation shareholder. The IRS declined to extend the concept of reasonable compensation to apply to guaranteed payments to partners for services, but the proposed regulations separately provide that guaranteed payments for the use of capital are not considered attributable to a trade or business and so cannot be included in QBI. Payments under Section 707(a) to a partner other than in the capacity of a partner are also excluded from QBI. Taxpayers must still deduct all of these payments from partnership income when calculating QBI.

> Grant Thornton Insight: The partnership payment rules are particularly unfavorable. The statutory language only excludes guaranteed payments for services, and not those for the use of capital, but the proposed regulations essentially expand this exclusion to cover all guaranteed payments. The IRS also justifies the exclusion for Section 707(a) payments by comparing them to wages, but unlike wages, they do not count toward the wage and asset test. Guaranteed payments also do not count toward the wage and asset test but still must be deducted when calculating a partner's share of the partnership's QBI. Although S corporation shareholder wages are also excluded from QBI, they at least count toward the wage and asset test. On the other hand, because reasonable compensation rules do not extend to partnerships, there is no requirement that partners must be treated as receiving guaranteed payments even if they provide services or capital. Partners who receive only a distributive share of income, and no guaranteed payments or Section 707(a) payments could potentially have all of their share of partnership income included in QBI.

Defining a trade or business

QBI must come from an activity that rises to the level of a trade or business. The trade or business of being an employee does not qualify for the deduction, though income from a sole proprietorship's trade or business can qualify. The proposed regulations rely on existing federal tax rules, regulations, and common-law employee classification rules to determine if a worker is properly classified as an employee or independent contractor. Independent contractors of businesses in which they were formerly employed are subject to a presumption that they are employees, and must establish and substantiate their status as an independent contractor.

The proposed regulations do not create a new definition of "trade or business," but instead refer to the trade or business standard under Section 162. The proposed regulations expand slightly on this definition by providing that renting tangible or intangible property to a trade or business under common control is considered a trade or business even if it would not have risen to the level of a trade or business on its own under a Section 162 analysis.

> Grant Thornton Insight: The reference to Section 162 is the same approach taken by the IRS in the proposed regulations defining trade or business for purpose of net investment income under Section 1411. While there is an existing body of case law and administrative guidance under the Section 162 principles, it is not without ambiguity. The question of when a rental activity rises to the level of a trade or business is a particularly difficult question. The Section 1411 regulations provided a safe harbor for certain rental activity for real estate professionals to ease compliance, but the Section 199A proposed regulations include only an allowance for self-rentals.

Wage and asset test

For taxpayers over the income threshold, the deduction for QBI is limited to the greater of either (1) 50% of the owner's allocable share of W-2 wages paid by the business or (2) 25% of those W-2 wages share plus 2.5% of the owner's allocable share of the original cost basis of qualified property.

Qualified property

Qualified property includes all depreciable tangible property used to generate QBI for which the depreciable period is not finished, but applying a minimum depreciable period of 10 years. The depreciable period is calculated without regard to 100% expensing under bonus depreciation or basis reductions for certain credits. The "unadjusted basis" is determined on the day the property is placed is service and the basis is generally defined as cost basis under Section 1012. Improvements added to basis are also included, and there are complex rules for determining basis in nonrecognition transactions. In addition, the proposed regulations state that basis adjustments under Sections 734 and 743 are not treated as separate qualified property for the wage and asset test.

There is an anti-abuse rule that excludes the basis of any property acquired within 60 days of the end of the tax year and disposed of within 120 days if the property was used in the trade or business for less than 45 days, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was not to increase the Section 199A deduction.

Wages

Wages are generally W-2 wages as defined under Section 3401(a), plus elective deferrals under Section 402(g)(3), deferred compensation under Section 457, and designated Roth contributions. The IRS separately issued a proposed revenue procedure (Notice 2018-64) that provides three methods for calculating W-2 wages. The guidance is substantially similar to the methods provided under Rev. Proc. 2006-47 for the Section 199 domestic production activities deduction.

The proposed regulations also address businesses that use payroll organizations like certified professional employer organizations (Section 7705), statutory employers (Section 3401(d)(1)), or agents (Section 3504). In these situations, the entity paying wages and issuing W-2 Forms may be listed as the employer on the W-2, even though the employees are considered employees of another trade or business under common law. Under the proposed regulations, the common law employer takes credit for the W-2 wages paid by these payroll organizations, while the payroll organizations themselves cannot include the wages for the purpose of their own testing.

When employees serve more than one trade or business of an individual or entity, W-2 wages must be allocated among its various trades or businesses in the same manner as the expenses associated with the wages. The wage expense is able to be allocated using any reasonable method based on all the facts and circumstances.

Aggregating activities for the wage and asset test

The IRS recognized that it is common for a single trade or business to be operated across multiple entities, and provided rules to allow taxpayers to elect to aggregate activities in different entities into a single trade or business for purposes of the asset and wage tests. The rules are not as permissive as the grouping rules under Section 469 for passive activities, but do allow taxpayers considerable flexibility. Trades or businesses may be aggregated under the proposed rules if the following four requirements are satisfied:

- Each aggregated trade or business itself rises to the level of a trade or business
- The same group of persons owns a majority interest in each of the businesses
- None of the aggregated business are SSTBs
- The aggregated businesses meet two of the following three factors:
    - Same or similar products

- Share facilities or business elements (like back-office functions)
- Operated in coordination with or reliance on the other businesses

Taxpayers may elect to aggregate activities in this way but are not required to do so. The aggregation is done at the individual level, and different owners may aggregate in different ways. Once aggregated, taxpayers cannot change the election unless there is a change in circumstances such as the acquisition of new business.

> Grant Thornton Insight: The rules provide some flexibility, but have limitations. It seems counterintuitive for the IRS to recognize that a single trade or business can operate across multiple entities, but allow aggregation only if the individual activities themselves rise to the level of a trade or business when separate. There are special rules for self-rentals, but other parts of a business held in separate entities could fail to rise to a level of a trade or business on their own and then be barred from aggregation.

Disqualified activities

The statute provides a specific list of SSTB activities that do not qualify for the pass-through deduction. Although much of this list mirrors similar lists in Sections 1202 and 448, the proposed regulations provide explicit and extensive new guidance on SSTBs due to the unique purpose and breadth of Section 199A. The rules construe many of the SSTB definitions relatively narrowly:

- Health – Medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient, excluding services not directly related to a medical field such as gyms, spas, payment processing, or pharmaceutical and medical device testing, manufacturing, or sales.

- Law – Legal services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals, but excluding services that do not require legal skills, such as printers, delivery or stenography.

- Accounting – Services of accountants, enrolled agents, return preparers, auditors and similar professionals in tax return preparation, auditing, and bookkeeping services, regardless of state licensure, but excluding payment processing and billing analysis.

- Actuarial science – Services by actuaries in actuarial sciences, but excluding including services of analysts, economists, mathematicians or statisticians who are not assessing the financial costs of risk or uncertainty.

- Performing arts – Participation in the creation of performing arts by individuals such as actors, singers, musicians, entertainers, directors and similar professionals, but excluding services that do not require skills unique to creating arts such as broadcasting or the operation of facilities.

- Consulting – Professional advice to clients to assist in achieving goals and solving problems, including lobbying. This test is more subjective than some of the others and will be based on all the facts and circumstances of the business. The IRS did provide an explicit exception for consulting services if ancillary to or embedded in the sale or manufacture of goods or services as long as the ancillary consulting services are not separately purchased or billed.

- Athletics – Participation in athletic competition, including by athletes, coaches and team managers, but excluding services that do not require skills unique to athletic competing, such as maintenance or operation of facilities.

- Investing and investing management – Earning fees or commissions or amounts calculated based on percentages for investment of asset management, including providing advice for buying and selling investments.

- Trading – Trading in securities, commodities, or partnership interests determined based on the facts and circumstances and relying on existing case law on who is considered a trader.

- Dealing in securities, partnership interests and commodities – Regularly purchasing and selling securities in the ordinary course of a trade or business.

- Brokerage services – Services arranging transactions between a buyer and seller of securities, excluding services of real estate and insurance agents and brokers.

- Financial services – Services typically performed by financial advisors and investment bankers such as wealth management, finance advising, retirement plan development, valuations, mergers and acquisitions, structuring, underwriting, and issuing securities. The preamble acknowledged that banking was not intended to be included by Congress, and the proposed regulations exclude traditional banking activities such as taking deposits and making loans, but it is unclear whether banks that perform other financial functions listed above could be disqualified.

- Any trade or business where the principal asset is the reputation or skill of owners or employees – The IRS limited this category to taxpayers receiving income for endorsing products, licensing an image, likeness, name, signature, voice, trademark, or other symbols associated with an individual's identity, and receiving appearance fees (including reality performers, media hosts, and video game players).

Grant Thornton Insight: The IRS construed the reputation and skill category in a very narrow and favorable way. The statutory language could potentially have allowed less favorable readings in which nearly any service activity could have been considered based on the "skill" of its employees or owners. The current version truly restricts SSTBs the enumerated services.

Anti-abuse and de minimis rules for SSTBs

The proposed regulations provide significant flexibility for taxpayers to aggregate activities in different entities for the wage and investment test, but no explicit guidance on when taxpayers can claim a single entity has separate trades or business, some of which qualify and other that are SSTBs. The proposed regulations do offer a de minimis rule for trades or businesses with a limited amount of income from SSTB services. A trade or business with up to $25 million in gross receipts can have up to 10% of its gross receipts from an SSTB activity before it is considered an SSTB. If gross receipts are greater than $25 million, the allowance is just 5%. It may be possible to instead claim that an SSTB activity within an entity is a separate trade or business from other qualifying activities in the entity, but an anti-abuse rule complicates the picture.

Under this rule, any business will be considered an SSTB if it has 50% common ownership with an SSTB and provides 80% or more of its services to an SSTB or if it shares expenses such as wages and overhead and if its gross receipts are no more than 5% of the combined gross receipts. There is also an anti-abuse rule for owners renting or licensing tangible or intangible property to an SSTB.

> Grant Thornton Insight: The de minimis exception and the allowance for ancillary consulting services provide some flexibility for businesses or entities with separate activities, some of which qualify and others

which do not. But if gross receipts exceed $25 million, as little as 6% of income from an SSTB activity would appear to treat an entire trade or business as an SSTB. It remains less clear how much leeway taxpayers will have to claim that such activities are simply separate trades or businesses, especially considering the anti-abuse rules. While there is explicit guidance on aggregating trades or businesses, there is no explicit guidance on when activities are considered separate trades or businesses (besides the existing body of administrative guidance and case law on what constitutes a trade or business).

Next steps

Taxpayers should assess how the proposed rules would affect them, and begin planning for opportunities to structure investments and activities in beneficial ways. The final regulations could modify the proposed rules, as significant comments are expected. Taxpayers should consider commenting on rules that may affect them negatively and in unintended ways. Comments are due 45 days from when the regulations are posted in the *Federal Register*, and the IRS has openly invited taxpayer and practitioner input in many areas.

It is unclear if the regulations will be finalized prior to the end of 2018. Under an April memorandum of agreement executed between Treasury and the Office of Management and Budget (OMB), the OMB's Office of Information and Regulatory Affairs (OIRA) will have the opportunity to review the final regulations prior to publication. Although tax reform-related regulations are subject to an expedited process for review, far-reaching and complex regulations such as these may be subject to increased scrutiny by regulators at Treasury and OIRA, which could slow down the process for finalizing the regulations.

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