Opportunities, pitfalls of the new Section 199A deduction
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The Tax Cut and Jobs Act (TCJA) passed in late 2017 included a heavily negotiated promise of lower effective tax rates for partnerships, S corporations and sole proprietorships. The lower rates were intended to offer some tax relief for businesses that would not benefit from the more substantial rate cut for C corporations — those rates were lowered from 35% to 21%.

The lower effective tax rate for these entities (flow-through entities, or “FTEs”) was achieved through a complex deduction of up to 20% of business income enacted as the new IRC Section 199A (the flow-through deduction, or “FTD”). Even when the deduction is allowed in full, the rate cut for pass-throughs is significantly smaller than one provided for C corporations.

Yet, despite the significantly lower tax rates on operating income for C corporations, the promise of the 20% FTD and a myriad of other tax planning factors still resulted in most FTE owners maintaining the flow-through status of their businesses for 2018, bypassing the opportunity to convert to C corporation status.¹

On Aug. 8, 2018, Treasury issued proposed regulations that illustrate the IRS’s interpretation of how the Section 199A deduction should work. On Jan. 18, 2019, the IRS issued final regulations, taking into account hundreds of documented comments from practitioners. While the regulations address many areas where guidance was desperately needed, including providing rules around determining the FTD when a taxpayer has multiple qualifying businesses, some unanswered questions remain. This article reviews the FTD in detail, as explained by the Section 199A regulations, illustrating how the FTD works (or does not work) for a variety of industries, and reviewing planning options for increasing the benefit.

¹ For an in-depth discussion of the factors, see Entity choice in the wake of tax reform.
Comparing the benefits
Table 1 illustrates the comparison of 2017 v. 2018 rates for both “active” and “passive” FTE owners and the rate cut for C corporations. The terms “active” and “passive” refer to a taxpayer’s participation in an activity under the Section 469 rules. If the taxpayer is “active” then it is assumed for the purposes of this article that the Net Investment Income Tax under Section 1411 would not apply.

<table>
<thead>
<tr>
<th>Entity</th>
<th>2017</th>
<th>2018</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTE active no FTD</td>
<td>39.6%</td>
<td>37%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>FTE passive no FTD</td>
<td>43.4%</td>
<td>40.8%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>FTE active with full FTD</td>
<td>39.6%</td>
<td>29.6%</td>
<td>-10%</td>
</tr>
<tr>
<td>FTE passive with full FTD</td>
<td>43.4%</td>
<td>33.4%</td>
<td>-10%</td>
</tr>
<tr>
<td>C corporation (without dividend tax)</td>
<td>35%</td>
<td>21%</td>
<td>-14%</td>
</tr>
</tbody>
</table>

The table describes the effects of qualifying for the full FTD (assuming the FTE owners are in the highest tax bracket), illustrating the advantage the TCJA gave to C corporations on tax rates.²

Table 1: Fast facts

One of the significant factors supporting an entity-retention choice for FTEs was the ability of FTEs to distribute earnings tax-free. Table 2 below illustrates this effect on tax rates.

When making the initial assessment of retaining flow-through status, business owners had to make educated guesses as to how the FTD would work. Guidance was at first limited to the statute and common-sense assumptions.

Table 2: Chart of top marginal rates

<table>
<thead>
<tr>
<th>Distributions limited to just taxes</th>
<th>FTE</th>
<th>FTE: passive</th>
<th>FTED</th>
<th>FTED: passive</th>
<th>2026 and beyond: active</th>
<th>2026 and beyond: passive</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTE rate</td>
<td>37%</td>
<td>40.8%</td>
<td>29.6%</td>
<td>33.4%</td>
<td>39.6%</td>
<td>43.4%</td>
</tr>
<tr>
<td>FTE passive no FTD</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
</tr>
<tr>
<td>FTE active with full FTD</td>
<td>16%</td>
<td>19.68%</td>
<td>8.6%</td>
<td>12.4%</td>
<td>18.6%</td>
<td>22.4%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Full distribution of all earnings</th>
<th>S corporation rate</th>
<th>39.8%</th>
<th>39.8%</th>
<th>39.8%</th>
<th>39.8%</th>
<th>39.8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>C corporation rate</td>
<td></td>
<td>39.8%</td>
<td>39.8%</td>
<td>39.8%</td>
<td>39.8%</td>
<td>39.8%</td>
</tr>
<tr>
<td>Difference</td>
<td>-2.8%</td>
<td>1%</td>
<td>-10.2%</td>
<td>-6.4%</td>
<td>-0.2%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Swing: no dividends</td>
<td>18.8%</td>
<td>18.8%</td>
<td>18.8%</td>
<td>18.8%</td>
<td>18.8%</td>
<td>18.8%</td>
</tr>
</tbody>
</table>

Overview of Section 199A rules
The Section 199A 20% pass-through deduction is available for income from publicly traded partnerships, certain dividends from real estate investment funds and qualified business income (QBI) of FTEs. QBI includes most income from qualified trades or businesses, including rent, but not for most investment income including capital gains, dividends and interest. Unless a taxpayer falls under certain taxable income thresholds, the deduction for QBI is also subject to significant limits based on wages and payments discussed below and is not available at all on income from a specific categories of service businesses termed specified service trades or businesses (SSTBs).

The exception for these limits and exclusions are phased out above the income thresholds shown in Table 3:

Table 3: Income thresholds for QBI limits and exclusion phase-outs

<table>
<thead>
<tr>
<th>Single taxpayers</th>
<th>Married, filing jointly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>Taxable income</td>
</tr>
<tr>
<td>SSTB/wage</td>
<td>SSTB/wage</td>
</tr>
<tr>
<td>limitation</td>
<td>limitation</td>
</tr>
<tr>
<td>Below $157,500</td>
<td>No limitation</td>
</tr>
<tr>
<td>No limitation</td>
<td>Below $315,000</td>
</tr>
<tr>
<td>From $157,500 to $207,500</td>
<td>Limitation phased-out</td>
</tr>
<tr>
<td>From $315,000 to $415,000</td>
<td>Limitation phased-out</td>
</tr>
<tr>
<td>Above $207,500</td>
<td>Full limitation</td>
</tr>
<tr>
<td>Above $415,000</td>
<td>Full limitation</td>
</tr>
</tbody>
</table>

For years after 2018, the threshold amount will be adjusted for inflation.

Above these thresholds, the deduction is limited to the greater of (1) either 50% of the owner’s allocable share of W-2 wages paid by the business, or (2) 25% of that W-2 wages share plus 2.5% of the original cost basis of qualified property (unless taxable income is below certain thresholds). These deduction amounts are calculated separately for each of the taxpayer’s qualified trades or businesses and are then added together to establish a combined FTD. There is an ability to aggregate separate trades or businesses for the purposes of these tests, discussed later.

An additional, an overall limitation applies if the total FTD from all qualified trades or businesses is greater than the amount of income subject to tax at ordinary tax rates. In this situation, the FTD will be limited to the excess of the taxpayer’s total taxable income over its net capital gains and qualified cooperative dividends (i.e., income taxed at reduced rates compared to ordinary income). This may occur when a taxpayer has a large amount of itemized deductions or is utilizing a net operating loss carryover.

Note that the FTD, and the overall limitation, occurs on the return of the individual (Form 1040), or trust (Form 1041) that owns the FTE (or multiple FTEs). The “taxpayer” of the FTE is not the entity, but the owner. Including elections, characterization of income, and the combining, or disaggregation of businesses. These subjects are discussed in detail on following page.

A significant amount of planning may be required at the individual or trust level to realize the full value of the FTD.
Defining qualified business income
QBI is defined as the net amount of qualified items of income, gain, deduction and loss from any qualified trade or business of a taxpayer. Qualified items of income, gain, deduction and loss only include items that are effectively connected with the conduct of a trade or business within the United States and that are included or allowed when determining taxable income. Excluded from the definition of QBI are items of investment income such as dividends, interest income and interest expense that is not properly allocable to a trade or business, capital gains, REIT dividends and income from qualified publicly traded partnerships (certain REIT dividends and PTP income are separately eligible for the deduction). Wages and guaranteed payments made by a qualified trade or business to a taxpayer for services rendered to the trade or business are also excluded from the definition of QBI. The regulations also exclude guaranteed payments for the use of capital from QBI. If a taxpayer has a net loss from all of its qualified trades or businesses in a tax year then that loss may be carried forward and treated as a loss from qualified trades or businesses in the succeeding year.

The characterization of payments to owner/managers of FTEs is one of the significant planning aspects of the 199A regulations. Wages and guaranteed payments cannot be offset by the FTD, while business profits – before owner compensation – can be offset.

The regulations provide that the determination of whether a trade or business exists is made under Section 162. There is considerable case law and administrative guidance on this standard (see Higgins v. Commissioner, 312, U.S. 212 (1914) and Commissioner v. Groetzinger, 480 U.S. 23 (1987)), but it is a highly factual analysis and the guidance is ambiguous in some areas, especially for real estate activities. In general, for a trade or business to exist there must be a profit motive or reasonable anticipation of profit potential and the taxpayers must engage in the activity on a considerable, regular and continuous basis. It is not necessary to offer goods or services to the public in order to be considered a trade or business. However, where the activity is primarily one of passive investment, a trade or business will not be found to exist. Acting as an employee is a trade or business under Section 162, but does not generate QBI for the purposes of Section 199A.

Importantly, as noted above, the QBI must be effectively connected with the conduct of a trade or business within the United States. This means that for certain FTEs with business operations outside of the country, not all of their income will be considered QBI. Historically, many FTEs selected to have their subsidiaries outside of the United States be treated as "disregarded entities" for U.S. tax purposes primarily because of the foreign tax credit rules and availability of credits. This means that the income of the foreign entity is treated as income of the U.S. FTE as if it were a branch of the U.S. company. As a result, FTEs with income from business operations outside the United States that are organized in this manner will not get the full benefit of the FTD, even though the income from the foreign operations is subject to tax in the United States. The new international regime created by tax reform should prompt a general reassessment of how international operations are structured, as a controlled foreign corporation owned by a C corporation blocker may provide better results in many circumstances.
Specified service trade or business
Section 199A defines specified service trades or businesses (SSTBs) with an explicit list of trades or businesses involving the performance of services in the following fields: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management (including trading, or dealing in securities, partnership interests or commodities), or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. Architects and engineers were specifically carved out of the SSTB definition, and will generally qualify for the 199A deduction.

Most service businesses rely on the reputations or skills of their employees in some capacity, and therefore it was feared that this provision could be interpreted very broadly and include any service business not named. Fortunately, the regulations defined this activity narrowly, providing that it only encompasses endorsing products or services, 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, and receiving appearance fees.

In addition, the regulations narrowly define many of the other categories of SSTB so that ancillary services may qualify. This may provide an opportunity to carve out qualifying activities as a separate trade or business from an SSTB, although two anti-abuse rules complicate the picture.

These businesses can be re-characterized as non-qualifying if they provide at least 80% of their goods and services to a related SSTB or if they share expenses with the SSTB and their gross receipts represent 5% or less of combined gross receipts. Even if an otherwise qualifying business does not exceed these thresholds, the deduction is not available for any income for providing goods and services to the related SSTB.

For example, let’s say a dentist owns a dental practice and also owns an office building, with the dentist renting half the building to his or her dental practice and renting the other half to unrelated persons. The renting of half of the building to the dental practice will be treated as an SSTB.

Opportunities, pitfalls of the new Section 199A deduction
These anti-abuse provisions will largely eliminate planning in which a professional services firm segregates administrative/support staff, equipment and buildings into separate trades or businesses to provide back to the firm in an effort to siphon off income from the SSTB. If separate activities will provide at least 20% of their goods and services to unrelated parties, there may be planning opportunities. However, the anti-abuse rules create tax inefficiencies in common arrangements in which real estate owned is separated from the trade or business for a variety of legal and economic reasons. In these situations, such as the in the dentist example above, the owner of the building could be in a better tax position if the entire building was rented to unrelated parties and the SSTB leased property from an unrelated party.

QBI from the sale of business assets
Section 199A specifically provides that “any items of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss,” is excluded from the calculation of QBI. The application is clear to an individual selling stocks or bonds — the deduction does not apply.

In the case of an owner of an FTE who sells business assets, the answer is more complicated. In the context of the sale of all of the assets of an operating business, Table 4 represents an illustration of common results. To understand it, it helps to define the different characterizations of income from the sale of business assets:

1 Ordinary income — Defined as income resulting from the sale of inventory, provision of services, or the sale of accounts receivable. These items are taxed at the ordinary rate for individuals, now 37%.

2 Section 1231 gain or loss — Defined as the sale of business assets held for more than year, either land or assets subject to amortization or depreciation (machinery and equipment, office equipment, vehicles, purchased intangibles, for example). At the taxpayer level, all Section 1231 gains and losses are netted. Gains are treated like capital gains; losses are treated like ordinary losses.

3 Section 1245 gains — Section 1245 gains result when an asset is sold for more than its tax basis (original cost, less depreciation or amortization). Machinery and equipment, office equipment, cars, trucks, etc. will typically sell for less than original cost. When selling for less than original cost, all gain is Section 1245 gain. Purchased intangible assets, on the other hand, will often sell for more than original cost. Gain from proceeds up to original cost is defined as Section 1245 gain (commonly referred to as “depreciation recapture”), and the gain from proceeds in excess of original cost is Section 1231 gain.

4 Section 1250 gain — Like intangible assets, buildings often sell for more than original cost. The excess of proceeds over original cost would result in Section 1231 gain. Proceeds in excess of tax basis, up to original cost, will give rise to depreciation recapture. Unlike machinery and equipment, the income from depreciation recapture on buildings is taxed at a special rate of 25%.

5 Capital gain — Capital gain in a business sale most commonly results from the sale of Intangible assets that were self-created by the business. Given changes in the law from the TCJA, the taxation of these assets is very complex, and subject to interpretation.
### Table 4: Characterization of income from the sale of business assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Characterization of gain or loss</th>
<th>Qualifies for FTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>Ordinary</td>
<td>Yes</td>
</tr>
<tr>
<td>Inventory</td>
<td>Ordinary</td>
<td>Yes</td>
</tr>
<tr>
<td>Machinery and equipment, cars and trucks sold at a gain, but for less than original cost</td>
<td>Section 1245: Treated as ordinary</td>
<td>Yes</td>
</tr>
<tr>
<td>Buildings, sold at a gain</td>
<td>• Recapture of prior depreciation (Section 1250) treated as capital gain, subject to special 25% rate</td>
<td>• No-but special 25% rate</td>
</tr>
<tr>
<td></td>
<td>• Remainder of gain, if any (Section 1231) treated as capital</td>
<td>• No</td>
</tr>
<tr>
<td>Intangible assets, including patents, secret formulas, customer or marketing based intangibles, workforce in place, goodwill, purchased in a M&amp;A transaction, sold at a gain</td>
<td>• Recapture of prior amortization (Section 1245) treated as ordinary</td>
<td>• Yes</td>
</tr>
<tr>
<td></td>
<td>• Remainder of gain, if any, (Section 1231) treated as capital</td>
<td>• No</td>
</tr>
<tr>
<td>Intangible assets self-created by the business including patents, models, designs, and secret formulas, sold at a gain</td>
<td>Ordinary</td>
<td>Yes</td>
</tr>
<tr>
<td>Intangible assets self-created by the business, including marketing-based intangibles, customer-based intangibles, workforce-in-place, sold at a gain</td>
<td>Capital gain</td>
<td>No</td>
</tr>
<tr>
<td>All losses from the Section 1231 assets, that when netted together at the taxpayer (not entity) level against all Section 1231 gains, still result in a loss</td>
<td>Ordinary</td>
<td>Yes (will reduce other QBI, since qualifies as QBI, and is a loss)</td>
</tr>
</tbody>
</table>

Table 4 is illustrative only and should not be relied on for these complex assets.

In summary, the application of the Section 199A deduction rules to the sale of business assets is very complex and includes uncertainties and planning opportunities, particularly in connection with the sale of intangibles. A business should plan its tax strategy prior to any sale, making sure positions are clearly documented and supported by appropriate appraisals.
Opportunities, pitfalls of the new Section 199A deduction

As Section 199A was being drafted, exclusions and two key limitations were added to reduce the loss of tax revenue and target the FTD away from service activities to businesses investing in employees or tangible property. First, the “wage” limitation was added to decrease the benefit to owners of very high-margin businesses with little human capital. A last-minute change, seen by many as a major concession to the real estate industry, provided an alternate limitation based more on the investment of tangible property into the business. Taxpayers get to choose the most advantageous limitation.

For the wage limitation, the FTD is limited to 50% of the owner’s allocable share of W-2 wages paid by a qualified trade or business. Wages, for this purpose, are defined as wages reported to employees on Form W-2 that are subject to withholding and other payroll tax provisions. The wages must be allocable to OBI and must be properly included in a return timely filed with the Social Security Administration.

When employees are treated as being paid by another taxpayer, such as under a common paymaster, the regulations state that the taxpayer considered to be the common-law employer will receive the credit for the W-2 wages.

For the alternative wage and qualified property (AWQP) limitation, the FTD is limited to 25% of the owner’s allocable share of W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition of qualified property (UBIAQP) (commonly referred to as “original cost”). Qualified property is defined as depreciable property that is held by and available for use in the qualified trade or business as of the end of its tax year. The property must also be within its “depreciable period,” defined as the period beginning on the date the property was placed in service and ending on the later of 10 years from that date or the last day of the last full year of the tax life of the property. Raw land is not considered qualified property as it is not depreciable for tax purposes. The important note here is that three-, five- and seven-year property that has been fully depreciated for tax purposes may be added at full cost into this computation.

Netting and aggregation issues
Many questions related to the FTD unanswered by the original legislation involved situations where a taxpayer has multiple qualifying trades or businesses. Those questions included whether to net losses from one or more qualifying trades or businesses with income from other qualifying trades or businesses and whether aggregation of a group of qualifying trades or businesses may be required or permitted. A common example is a closely-held business that, typically for isolation of legal liability, segregates its operating business in one entity from its real estate in one or more other entities.
The regulations address some questions on where netting is required and when aggregation is permissible and can be elected.

First, the regulations provide that if an individual has QBI of less than zero from one trade or business but has overall QBI greater than zero when all of the individual’s trades or businesses are taken together, then the individual must offset the net income in each trade or business that produced net income with the net loss from each trade or business that produced net loss before the individual applies the limitations based on W-2 wages and UBIAQP. The W-2 wages and UBIAQP from the trades or businesses which produced negative QBI are not taken into account for purposes of the regulations and are not carried over into the subsequent year.

Additionally, the regulations provide that if an individual or an FTE directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the taxpayer or entity must allocate those items among the several trades or businesses to which they are attributable using a “reasonable method” that is consistent with the purposes of Section 199A.

Finally, under the regulations, aggregation is permitted for purposes of applying the limitations based on W-2 wages and UBIA. This aggregation is not required and can only be done by the individuals or trusts that own the entities, not the entities themselves. Additionally, if a single entity owns multiple trades or businesses that qualify for aggregation, the entity may elect aggregation for those businesses. An individual may aggregate trades or businesses only if the individual or entity can demonstrate that the following requirements are met:

1. Consistent with other provisions in the regulations, each trade or business must itself rise to the level of a trade or business under Section 162.

2. The same person, or group of persons, must directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. All of the items attributable to the trades or businesses must be reported on returns with the same taxable year (not including short years). Rules are provided allowing for family attribution. Because the rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate.

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

4. Individuals and trusts must establish that the trades or businesses meet at least two of three factors which demonstrate that the businesses are, in fact, part of a larger, integrated trade or business. These factors include:
   - Providing products and services that are the same (for example, a restaurant and a food truck) or products and services that are customarily provided together (for example, a gas station and a car wash)
   - Sharing facilities or significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources or information technology resources)
   - Operating in coordination with, or reliance on, other businesses in the aggregated group (for example, supply-chain interdependencies)
The regulations require an annual disclosure for taxpayers choosing to aggregate trade or businesses. For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated.

The statement must contain:

• A description of each trade or business
• The name and EIN of each entity in which a trade or business is operated
• Information identifying any trade or business that was formed, ceased operations, was acquired or was disposed of during the taxable year
• Such other information as the IRS Commissioner may require in forms, instructions, or other published guidance

**Wage and UBIAQP limitations: a deeper dive**

The mathematical foundation of the limitations is the relationship of wages, or wages and UBIAQP, to QBI (for this discussion, think of QBI as the taxable income from a qualified business). If 20% of QBI cannot exceed 50% of wages, without limitation, then mathematically, 100% of QBI cannot exceed 250% of wages. This means that wage expense must generally represent 40% of qualifying income for the deduction to avoid limits, or in reverse, qualifying income must be two-and-a-half times wage expense. Similarly, for, say, a real estate entity, if 20% of QBI cannot exceed 2.5% of UBIAQP (ignoring the added benefit of the 25% wage limitation), then 100% of QBI cannot exceed 12.5% of UBIAQP (again, ignoring the 25% of wages additional limitation). This would mean the QBI in any year could reach as high as one-eighth of the original cost of the real estate without hitting the limit.

Let us look at some industry examples to see how close we can get to failing these limitation tests.

The examples in Table 5 are realistic examples from industry that represent common relationships between the attributes listed above. Note that to fail these tests, the qualified business needs to be too profitable. Poor performance will insure no limitations come into play. So our examples are industry illustrations of successful businesses.
Table 5: Illustrative industry examples of the FTD limitations

<table>
<thead>
<tr>
<th></th>
<th>Manufacturer</th>
<th>Transportation</th>
<th>Tech company</th>
<th>Real estate</th>
<th>Construction</th>
<th>Service business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue (1)</td>
<td>$250,000,000</td>
<td>$150,000,000</td>
<td>$125,000,000</td>
<td>$20,000,000</td>
<td>$460,000,000</td>
<td>$170,000,000</td>
</tr>
<tr>
<td>CGS</td>
<td>$(165,000,000)</td>
<td>$(45,000,000)</td>
<td>$(390,000,000)</td>
<td>$(30,000,000)</td>
<td>$(49,000,000)</td>
<td>$(100,000,000)</td>
</tr>
<tr>
<td>Gross margin</td>
<td>$85,000,000</td>
<td>$150,000,000</td>
<td>$80,000,000</td>
<td>$20,000,000</td>
<td>$70,000,000</td>
<td>$70,000,000</td>
</tr>
<tr>
<td>SG&amp;A/wages/other</td>
<td>$(70,000,000)</td>
<td>$(125,000,000)</td>
<td>$(53,000,000)</td>
<td>$(9,000,000)</td>
<td>$(30,000,000)</td>
<td>$(49,000,000)</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$15,000,000</td>
<td>$25,000,000</td>
<td>$27,000,000</td>
<td>$11,000,000</td>
<td>$40,000,000</td>
<td>$21,000,000</td>
</tr>
<tr>
<td>Depreciation and</td>
<td>$(2,500,000)</td>
<td>$(12,000,000)</td>
<td>$(4,500,000)</td>
<td>$(4,000,000)</td>
<td>$(14,000,000)</td>
<td>$(1,000,000)</td>
</tr>
<tr>
<td>amortization</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$(800,000)</td>
<td>$(3,500,000)</td>
<td>$(4,500,000)</td>
<td>$(6,000,000)</td>
<td>$(1,800,000)</td>
<td>$(1,000,000)</td>
</tr>
<tr>
<td>Taxable income/Pre-</td>
<td>$11,700,000</td>
<td>$9,500,000</td>
<td>$22,000,000</td>
<td>$1,000,000</td>
<td>$24,200,000</td>
<td>$19,000,000</td>
</tr>
<tr>
<td>tax operating income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>W-2 wages</td>
<td>$50,000,000</td>
<td>$45,000,000</td>
<td>$42,000,000</td>
<td>$150,000,000</td>
<td>$60,000,000</td>
<td>$60,000,000</td>
</tr>
<tr>
<td>Unadjusted UBIAQP</td>
<td>$35,000,000</td>
<td>$55,000,000</td>
<td>$30,000,000</td>
<td>$65,000,000</td>
<td>$246,000,000</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

Limitation tests

<table>
<thead>
<tr>
<th></th>
<th>Manufacturer</th>
<th>Transportation</th>
<th>Tech company</th>
<th>Real estate</th>
<th>Construction</th>
<th>Service business</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% wages</td>
<td>$25,000,000</td>
<td>$22,500,000</td>
<td>$21,000,000</td>
<td>$75,000,000</td>
<td>$30,000,000</td>
<td></td>
</tr>
<tr>
<td>25% wages + 2.5% UBIAQP</td>
<td>$13,375,000</td>
<td>$12,625,000</td>
<td>$11,250,000</td>
<td>$1,625,000</td>
<td>$43,650,000</td>
<td>$15,100,000</td>
</tr>
<tr>
<td>Highest limit</td>
<td>$25,000,000</td>
<td>$22,500,000</td>
<td>$21,000,000</td>
<td>$1,625,000</td>
<td>$75,000,000</td>
<td>$30,000,000</td>
</tr>
<tr>
<td>20% OBI (Taxable in-</td>
<td>$2,340,000</td>
<td>$1,900,000</td>
<td>$4,400,000</td>
<td>$200,000</td>
<td>$4,840,000</td>
<td>No deduction</td>
</tr>
<tr>
<td>come)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deduction</td>
<td>$2,340,000</td>
<td>$1,900,000</td>
<td>$4,400,000</td>
<td>$200,000</td>
<td>$4,840,000</td>
<td>allowed-SSTB</td>
</tr>
</tbody>
</table>

Analysis

<p>| | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>QBI/wages</td>
<td>23%</td>
<td>21%</td>
<td>52%</td>
<td>16%</td>
<td>32%</td>
<td></td>
</tr>
<tr>
<td>QBI/UBIAQP</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2%</td>
</tr>
<tr>
<td>For limit OBI/wages</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; 250%</td>
<td>250%</td>
<td>250%</td>
<td>250%</td>
<td>250%</td>
<td>250%</td>
<td></td>
</tr>
<tr>
<td>For limit OBI/UBIAQP</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>12.50%</td>
</tr>
<tr>
<td>&gt; 12.5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>QBI growth required</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>before limitation</td>
<td>968%</td>
<td>1084%</td>
<td>377%</td>
<td>1450%</td>
<td>689%</td>
<td></td>
</tr>
<tr>
<td>QBI growth required</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>before limitation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>713%</td>
</tr>
</tbody>
</table>

(1) assumes all income is qualified domestic business income

The examples in Table 5 show that to hit the limitations, these businesses would have to increase profits, without any increase in wages (or qualified property in the real estate example), by between four and 15 times.
Opportunities, pitfalls of the new Section 199A deduction

Reporting requirements
Although the deduction is ultimately taken at the individual (or trust) level, FTEs are required to provide extensive information to their owners to allow them to calculate and claim the credit. The proposed regulations define entities with reporting obligations as relevant pass-through entities (RPEs). An RPE is an entity that either directly operates a trade or business or is a pass-through that owns a lower-tier RPE (such as a holding company, structured as a pass-through). Each RPE is required to report by RPE, for each trade or business, by owner, each owner’s share of:

- Qualified business income
- 199A W-2 wages
- 199A unadjusted basis of qualified property
- REIT dividends
- Publically traded partnership income

In addition, each RPE must specify if the business is a qualified business or an SSTB. Treasury has assured compliance by adding language in the regulations that effectively eliminates an FTD for those that do not make a good faith effort to report correctly.

Section 199A planning
Considering the myriad rules regarding eligibility for the deduction, limitation calculations and reporting requirements, how should taxpayers go about the process of maximizing the FTD so as to make their effective tax rate as low as possible?

The starting point for planning under 199A is understanding the different layers of calculations and reporting:

- Trade or business: Defined as an activity that rises to the level of a trade or business under Section 162. A single entity can have multiple trades or businesses (TorBs). Section 162 generally does not allow for an activity spread across multiple entities to be considered a single trade or business, but taxpayers can potentially make an election to aggregate the activities of these entities into a single trade or business if the circumstances meet the aggregation standard.
  - Note: Aggregating TorBs under Section 199A is different than making group elections under Section 469 for passive activities. The IRS made a special point of this in the regulations. The rules are very similar, but unfortunately, the rules for Section 199A are not as permissive, and both must be reported separately.
- Relevant pass-through entity (RPE): An RPE is defined as a partnership, S corporation or an LLC taxed as a pass-through. An RPE may own multiple DREs (partnerships of qualified subchapter S subsidiaries) with business operations. An RPE may own TorBs or other RPEs.
- Owner: An owner can be a majority owner of an RPE (directly or by attribution), minority owners of RPEs, and/or common owners of RPEs, and by extension, common owners of TorBs.

The starting point for planning under 199A is understanding the different layers of calculations and reporting.
Planning step 1: Getting started

All the 199A planning revolves around TorBs. Here are the first steps:

• Determine if the activities of an RPE rise to the level of a trade or business and whether the activities represent a single or multiple trades or businesses.
• Determine if any of the TorBs are SSTBs.
• Model whether any of the trades or businesses are at risk of running into the limits.
• Determine the potential reporting obligations for each by owner.
• Consider if restructuring or aggregation elections would provide a better result.

Planning step 2: Goal setting

Some reasonably universal goals for Section 199A planning would be:

• Maximizing the 199A deduction.
  – Eliminate, reduce, and/or segregate SSTBs
  – Maximize qualified business income
  – Eliminate or reduce any loss of deduction due to limitations
• Always remember to check with attorneys regarding separation of liability. Generally, Section 199A planning will look to combine TorBs, RPEs, etc. Attorneys generally prefer the opposite.
• Model whether any of the trades or businesses are at risk of running into the limits.
• Determine the potential reporting obligations for each by owner.
• Consider if restructuring or aggregation elections would provide a better result.
Some reasonably universal goals for Section 199A planning would be:

- Guaranteed payments and wages paid to owners of FTEs will generally reduce the benefit of the FTD. They reduce QBI, and hence the FTD, but are not considered QBI themselves. Partnerships have no requirement to pay a “reasonable” amount of “compensation” to partners as guaranteed payments for services, so partners can increase QBI by reducing guaranteed payments. Owners of S corporations must receive a “reasonable” amount of compensation as wages, but these wages count toward the wage test, while guaranteed payments do not.

- SSTB planning must be carefully done. The IRS has gone to great lengths to prevent abusive tax planning. Document allocations carefully.

- If the Section 199A deduction is limited:
  - Consider combining tax entities first (if you can treat the business activities in both entities as one TorB, that is preferred)
  - Elect aggregation

- For a TorB with losses:
  - The loss reduces 80% of overall income (100% of the loss, less the 20% FTD lost).
  - The wages associated with the loss business are lost for limitation calculation purposes, too.
  - Better to have a TorB with $100 of losses and $40 of wages than $1 of loss and $40 of wages.
  - It can be beneficial to combine loss companies with profitable companies if you can support they represent one TorB.

- Net operating losses will reduce taxable income, but will likely reduce the taxpayer’s FTD by limitation. Combining entities so there is a single trade or business can reduce or eliminate internal and external compliance costs.

- In general, many businesses are not at risk of the limitations on the FTD governed by wages and UQBP:
  - Many industries appear particularly safe from the limits.
  - Combining trades or businesses into a single trade or business at the entity level or electing to aggregate them at the individual level can help.
The good news for most owners of domestic operating companies, other than SSTB companies, is it is likely that the full benefit of the Section 199A deduction will be available.

Conclusion
We see three takeaways from the new Section 199A regulations: The good news, the bad news and the things to focus on.

The good news for most owners of domestic operating companies, other than SSTB companies, is it is likely that the full benefit of the Section 199A deduction will be available. This should apply in most cases across most industries. Our analysis has shown that the ratio requirements (of wages, UBIAQP and profits) of the limitation tests should be easy to meet.

The bad news is that the rules and regulations governing the Section 199A deduction, RPE reporting, individual and trust reporting, aggregation calculations and elections will be time-consuming and tedious. The IRS rules, that generally silo activities by trades or businesses for many of the tests, make the aggregation elections critical to evaluate. The anti-abuse rules also can combine trade or business activities for purposes of determining what qualifies as an SSTB. The late change allowing entities to elect aggregation of multiple trades or businesses owned by the same entity should provide some relief.

The points of focus to maximize the benefits of 199A, in light of the final regulations:

1 Owners with high salaries (W-2 compensation) and/or high guaranteed payments should review what restructuring options are available for their compensation, and if restructuring will yield more favorable results. Profits interests in the partnership setting are a definite opportunity to explore, among other options.

2 Owners of multiple businesses or divisions, which contain one or more SSTBs or activities that could be construed to be an SSTB, should determine if there are appropriate restructuring options, or new business arrangements permitted under the final regulations, that will create more opportunities for the FTD. Due to the number of anti-abuse provisions in the final regulations, taxpayers should proceed with caution, and carefully document and support the arrangements.

3 Owners of domestic entities with foreign subsidiaries or branches need to carefully analyze the current effective tax rate on their foreign income and determine if any elections, restructuring, or changes to financial arrangements or geographies would be helpful.

Overall, it is likely that the final 199A regulations will not impact the choices every flow-through owner had to make a year ago, in the wake of tax reform. Taxpayers that were expecting to receive the full FTD based on prior analysis should have even more options to ensure the deduction using the aggregation rules available in the final regulations.

For those taxpayers with SSTBs, the final regulations have significantly curtailed restructuring options some owners and practitioners were hoping might be available. Nevertheless, it still is a good housekeeping practice to review your ownership and compensation periodically. Rechecking your 2018 assumptions for 2019 would be wise. At a minimum, those that continue to own flow-throughs need to set aside extra time this year for the documentation requirements ahead of them.
Opportunities, pitfalls of the new Section 199A deduction

Section 199A: A history of its creation
In June 2011, Mark Stutman, then national managing partner of Tax Services for Grant Thornton, testified to the House Ways and Means Committee at a hearing focused on how tax reform can encourage job creation. The focus in Washington was primarily centered on lowering the corporate tax rate, which at the time was at 35%, making it one of the highest corporate rates among the United States’ OECD trading partners.

Grant Thornton continued to focus on including pass-throughs in rate relief, and in the fall of 2015, began drafting legislation that would form the basis of the 2016 campaign for tax reform. Working hand-in-hand with Rep. Vern Buchanan (R-Fla.), Grant Thornton developed legislation that would cap the rate on pass-through business income at the top rate for C corporations.

This legislation, the Main Street Fairness Act, later became part of the House Leadership’s Better Way agenda. The parity message had broken through.

After the 2017 elections, tax reform became a realistic possibility. However, much of the focus remained on lowering the corporate rate. Efforts to lower the rate for pass-through income faced revenue constraints, and lawmakers feared that a lower rate for pass-throughs would invite tax planning to use the lower rate against wage or service income.

The tax writing committees began developing proposals that would adhere to revenue restrictions and target the benefit toward true business income and not equivalent to wage or service income.

The Ways and Means Committee introduced a provision that would establish a 25% top tax rate on pass-through business income. Passive owners would enjoy this rate on all their income. Active owners would only receive this lower rate on a calculation of income based on the amount of capital invested in the business. A safe harbor would allow these active owners to apply the rate to 30% of their income, but the safe harbor would not be available for a specified list of service businesses.

The Senate Finance Committee took a different approach based on a proposal from former House Majority Leader Eric Cantor, (R-Va.). The proposal offered a 17% deduction with many of the same exclusions and limits as were included in the final legislation.

Grant Thornton and other groups argued that a 17.4% deduction was not sufficient to provide parity with C corporations. Sens. Ron Johnson (R-Wis) and Steve Daines (R-Mont.), both businessman before coming to the Senate, argued for a deduction of at least 25%. Senate Majority Leader Mitch McConnell (R-Ky.) and former Senate Finance Committee Chair Orrin Hatch (R-Utah) agreed to increase the deduction to 20% before a floor vote. Supporters kept pushing and ultimately secured an increase to 23%, which brought the top effective rate on pass-through income to just under 30% (based on a top individual rate of 39.6%). This was enough to secure the votes of both Daines and Johnson, and the bill was passed 51-49.

When the bill went to conference, the top rate was lowered from 39.6% to 37%. This tradeoff meant that the pass-through rate could be lowered to 20% before final passage without changing the effective top rate (still under 30%). The conference report was passed, and President Donald Trump signed the bill into law Dec. 22, 2017.
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