A Practical Approach to Section 199A

Thursday, October 3, 2019

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Overview

- Flow-Through Trade or Business
- Qualified Business Income
- Wage and UBIA Limitations
- Phase-in Amounts
- Specified Service Trade or Business (SSTB)
- Multiple Trades or Businesses and Aggregation
Code Section 199A – Generally

• 20% Deduction:
  – §199A provides a potential 20% deduction with respect to an individual’s share of “combined qualified business income” from partnerships, S corporations, or sole proprietorships (a “relevant passthrough entity” (RPE))
  – Effectively reduces the tax rate
    • E.g., a taxpayer subject to a 37% tax rate would receive an effective rate of 29.6%
  – Deduction expires for taxable years beginning after December 31, 2025
Is there a flow-through trade or business?
ELIGIBILITY

• Section 199A deduction only applies to an individual’s share of combined qualified business income from:
  – Partnerships;
  – S-Corporations; or
  – Sole proprietorships
    Each known as a relevant passthrough entity (“RPE”).

• Not available to C-Corporations.
QUALIFIED TRADE OR BUSINESS

• Qualified Trade or Business:
  – The term “qualified trade or business means a trade or business other than a specified service trade or business (“SSTB”) or the trade or business of performing services as an employee. [Section 199A(d)(1)]

• Trade or Business (“ToB”)
  – “A trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee” [Treas. Reg. 1.199A-1(b)(14)]
  – Section 162(a) does not provide a specific definition as to what constitutes a trade or business.
  – The IRS and Treasury have declined to establish a bright lined test for what is a ToB.
  – Case law has provided that to establish a ToB (Groetzinger v. Commissioner, 480 U.S. 23 (1987):
    • Taxpayer must enter into and carry on the activity with a good-faith intention to earn a profit.
    • taxpayer must engage in the activity on a regular and continuous basis .
Consider whether the activities of an RPE constitute separate trades or businesses.

- Generally, activities operated in separate taxable entities are considered separate trades or businesses.

- Additionally, a single entity may also have multiple trades or businesses.

- The IRS declined to adopt any specific bright-line guidance on how to determine if an RPE has more than one ToB. However, the preamble to the final Section 199A regulations provide that “multiple trades or business will generally not exist within an entity unless different methods of accounting could be used for each trade or business under [Regs. Sec.] 1.446-1(d).”
The Treasury Regulations under Section 446 provide that:

- In order for a taxpayer to have separate and distinct trades or businesses, the taxpayer must use a different method of accounting for each trade or business. [Treas. Reg. 1.446-1(d)(1)]

- No trade or business will be considered separate and distinct . . . unless a complete and separable set of books and records is kept for such trade or business. [Treas. Reg. 1.446-1(d)(2)]

- No trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business. [Treas. Reg. 1.446-1(d)(2)]

- However, trades or businesses will not be considered separate and distinct if the maintaining of different methods of accounting creates a shifting of profits and losses between the trades or businesses. [Treas. Reg. 1.446-1(d)(3)]
SEPARATE TRADES OR BUSINESSES

• Other factors to consider for separate Trades or Businesses:
  – whether the two businesses are operated as separate divisions, with separate books of account, employees, management, and other incidents of business;
  – the self-sufficiency of each business;
  – whether the right for the separate division to exist is granted by federal law and regulations;
  – whether assets, books, records, and activities of the two divisions must be segregated under federal law;
  – whether the two divisions have different office space or are located at physically separate locations; (6) whether the clientele of the two divisions are the same or are mutually exclusive;
  – whether one business is a branch of the other business;
  – whether each business has the requisite assets and employees for the production of income; and
  – whether items in common between the two divisions could be shared by any two dissimilar businesses owned by the same taxpayer.
What is qualified business income (QBI)?
Qualified Business Income

- **Qualified Business Income (QBI):**
  - Qualified items of income, gain, deduction and loss that are (a) effectively connected with a U.S. trade or business within the meaning of §864 (i.e., non-U.S. income does not qualify for the deduction) and (b) included or allowed in determining taxable income for the year

- **QBI Includes:**
  - With respect to a partnership, gain or loss under §751(a) or §751(b) (not just in the context of a PTP)
  - Gain resulting from adjustments under §481 so long as the adjustment arises in tax years ending after December 31, 2017 and is attributable to a QTB
Income Not Treated as Qualified Business Income

• QBI does NOT Include:
  – Capital gain or loss (long or short term), including §1231 gains or losses
  – Interest income other than interest income properly allocable to a trade or business, which does not include interest income received on working capital, reserves, and similar accounts
  – Reasonable compensation from an S corporation
    • “Reasonable compensation” only applies to S corporations.
    • Thus, economically similar payments made by partnerships, e.g., guaranteed payments, may have different §199A consequences
Income Not Treated as Qualified Business Income

- QBI does NOT Include:
  - Guaranteed payments for partner services under § 707(a) and (c)
    - Includes payments for the use of capital and payments to upper-tier partnership
  - Dividends and dividend equivalents, including payments in lieu of dividends under §954(c)(1)(G)
  - Gains/loss from certain commodities transactions, or foreign exchange gains, certain gains from notional principal contracts, non-business annuity income, and any item of deduction or loss properly allocable to any of the previous amounts
What Income Qualifies for the Deduction?

• Qualified REIT Dividends and Qualified PTP Income are eligible for 20% Deduction
  – Qualified REIT Dividend:
    • any dividend from a REIT received during the taxable year which is neither:
      – a capital gain dividend, as defined in §857(b)(3), nor
      – qualified dividend income, as defined in §1(h)(11)
    • If the REIT stock is held for fewer than 45 days, the dividend will not be treated as a qualified REIT dividend
    • Uncertainty regarding REIT dividends received through RICs
What Income Qualifies for the Deduction?

• Qualified REIT Dividends and Qualified PTP Income are eligible for 20% Deduction
  – Qualified PTP Income:
    • the net amount of such taxpayer’s allocable share of income, gain, deduction and loss from a PTP plus
    • any gain or loss attributable to assets of the PTP giving rise to ordinary income under §751(a) or (b) that is considered attributable to the trades or businesses conducted by the PTP
    • §707(a) and (c) payments generally not eligible
Do the taxable income based limitations apply?
Threshold Amounts and Phase-in Range

• Threshold Amounts (2018)
  – Individuals and Trusts/Estates: $157,500
    • $50,000 phase-in range (up to $207,500)
  – Married, Filing Jointly: $315,000
    • $100,000 phase-in range (up to $415,000)
  – These amounts are adjusted annually for inflation.

• Is the taxpayer’s taxable income at or below the threshold?
  – SSTB, W-2 wage and UBIA of qualified property limitations do not apply.

• Within the phase-in range?
  – W-2 wage and UBIA of qualified property limitations phased-in.
  – An SSTB is a qualified trade or business but only a portion of its QBI can be used in determining the de

• Above the phase-in range?
  – SSTBs are not qualified trades or businesses (not eligible for deduction).
  – W-2 wage and UBIA of qualified property limitations apply in full.
Is QBI limited by the W-2 wage or UBIA of qualified property limitations?
The W-2 Wage and UBIA of Qualified Property Limitations

• For taxpayers with taxable income above the phase-in range, the amount of QBI from each qualified trade or business that is used in determining the section 199A deduction is limited to the lesser of:
  – 20% of the QBI from the trade or business OR
  – the greater of:
    • 50% of the W-2 wages paid with respect to the trade or business OR
    • 25% of the W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of all qualified property held for use in the trade or business as of the last day of the taxable year.

• These limitations are phased in for taxpayers with taxable income within the phase-in range.
Determining W-2 Wages

• W-2 wages means the amount paid with respect to a trade/business as W-2 wages to employees for services rendered.

• W-2 wages include the total amount of W-2 wages as defined in section 3401(a) plus:
  – Total amount of elective deferrals within the meaning of § 402(g)(3)
  – Compensation deferred under § 457
  – Designated Roth contributions as defined in § 402A

• Rev. Proc. 2019-11 provides guidance on methods for determining W-2 wages for purposes of the § 199A wage limitations

• W-2 wages only includes amounts properly reported on a return filed with the Social Security Administration on or within 60 days of the due date (including extensions) for the return.
Determining W-2 Wages

• Only W-2 wages properly allocable to QBI are included. Wages must also be allocated among various trades/businesses if the taxpayer or RPE conducts more than one trade/business.

• W-2 wages paid by a different person (such as a payroll agent, common paymaster, or professional employer organization (PEO) may be taken into account, provided that the W-2 wages are paid to common law employees of the individual or RPE.

• W-2 wages do not include:
  – Guaranteed payments for services
  – Section 707(a) payments for services
  – Payments to independent contractors
  – Reasonable compensation not paid as W-2 wages
Determining UBIA of Qualified Property

- **Qualified Property is:**
  - tangible property of a character subject to an allowance for depreciation under § 167(a),
  - held by and available for use in the trade or business at the close of the year,
  - used at any point during the year in the production of QBI, and
  - the depreciable period has not ended before the end of the tax year.

- **The depreciable period is the later of:**
  - 10 years after the placed-in service date
  - The last full day of the last full year in the applicable recovery period under § 168(c).

- **Improvements to qualified property are treated as separate qualified property placed in service on the date the improvement is placed in service.**
Determining UBIA of Qualified Property

• Unadjusted Basis Immediately after Acquisition (UBIA)
  – Basis on the placed in service date of the property as determined under § 1012 or other applicable section of the Code.
  – Determined without regard to any adjustments described in § 1016

• Nonrecognition Transactions Described in § 168(i)(7)
  – If qualified property is acquired in a nonrecognition transaction such as a § 351 or § 721 contribution, the UBIA for the property in the hands of the transferee will generally be the same as the transferor’s UBIA, adjusted for money paid/received in the transaction.

• § 1031 or § 1033 Transactions.
  – The UBIA of the replacement property will generally be the same as the UBIA of the relinquished property, adjusted for money or other property transferred in the transaction.
Is the taxpayer in a SSTB?
The Impact of Multiple Trades or Businesses