Real Life Issues Under 199A

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Introduction

• New “below the line” deduction for “qualified business income” (“QBI”) from pass-through entities and sole proprietorships
• Maximum deduction is 20% of QBI
• Non-corporate taxpayers (including estates and trusts) are eligible to claim the deduction
• Effectively reduces the rate on pass-through income to eligible taxpayers to 29.6%
• Sunsets in 2026
Special Rules for Section 199A Understatements

• Generally, Section 6662 imposes a 20% penalty if there is a substantial understatement of income tax
• A “substantial understatement” usually means the greater of 10% of the tax required to be shown on the return or $5,000
• Understatement threshold lowered to 5% for Section 6662 accuracy related penalty for taxpayers claiming Section 199A deduction (See Section 6662(d)(1)(C))
• Accordingly, “getting it right” for Section 199A purposes is of critical importance
Issue 1: Management Company Issues
Management Company Issues

- Client is a partner in a number of partnerships that all own real property
- Client also is a partner in a partnership that manages the real property; the management entity is the sole entity with employees
  - Variation 1: The same persons own the partnerships in the same proportions
  - Variation 2: The management partnership is “unrelated” to the other partnerships
- Can client use the management entity wages to calculate client’s W2 amount for Section 199A purposes?
Limiting the Section 199A Deduction

- For taxpayers with income above a certain threshold, QBI with respect to any trade or business means the lesser of:
  - Twenty percent of the taxpayer’s QBI with respect to a qualified trade or business (“QTB”), or
  - The greater of
    - 50% of the QTB’s W-2 wages, or
    - 25% percent of the W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property
Aggregation

- Taxpayers can aggregate businesses to calculate QBI and W2 and basis limits if:
  - The same person or group of persons own 50% or more;
  - The 50% ownership must exist for a majority of the taxable year in which the aggregation is to occur;
  - All of the trades or businesses being aggregated are reported on returns with the same taxable year;
  - None of the trades or businesses is a specified service trade or business; and
  - The trades or businesses to be aggregated satisfy at least two of the following factors:
    - The trades or businesses provide products and services that are the same or customarily offered together;
    - The trades or businesses share facilities or significant centralized business elements (personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology); or
    - The trades or businesses are operated in coordination with, or reliance upon, one or more of the other trades or businesses in the aggregated group
What if aggregation is not possible?

• If an entity does not qualify for aggregation, can still use wages paid by another entity if
  • The wages are paid to common law employees of the taxpayer, and
  • The payor does not take such wages into account for its 199A calculation
Common Law Employees/Employers

- Under common law, an employer-employee relationship exists if the employer has the right to control and direct the worker as to the result to be accomplished and the details and means by which the result is to be accomplished.
- Where two persons have the right to control and direct a worker simultaneously, and service to one doesn't involve the abandonment of service to the other, the worker may be the employee of both—i.e., may be “co-employed”—with respect to the same performance of services.
  - Chief Counsel Advice 200415008
Common Law Employees/Employers

• Some factors include:
  • Which party is responsible for administrative matters (payroll, recordkeeping, etc.)
  • Which party has the responsibility of recruiting, hiring, training, disciplining, evaluating, and terminating the workers
  • Whether one party can assign additional projects to the worker
Management Companies

- In Variation 1 of our hypo, it is likely that the client can aggregate the businesses and therefore, the common law employer/employee issue is irrelevant.
- In Variation 2 of our hypo, the businesses cannot be aggregated - must look at the facts and circumstances to determine whether the wages paid by the management company can be applied to the entities that own the real property.
Issue 2: SSTB Issues
Facts

- Client develops and sells computer software
- Client offers customers the opportunity to retain client as a consultant with respect to software issues
- Is the income from client’s “consulting” portion of the business eligible for the Section 199A deduction?
What is a Qualified Trade or Business?

- A QTB is any trade or business other than a specified service trade or business
- Specified service businesses (“SSTBs”) include the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or where the principal asset of the business is the reputation or skill of one or more of its employees, or which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests or commodities
De Minimis Rule

- Under the Proposed Regulations, a QTB will not be classified as a SSTB if it only provides a small amount of specified services
  - Gross Receipts of $25M or Less: Less than 10% of the gross receipts of the business are attributable to SSTB services
  - Gross Receipts in Excess of $25M: Less than 5% of the gross receipts of the business are attributable to SSTB services
Incidental Businesses

- Under the Proposed Regulations, a QTB can be re-classified as an SSTB in certain circumstances:
  - The QTB and the SSTB have 50% or more common ownership;
  - The QTB and the SSTB have shared expenses (such as wages or overhead); and
  - The gross receipts of the QTB are no more than 5% of the total combined gross receipts of the QTB and the SSTB
Facts

- Client operates an assisted living facility
- Is client’s income from the facility QBI?
Health as a SSTB

- As noted above, an SSTB includes the performance of services in the field of health.
- Generally ineligible: doctors, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide services directly to a patient.
- Generally eligible: people who provide services that may improve the health of the recipient, such as the operator of a health club or spa, or the research, testing, and sale of pharmaceuticals or medical devices.
Facts

- Client owns 100% of a single entity, which currently operates two lines of business
- One business is a QTB, the other is an SSTB
- Are there any restructuring options that would allow client to separate out the QTB from the SSTB?
Supporting Businesses

• Under the Proposed Regulations, a QTB also can be re-classified as an SSTB if:
  • The QTB and the SSTB have 50% or more common ownership; and
  • The QTB provides 80% or more of its property or services to an SSTB

• Generally, this provision of the Proposed Regulations prohibits taxpayers from separating out non-SSTB businesses from SSTB businesses where currently the two businesses are integrated (i.e., law firms separating out HR functions)
Issue 3: Cannabis Business Issues
Facts

• Client intends to operate an integrated cannabis business - growing, processing and distributing cannabis
• Client is reviewing choice of entity for each activity
• May see growing/processing businesses established as flow-through entities and distribution business as a C corporation as part of Section 280E tax planning
• Does Section 280E prevent client from claiming a Section 199A deduction with respect to the cannabis business if operated through a flow-through entity?
Section 280E

- Section 280E prohibits deductions for amounts paid or incurred in carrying on a trade or business of trafficking in certain controlled substances that is illegal under Federal or State law.
- Before the promulgation of the Proposed Section 199A Regulations, the question was whether Section 280E would deny the Section 199A deduction?
- After the promulgation of the Proposed Section 199A Regulations, an additional question is whether the calculation of W-2 wages in a cannabis business includes wages that are nondeductible under Section 280E? See Prop. Reg. Sec. 1.199A-2(b)(4)
  - What about W-2 wages included in cost of goods sold?
Issue 4: Wage Issues
Facts

• Client’s employees have asked client to change their status from employees to that of independent contractors
• Client understands that this may provide a tax break to client’s employees and wants to help them to the greatest extent possible
• How should you advise client?
Reasonable Compensation

• QBI does not include “reasonable compensation”

• Per the Proposed Regulations, IRS will not apply a reasonable compensation approach to partnerships and individuals for purposes of calculating QBI

• Accordingly, an employee cannot claim a Section 199A deduction with respect to his or her wages, but an independent contractor could claim a Section 199A deduction with respect to his or her consideration
Change in Classification Issues

• Proposed Regulations anticipate employees may want to make this change and presume that an employee who becomes an independent contractor continues to be an employee

• Employer issues:
  • Risk that the employer now is misclassifying its workers as independent contractors
  • Employer loses the benefit of including the independent contractor’s consideration in the employer’s W2 wage calculation

• Worker issues
  • Independent contractors loss all employee benefits (health insurance, 401K, etc.)
  • Independent contracts need to pay self-employment taxes

• Impact on partner promotions?
Facts

- Client operates a QTB through a pass-through entity
- Client has income in excess of the applicable thresholds, such that client is subject to the W2 test
- Client wants to know whether he should take out more cash as compensation in order to maximize the W2 amount paid by the QTB
Owner Compensation Issues: Partnerships

• Guaranteed payments are not considered QBI
  • Consider whether an affiliated entity of the partner could receive a fee, rather than having the partner receive the amount directly as a guaranteed payment
  • Consider restructuring the guaranteed payment to make it dependent on the profit of the partnership
• Partners cannot be paid W-2 wages
Owner Compensation Issues: 
S Corporations

• Under-compensation: Reasonable compensation paid to S corporation owners also is not considered QBI, regardless of what was actually paid.
  • W-2 wages paid to S corporation owners is included in the W2 wage base
  • However, reasonable compensation adjustments are not (because they are not reported on W-2s)
• Over-compensation can also be a concern, in cases where the S corporation shareholder is adjusting wages to maximize the Section 199A wage base.
• Consider reasonable compensation study
Issue 5: Family Aggregation Issues
Facts

• Client is a partial owner of a QTB but has income in excess of the specified thresholds such that client is subject to the W2/basis limitation
• The QTB is operated through a number of different entities
• Each QTB entity is owned in varying amounts by client, client’s family members, and trusts for the benefit of client’s family members
• Can these entities be aggregated?
Aggregation

- As noted above, taxpayers can aggregate businesses to calculate QBI and W2 and basis limits if, among other things, the same person or group of persons own 50% or more.
- Under the Proposed Regulations, an individual is considered to own interests in the QTB owned, directly or indirectly, by or for:
  - The individual’s spouse; and
  - The individual’s children, grandchildren and parents.
Aggregation

- The Proposed Regulations do not include siblings as family members for purposes of the aggregation rules (See Treas. Reg. Sec. 1.199-4(b)(3))

- In contrast, the SSTB rules do aggregate siblings in determining common ownership for purposes of the SSTB rules (See Treas. Reg. Sec. 1.199A-5(c)(2)(ii) (applying Section 267(b) and Section 707(b)))
Issue 6: Business Interest Issues
Facts

- Client operates a QTB
- A significant amount of expenses of the QTB are business interest expenses, such that client is subject to the Section 163(j) limitation
- How does client calculate the Section 199A deduction, in light of the Section 163(j) limitation?
Section 163(j) limitation

- Under Section 163(j), a taxpayer can deduct business interest for a taxable year in an amount not exceeding the sum of:
  - the business interest income of such taxpayer for such taxable year,
  - 30% of the adjusted taxable income of such taxpayer for such taxable year, plus
  - the floor plan financing interest of such taxpayer for such taxable year
Section 163(j) limitation: ATI

- Adjusted Taxable Income (ATI) is taxable income without regard to certain items, including (but not limited to):
  - Any deduction under 199A
  - Items not properly allocable to a trade or business
  - Business interest expense or income
  - NOLs
  - Depreciation and amortization deductions
  - Capital loss carrybacks or carry forwards
Follow the Money - Example 1

- A partnership is engaged in a qualified business for purposes of 199A and a non-excepted business for purposes of 163(j)
  - Business Income: $100,000,000
  - Business Deductions (non-199A, non-163(j)): $25,000,000
  - Business Interest Expense: $45,000,000
Follow the Money - Example 1, cont.

- First, determine Adjusted Taxable Income (ATI) and 163(j) Limit

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Income</td>
<td>100,000,000.00</td>
</tr>
<tr>
<td>Less: Business Deductions (Non-199A, Non-163(j))</td>
<td>25,000,000.00</td>
</tr>
<tr>
<td>Adjusted Taxable Income</td>
<td>75,000,000.00</td>
</tr>
<tr>
<td>Multiplied by</td>
<td>30%</td>
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<tr>
<td><strong>163(j) Interest Limit</strong></td>
<td>22,500,000.00</td>
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<tr>
<td>Interest Carryover</td>
<td>17,500,000.00</td>
</tr>
</tbody>
</table>
Follow the Money – Example 1, cont.

- Then, using the 163(j) interest limit, determine 199A deduction

<table>
<thead>
<tr>
<th>163(j) Interest Deduction Reduces QBI</th>
<th>If Full Interest Expense Reduced QBI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Income</td>
<td>100,000,000.00</td>
</tr>
<tr>
<td>Less: Business Deductions (Non-199A, Non-163(j))</td>
<td>25,000,000.00</td>
</tr>
<tr>
<td>Less: 163(j) Limit Interest Expense</td>
<td>22,500,000.00</td>
</tr>
<tr>
<td>QBI</td>
<td>52,500,000.00</td>
</tr>
<tr>
<td>Multiplied by</td>
<td>20%</td>
</tr>
<tr>
<td>20% QBI Deduction</td>
<td>10,500,000.00</td>
</tr>
</tbody>
</table>

**Note:** The 20% QBI Deduction calculation is based on the reduced QBI amount after applying the 163(j) interest limit and subtracting non-199A, non-163(j) business deductions.
Finally, calculate Taxable Income

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>163(j) Interest Deduction Reduces QBI</th>
<th>If Full Interest Expense Reduced QBI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Income</td>
<td>100,000,000.00</td>
<td>Business Income</td>
</tr>
<tr>
<td>Less: Business Deductions (Non-199A, Non-163(j))</td>
<td>25,000,000.00</td>
<td>Less: Business Deductions (Non-199A, Non-163(j))</td>
</tr>
<tr>
<td>Less: 163(j) Limit Interest Expense</td>
<td>25,000,000.00</td>
<td>Less: 163(j) Limit Interest Expense</td>
</tr>
<tr>
<td>Less: 199A Deduction</td>
<td>10,500,000.00</td>
<td>Less: 199A Deduction</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>39,500,000.00</td>
<td>Taxable Income</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>45,500,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income</td>
<td>45,500,000.00</td>
</tr>
</tbody>
</table>
Follow the Money - Example 2

- Same facts as before, however the partnership is engaged in a real property trade or business that qualifies for the QBI deduction and is an electing real property trade or business not subject to the 163(j) limit.
  - Business Income: $100,000,000
  - Business Deductions (non-199A, non-163(j)): $25,000,000
  - Business Interest Expense: $45,000,000
Follow the Money - Example 2

• First, calculate the QBI deduction
  • Electing real property trades or businesses are not subject to the 163(j) business interest expense limitation

<table>
<thead>
<tr>
<th>Business Income</th>
<th>100,000,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Business Deductions (Non-199A, Non-163(j))</td>
<td>25,000,000.00</td>
</tr>
<tr>
<td>Less: Full Interest Expense</td>
<td>40,000,000.00</td>
</tr>
<tr>
<td>QBI</td>
<td>35,000,000.00</td>
</tr>
<tr>
<td>Multiplied by</td>
<td>20%</td>
</tr>
<tr>
<td>20% QBI Deduction</td>
<td>7,000,000.00</td>
</tr>
</tbody>
</table>
Then, using the full interest expense and the 20% Deduction calculate taxable income

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Income</td>
<td>100,000,000.00</td>
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<tr>
<td>Less: Business Deductions (Non-199A, Non-163(j))</td>
<td>25,000,000.00</td>
</tr>
<tr>
<td>Less: Full Interest Expense</td>
<td>40,000,000.00</td>
</tr>
<tr>
<td>Less: 199A Deduction</td>
<td>7,000,000.00</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>28,000,000.00</td>
</tr>
</tbody>
</table>
Issue 7: 2018 Fiscal Year Issues
Facts

• Client files tax returns on a fiscal year basis, with a fiscal year end of 9/30/18
• How does client calculate the Section 199A deduction?
Fiscal Year Filers and Section 199A

• Fiscal year filers for year ended in 2018 are entitled to Section 199A on full year taxable income

• W-2 wages for wage limitation are based on the calendar year ending during the taxpayer’s year, or December 31, 2017 in this example
Fiscal Year Filers and Section 199 for Years Beginning in 2017

- Outstanding question on whether Section 199 Domestic Producer’s Activity Deduction will be available for the fiscal year filers
  - Informal IRS Guidance
  - Blue Book (recently released)
  - Pending technical corrections bill
Issue 8: Flowthrough Tax Distributions
Facts

- Client is a partnership operating in a qualified business that has agreed to make tax distributions to cover the federal tax liability of its owners.
- They are considering whether they should take into account the Section 199A deduction in calculating its tax distributions.
Example 1 - Tax Distributions with Unlimited QBID Deduction

- **Year 1:** Partnership 1 - $1M income with sufficient wages. $296K of tax distributions
- Partnership 2 - $0.5M Loss
  - Net QBI of $0.5M
  - The $0.5M loss benefits at 29.6%
  - Extra $148K of tax distributions from Partnership 1
- **Year 2:** When Partnership 2 has $1M of income and sufficient wages, they receive $148K of distributions and they use the $148K overpayment from Year 1

<table>
<thead>
<tr>
<th></th>
<th>Tax Distributions</th>
<th>Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$296K (P1)</td>
<td>$148K (500K x 29.6%)</td>
</tr>
<tr>
<td>Year 2</td>
<td>$148K (P2)</td>
<td>$296K (1M x 29.6%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$444K</strong></td>
<td><strong>$444K</strong></td>
</tr>
</tbody>
</table>
Example 2 - Some QBI Businesses Are Wage/UBIA Limited

- What if Partnership 1 is $0 limited (and makes tax distributions at 37%)? Partner Windfall

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Tax Distributions (P1)</th>
<th>Tax Due (500K x 37%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$370K</td>
<td>$185K</td>
</tr>
<tr>
<td>Year 2</td>
<td>$148K</td>
<td>$296K (1M x 29.6%)</td>
</tr>
</tbody>
</table>

$518K

$481K

- What if Partnership 2 is $0 limited (and makes tax distributions at 37%)? Distribution shortage

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Tax Distributions (P2)</th>
<th>Tax Due (500K x 29.6%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$296K</td>
<td>$148K (500K x 29.6%)</td>
</tr>
<tr>
<td>Year 2</td>
<td>$185K</td>
<td>$370K (1M x 37%)</td>
</tr>
</tbody>
</table>

$481K

$518K
Example 3: QBI Loss Connected with Sale

- Bob is a partner in our client
- Unrelatedly, Bob’s S corporation sold assets in 2018 for $500M
- There is no ordinary recapture (all intangible value) or basis. $500M of capital gain
- The Company pays deductible transaction costs and transaction bonuses of $80M
- The transaction costs and bonuses offset capital gain on the 2018 return (effective 20% rate)
- QBI loss carryover is $80M, which will taint QBI for years to come
Issue 9: M&A Considerations
Facts

• S corporation operates a QTB and plans to sell all its stock on December 31, 2018 and the parties have agreed to make a Section 338(h)(10) election
• Buyer has proposed delaying the sale to January 1, 2019
• The gain on sale will be $100M, of which $50M relates to ordinary gain from depreciation and intangible recapture
• Should the seller agree?
Taxation of gains on sale

- QBI does not include any capital gains or losses
  - While not specifically addressed, unrecaptured section 1250 gain is a capital gain taxed at a higher tax rate, so would not be eligible
- However, items of gain that are not capital gain can be QBI
  - Section 1231 gain taxed as ordinary, including ordinary section 1245 and 1250 recapture or 1231 recapture
  - Section 751 hot assets for a partnership
Taxation of gains on sale

• In the example, the $50M of ordinary gain may have been entitled to a $10M deduction, assuming sufficient wages paid during the year

• Delaying the sale to January 1 may severely limit the QBI deduction
  • Wages paid on January 1 - Limited to transaction bonuses, if any?
  • UBIA is $0, because it is tested at the close of the taxable year

• What if the parties have agreed to a gross up payment on the difference between stock and asset deal?
Questions?