CREATIVE PLANNING WITH 199A

Presented to the American Bar Association Tax Section Mid-Year Meeting

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Deduction Is Provided For Qualified Business Income

Qualified business income is “active trade or business income,” and must come only from one of the following five places:

1. S corporation K-1 income (includes income from LLCs taxed as S corporations).

2. Partnership K-1 income (includes income from LLCs taxed as partnerships).

3. Trade or Business income reported on Schedule C of a taxpayer’s Form 1040 (includes income from single member LLC that is disregarded for income tax purposes).

4. Net rental income reported on Schedule E of Form 1040, from an “active trade or business.”

5. Farm income reported on Schedule F of Form 1040.

6. Section 501(c)(3) organizations receiving Unrelated Business Taxable Income (“UBTI”) may qualify. IRS indicated in Preamble to Final Regulations that they are continuing to study this issue.

**Note** - For most taxpayers, K-1 income is cash based, but pension deductions are commonly accrued - you have until December 31st to put new pension plans into place that may be funded next year for 199A and other planning.

**Trap for Unwary** - Don’t make contributions to a SEP-IRA or 401k before determining what plans the client will want for the year – once contributions are made, plans cannot be changed.
### Two Main Rules To Know
(Besides that taxpayers below the threshold can typically take the deduction, most of the time.)

<table>
<thead>
<tr>
<th>1</th>
<th>Specified Service Trade or Business (“SSTB”)</th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>A</strong></td>
<td>Taxpayer's Taxable Income is under $315,000 for Taxpayers married filing jointly, or $157,500 for single filers ($160,700 and $321,400 for 2019)</td>
<td><strong>No Limitation applies</strong></td>
</tr>
</tbody>
</table>
| **B** | Taxpayer's Taxable Income is between $315,000-$415,000 for Taxpayers married filing jointly or $157,500-$207,500 for single filers | Limitation is phased in by the amount Taxable Income exceeds threshold amount
Example – Married with Taxable Income of $365,000. Deduction is equal to 10% of QBI (50% ((365-315)/100) * 20% Deduction. |
| **C** | Taxpayer's Taxable Income exceeds $415,000 for Taxpayers married filing jointly or $207,500 for single filers | **No Deduction** |

<table>
<thead>
<tr>
<th>2</th>
<th>Wage and Qualified Property Test</th>
<th></th>
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<tbody>
<tr>
<td><strong>A</strong></td>
<td>Taxpayer's Taxable Income is under $315,000 if married filing jointly, or $157,500 for single filers</td>
<td><strong>No Limitation applies</strong></td>
</tr>
<tr>
<td><strong>B</strong></td>
<td>Taxpayer's Taxable Income is between $315,000-$415,000 if married filing jointly or $157,500-$207,500 for single filers</td>
<td>Limitation is phased in by the amount Taxable Income exceeds threshold amount</td>
</tr>
<tr>
<td><strong>C</strong></td>
<td>Taxpayer's Taxable Income Exceeds $415,000 if married filing jointly or $207,500 for single filers</td>
<td>Limitation applies unless 50% of Wages, or 25% of Wages plus 2.5% of Qualified Property, are met at the entity level</td>
</tr>
</tbody>
</table>
Important Definitions You Need To Know

**Qualified Business Income ("QBI")** – Active trade or business income from flow through entities such as S corporations, entities taxed as partnerships, LLCs, disregarded entities, and Schedule C entities such as sole proprietorships effectively connected to a US trade or business. This does not include monies earned as wages, reasonable compensation, or “guaranteed payments” from entities taxed as partnerships.

**Specified Service Trades or Businesses ("SSTB")** - Categories of businesses or activities which will not qualify for the flow-through deduction if the individual taxpayer reporting QBI has taxable income exceeding the levels described in slide 10.

**Unadjusted Basis Immediately After Acquisition of Qualified Property ("UBIA")** – Cost basis of physical assets, including real estate, furniture and equipment owned by a flow-through entity at the end of the taxable year which has not reached the date that is the later of (a) the end of the depreciable life; or (b) ten years from acquisition.

**W-2 Wages** - Compensation paid to employees of a flow-through entity (including pension contributions and other elective deferrals), which does not include (1) wages earned by an individual taxpayer from sources other than a flow-through entity; (2) compensation paid to independent contractors; or (3) income that is subject to self-employment taxes, if not paid and treated as wages paid to an employee.

**Effectively Connected Income** – Income that is derived from assets used in or held for use in the US, and the activities of the US business were a material factor in the realization of such income. Puerto Rico based income will also qualify.

**Guaranteed Payments** – Payments made by a partnership to partners without regard to the partnership’s income, which are not considered wages under applicable wage and partnership law.

**IRS Notice 2019-7** – Providing the 250 hour safe harbor test for non-triple net lease rental activities to be considered as an active trade or business.
## Combining Operations vs. Aggregating Entities

<table>
<thead>
<tr>
<th>COMBINING</th>
<th>AGGREGATING</th>
</tr>
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<tbody>
<tr>
<td>Refers to combining the activities of separate entities owned and operated by the same taxpayer for purposes of satisfying the active trade or business test under IRC Section 162.</td>
<td>Refers to the ability to have separately owned trades or businesses, which may be in separately owned entities, aggregate their wages and/or qualified property, so that high income owners can qualify for a Section 199A deduction.</td>
</tr>
<tr>
<td>Separate trades or businesses may not have sufficient activity to be considered an active trade or business, in which event no Section 199A deduction would be permitted.</td>
<td>These rules are summarized at slides 64-67.</td>
</tr>
</tbody>
</table>
Important Definitions You Need To Know

For the purposes of this presentation:

• We refer to the trade or business entity as being the flow-through entity.

• We refer to the owner or part owner of the entity as the “taxpayer.”

For example, if John Smith and a complex trust formed by John Smith are partners in a widget business, then John Smith and the complex trust are “taxpayers” and the widget business is a “flow-through entity,” assuming that it is taxed as a partnership or an S corporation.

• For the layman, the term “partnership” refers to an entity taxed as a partnership. LLCs can be taxed as disregarded, partnerships, S corporations or C corporations.
The Following Are Abbreviations That Are Used In The Regulations, And Their Meaning:

<table>
<thead>
<tr>
<th>The Regulations use the following new abbreviations:</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>PTP</td>
<td>Publicly Traded Partnership</td>
</tr>
<tr>
<td>QBI</td>
<td>Qualified Business Income</td>
</tr>
<tr>
<td>REIT</td>
<td>Real Estate Investment Trust</td>
</tr>
<tr>
<td>RPE</td>
<td>Relevant Pass-Through Entity</td>
</tr>
<tr>
<td>SSTB</td>
<td>Specified Service Trade or Business</td>
</tr>
<tr>
<td>UBIA</td>
<td>Unadjusted Basis Immediately After Acquisition (of Qualified Property)</td>
</tr>
<tr>
<td>DNI</td>
<td>Distributable Net Income (applies to trusts and estates)</td>
</tr>
</tbody>
</table>
**Items Relating To: Individual Taxpayers**

**Qualified Business Income (Section 199A)**

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Tax Year 2018</th>
<th>Tax Year 2019</th>
<th>Tax Year 2020</th>
</tr>
</thead>
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<tr>
<td>Single</td>
<td>$157,500</td>
<td>$160,700</td>
<td>$163,300</td>
</tr>
<tr>
<td>Married Jointly</td>
<td>$315,000</td>
<td>$321,400</td>
<td>$326,600</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$157,500</td>
<td>$160,700</td>
<td>$163,300</td>
</tr>
</tbody>
</table>

**2019 Phase-out**

- Married Filing Jointly - $321,400 – $421,400
- Single/Head of Household - $160,700 – $210,700

**QBI INCREASED BY STANDARD DEDUCTION**

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Tax Year 2018</th>
<th>Tax Year 2019</th>
<th>Tax Year 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$157,500 + $12,000 = $169,500</td>
<td>$160,700 + $12,200 = $172,900</td>
<td>$163,300 + $12,400 = $175,700</td>
</tr>
<tr>
<td>Married Jointly</td>
<td>$315,000 + $24,000 = $339,000</td>
<td>$321,400 + $24,400 = $345,800</td>
<td>$326,600 + $24,800 = $351,400</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$157,500 + $18,000 = $175,500</td>
<td>$160,700 + $18,350 = $179,050</td>
<td>$163,300 + $18,650 = $181,950</td>
</tr>
</tbody>
</table>

$172,900 x 7.4% = $12,794.60

3.8% of $172,900 is $6,570.20

$12,794.60 + $6,570.20 = $19,364.80
Potential Section 199A Savings

**High Income Taxpayer with No Section 199A Deduction**

Total Taxes on $169,500 of Income at 40.8% (37% + 3.8%) = $69,156 of Income Taxes

**Low Income Taxpayer with No Section 199A Deduction**

$169,500 of Income for Single Taxpayer = $32,090 of Income Taxes

(20.37% Effective Rate)

Savings From Income Tax Rate Brackets and Medicare Tax
(Assuming No Section 199A Deduction) = $37,067

**Low Income Taxpayer with Section 199A Deduction**

$169,500 of Income for Single Taxpayer = $23,954 of Income Taxes

(19.38% Effective Rate)

Additional Section 199A Savings = $13,113

Total Savings if Kiddie Tax and 3.8% NIIT Avoided = $45,203
The Kiddie Tax was modified and taxes a child’s unearned investment income over a certain threshold if the child is under 18, or over 18 but under 24 if a “full-time student” without significant earned income. Under prior law, unearned income of the child was taxed at the parents’ rates. Under the 2017 Tax Act, unearned income will be taxed using the trust tax rates, which are as follows:

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<tr>
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<tbody>
<tr>
<td>$0 – $2,550</td>
<td>$0 – $2,600</td>
<td>$0 – $2,600</td>
<td>10%</td>
</tr>
<tr>
<td>$2,551 – $9,150</td>
<td>$2,601 – $9,300</td>
<td>$2,601 – $9,450</td>
<td>24%</td>
</tr>
<tr>
<td>$9,151 – $12,500</td>
<td>$9,301 – $12,750</td>
<td>$9,451 – $12,950</td>
<td>35%</td>
</tr>
<tr>
<td>$12,501 +</td>
<td>$12,751 +</td>
<td>$12,951 +</td>
<td>37%</td>
</tr>
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The lower trust brackets save $1,643 in income taxes on the first $12,750 of income. This increases to $2,127 if the 3.8% Net Investment Income Tax is also saved (additional savings of $2,127-$1,643=$484).

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</thead>
<tbody>
<tr>
<td>$0 – $2,600</td>
<td>$0 – $2,650</td>
<td>$0 – $2,650</td>
<td>0%</td>
</tr>
<tr>
<td>$2,661 – $12,700</td>
<td>$2,651 – $12,950</td>
<td>$2,651 – $13,150</td>
<td>15%</td>
</tr>
<tr>
<td>$12,701 +</td>
<td>$12,951 +</td>
<td>$13,151 +</td>
<td>20%</td>
</tr>
</tbody>
</table>

A student is “full-time” if enrolled on the first day of at least five calendar months in the year.

“Turn on, Tune in, Drop out” – Timothy Leary
Kiddie Tax And Trust Tax Rates

The Kiddie Tax will NOT apply if the child’s earned income exceeds one-half (1/2) of the support provided by the parents.

For example, if the child earns $13,000 as a part time employee of the parents’ law office and the parents provide the child with $25,000 of support during the tax year, then the child would NOT be subject to the Kiddie Tax. If the child only earned $10,000, then the child would be subject to the Kiddie Tax.

The BNA Portfolio on the subject states that “support” includes food, shelter, clothing, medical and dental care, education, and similar items. Support also includes real property insurance, renter insurance, medical insurance, the cost of such items as maid or housekeeping services, laundry and dry cleaning, babysitters, child care, vitamins, toys, bicycle repairs, telephones, televisions, book club costs, hair styling and haircuts, pets, entertainment, wedding expenses, vacations, gifts, and charitable contributions by or on behalf of the individual.

Educational expenses do not include amounts received as scholarships, and there are conflicting views as to whether distributions from 529 plans count as "support", and the IRS has not formally or informally addressed this in any guidance.

Some practitioners take the position that since the student is taxed on non-qualified 529 plan distributions (distributions not used for educational expenses), payments from 529 plans should be considered as contributed by the student for his or her own support.

Others say that if the parent is the owner of the account and can change the beneficiary of the account then it should be considered as support provided by the parent.
Potential Section 199A Savings

Be on the lookout for the following individuals that a client may shift income to in order to maximize Section 199A tax savings:

1. Age 25 and older with low income
2. Between 18 and 24 and not a full-time student
3. Low income parents and others to support
4. Significant others, not married
5. Brothers - and sisters-in-law
Qualified Business Income ("QBI") Must Be Income from an “Active Trade or Business”

The Final Regulations tell us to use the IRC Section 162 definition, so the following rules apply:

a. Definition is from IRC Section 162.
   i. Must be active and continuous.
   ii. Must have entrepreneurial risk and profit motive.

b. Like pornography – the courts know it when they see it.

c. Triple Net and other “low landlord responsibility” arrangements will usually not be sufficient.

d. Whether an activity rises to the level of a trade or business is measured at the individual or Relevant Pass Through Entity (RPE) level. Each separate trade or business must be measured independently, regardless of whether the trades or businesses are owned by the same taxpayer or under the same entity.

Activities conducted by owners, employees, and agents under separate taxable entities (entities taxed as partnerships and S Corporations) cannot be aggregated to determine whether cumulative activities and entrepreneurial risk is sufficient for an activity to be considered a trade or business.
Combining Multiple Entities For Active Trade Or Business Measurement Purposes

Four separate LLCs, each taxed as partnerships – Each LLC must separately rise to the level of a Trade or Business

Each LLC contributes its business to a new co-owned partnership. Now the consolidated operations are under one entity to allow the taxpayer to combine all the LLCs activities to determine if active trade or business exists but increases liability exposure – consider leveraging.
A and B contribute their 50/50 ownership of the four LLCs to a new HoldCo, LLC taxed as a partnership. Activities of LLCs can be combined to determine if HoldCo is a Trade or Business.
Qualified Business Income ("QBI") Must Be Income From An “Active Trade Or Business”

1. Activities conducted by owners, employees, or agents under commonly owned disregarded LLCs and/or Q-subs (Qualified Subchapter S Subsidiaries) held by the same person, a married couple, or an entity taxed as a partnership or S corporation can be combined for this purpose.

   This is completely separate and apart from whether separate trades or businesses can be aggregated for wage and for qualified property testing.

2. The Final Regulations indicate that commonly owned commercial and residential real estate cannot be combined for active trade or business testing. It is unclear if they can be combined if they are intricately integrated (such as being in the same building) when other qualifications are met, and the Final Regulations make no mention of this other than simply stating that commercial and residential real estate cannot be combined.

3. The case law confirms that work and efforts put forth by employees, independent contractors, management companies, repair companies, and others can be considered to be activities of the taxpayer on whose behalf they work.

4. Interest income from lending activities that are not “an active trade or business” will not qualify.

5. IRS Notice 2019-7 provides a safe harbor for landlords that will not apply to triple net leases and will require at least 250 hours of contemporaneous recording of functions, as described later in this PowerPoint.

   If and when rental real estate is an active trade or business is discussed later in this presentation.
Under the Final Regulations, most triple net leases will not qualify as a Trade or Business for the purpose of determining eligibility for the Section 199A deduction.

Exception for related party leasing - Under the Final Regulations, a passive lease to an active trade or business where the tenant is an S corporation, partnership, or individual taxpayer with related party ownership will be considered active if the tenant is not a Specified Trade or Business.

The Final Regulations provide that the related party leasing exception will not apply when property is rented to a commonly owned C corporation – the Proposed Regulations held otherwise.

An active lease between a specified trade or business and affiliated owner will be considered to be a separate Specified Trade or Business under the Final Regulations.
Top Planning Opportunities

1. Shift Section 199A Income to Lower Taxpayers

2. Use of Section 678 Trusts, Qualified Sub-Chapter S Trusts and Other Vehicles to Transfer Active Income to Low Income Relatives

3. Taking Advantage of the Benefits of the Use of a Complex Trust (If the Anti-Abuse Rules Under the Final Regulations Can be Avoided)

4. Using Pension, Cash Balance, and Defined Benefit Plans to Reduce Taxable Income

5. Taking Advantage of Other Ways to Reduce a Taxpayer’s Income Below Threshold Amounts

6. Use of Management, Marketing, Billing, Factoring and Other Entities for High Income Taxpayers with Rental Real Estate or SSTBs

7. Aggregation of Multiple Entities to Calculate the Wage/Qualified Property Limitation at the Individual or Entity Level

8. Safer To Use Separate Accounts To Separate SSTB and Non-SSTB Activities, or at Least Make Sure That Activities Are Separable

9. Restructuring Partnerships to Avoid Guaranteed Payments

10. More Active Arrangements for Landlords

11. Changing Employees to Independent Contractors and Independent Contractors to Employees Depending Upon Circumstances
Top Mistakes/Traps For The Unwary

1. Not Understanding the Definition of SSTBs – Not as Simple as They First Appear

2. Failure to Assure That Separate Books and Records Can Be Created When Needed to Separate SSTB from Non-SSTB Businesses Held by a Single Entity – Or Separate Then Into Separate Entities

3. Transfer Ownership to Taxpayers who are Under the $157,500/$315,000 Thresholds

4. Not Planning Ahead for Wages/Qualified Property

5. Not Reporting W-2 Wages/Qualified Property on Appropriate Forms

6. Failure to Realize that an Election to Aggregate is Permanent, or That Aggregation at the Entity Level can Prevent Aggregation at the Individual Level in Certain Circumstances

7. Failure to Convert Triple Net Leases to Active Lease Businesses

8. Failure to Maintain Contemporaneous Time Records When Relying on Real Estate Safe Harbor

9. Failure to Have Otherwise Aggregatable Businesses Share Facilities or Significant Centralized Business Elements to Share Wages and Property

10. Not Reconsidering Choice of Entity

11. Failure to Shift Debt to Allow Interest Expense to Apply to Non-QBI Income Where Applicable, and Coordinate with Creditor Planning

12. Failure to Warn About Substantial Understatement Penalty

13. Failure to Consider Employment Taxes
Whether To Report 2018 Income Under The Proposed Regulations Or Final Regulations

The Final Regulations confirm that for 2018, a taxpayer may choose to follow the Proposed Regulations or the Final Regulations, but not partly from one or partly from the other.

For example, the Proposed Regulations were more generous than the Final Regulations on the question of whether a medical related business or professional who does not directly interact with patients will be considered to be an SSTB.

Certain owners of radiology groups and practices may therefore prefer to use the Proposed Regulations on this point, but would then not have the benefit of Final Regulation advantages.

On the other hand, the FINAL REGULATIONS are much more favorable than the PROPOSED REGULATIONS in a number of ways, and can not be relied upon if the PROPOSED REGULATIONS are used, or for any year after 2018.
# Proposed vs. Final Regulations Under Section 199A

<table>
<thead>
<tr>
<th>Reasons to Rely Upon Proposed Regulations for 2019</th>
<th>Reasons to Rely Upon Final Regulations for 2019</th>
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<tbody>
<tr>
<td>A flow-through entity renting property to a commonly controlled C corporation will be considered an active trade or business whereas the Final Regulations require that the property be rented to another flow-through entity or an individual.</td>
<td>Taxpayers may take into account Section 743 basis adjustments including 754 elections for partnerships.</td>
</tr>
<tr>
<td>The field of health was limited to those who provide medical services directly to patients which could be beneficial for those in the health field that do not have direct contact with patients.</td>
<td>Taxpayers may aggregate at the entity level.</td>
</tr>
<tr>
<td>An entity that provides services to a commonly controlled SSTB will be treated as part of the SSTB that it is providing services to. This could be beneficial to taxpayers within the phase-out range if the entity providing services does not have sufficient wages or qualified property to qualify for the Section 199A deduction and would be impacted by the double phase-out. The Final Regulations require the entity providing services to be treated as a separate SSTB which would require separate testing under the wage and qualified property test.</td>
<td>UBIA will be carried over when property is contributed to a partnership or an S corporation.</td>
</tr>
<tr>
<td>ESBTs - Electing Small Business Trusts may be able to use two threshold limitations, one for the S portion of the trust and another for the non-S portion of the trust under the Proposed Regulations.</td>
<td>The incidental rule that would require an SSTB offering products or services as part of the SSTB to be more than 5% of gross receipts in order to be considered separate and apart from the SSTB.</td>
</tr>
<tr>
<td>Examples under the multiple trust rules were deleted from the Final Regulations which provided additional guidance on when a trust is considered to have substantially different beneficiaries.</td>
<td>Presumption that a former employee who becomes an independent contractor remains an employee only applies for three years.</td>
</tr>
</tbody>
</table>
## Proposed vs. Final Regulations Under Section 199A, Continued

<table>
<thead>
<tr>
<th>Reasons to Rely Upon Proposed Regulations for 2019</th>
<th>Reasons to Rely Upon Final Regulations for 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Siblings were not considered to be related parties for purposes of determining whether 50% or more ownership of an entity deriving income from an SSTB would cause the service provider or landlord to be an SSTB.</td>
<td>Under the anti-abuse rules the Proposed Regulations provided that if the trust was funded for the “significant purpose of receiving a deduction under Section 199A” it would not be respected whereas the Final Regulations changed this to “a principal purpose of using more than one threshold” which seems to be a lower standard.</td>
</tr>
<tr>
<td></td>
<td>The Final Regulations do not include a presumption that the trust was formed or funded for a principal purpose if a significant income tax benefit would result.</td>
</tr>
<tr>
<td></td>
<td>Trusts have the ability to take into account distributable net income (“DNI”) deduction for distributions made from a trust.</td>
</tr>
</tbody>
</table>
What IRS Personnel Said In May 2019 Webinars

1. Separate books and records may not be required to separate SSTB and non-SSTB income as long as the businesses and reporting are “separable”.

“The language was always intended to be separable, and separable does mean that the trades or business do not actually be, have to be separated as you noted. But the books and records must be separable and this is a concept from law that’s existed, well prior to Section 199A, separate trades or businesses can’t be found though if the books and records are not separable. But if the books and records are separable, then each business must still be considered a separate trade or business under Section 162, and then if there are multiple trades or businesses that exist under Section 162 and one of those trades or businesses is an SSTB, income from the other trades or businesses could still be eligible for the 199A Section.”

- Audrey Ellis, Office of Tax Policy, Department of the Treasury speaking in a recent ABA Webinar on Section 199A.

The Preamble to the Final Regulations states the following:

The Treasury Department and the IRS also believe that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under §1.446-1(d). Section 1.446-1(d) explains that no trade or business is considered separate and distinct unless a complete and separable set of books and records is kept for that trade or business.

Further, trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected.

2. For purposes of applying the Section 267(b) and 707(b) attribution rules, all the relevant rules under Section 267 and 707 will apply, including the constructive ownership rules under Section 267(c).
3. Income from trusts formed or funded for purposes of avoiding tax under 199A may be aggregated with the grantor even if income is distributed to a beneficiary for purposes of determining whether the income threshold limitation is met, as per the example on the following slide.

The Final Regulations state the following:

Treas. Reg. 1.199A-6(d)(3)(iv) - For purposes of determining whether a trust or estate has taxable income in excess of the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under Sections 651 or 661.

Treas. Reg. 1.199A-6(d)(3)(vii) - A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of Section 199A.

See surprising example on the next page.
Example Used in April 4, 2019 ABA Webinar

Mom - $200,000 of Income but $400,000 of Income for purposes of applying 199A threshold
Son - $100,000 of Income
Trust - $100,000 of Income
Result - NOT eligible for 199A
*but unclear whether Mom has $300,000 or $400,000 of SSTB income for measurement purposes
Calculating Phase-Out Situations When They Apply

It gets very complicated when a taxpayer during the phase-out has an interest in an SSTB that does not fully satisfy the wage/qualified property test.

<table>
<thead>
<tr>
<th>Scenario:</th>
<th>$315,000</th>
<th>$340,000</th>
<th>$365,000</th>
<th>$390,000</th>
<th>$415,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specified Service Income - $100,000</td>
<td>20%</td>
<td>15%</td>
<td>10%</td>
<td>5%</td>
<td>0%</td>
</tr>
<tr>
<td>Wages - $60,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Specified Service Income - $100,000</td>
<td>20%</td>
<td>11.25%</td>
<td>5%</td>
<td>1.25%</td>
<td>0%</td>
</tr>
<tr>
<td>Wages - $0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Specified Service Income - $100,000</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Wages - $60,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Specified Service Income - $100,000</td>
<td>20%</td>
<td>15%</td>
<td>10%</td>
<td>5%</td>
<td>0%</td>
</tr>
<tr>
<td>Wages - $0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Specified Service Income - $100,000</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Wages - $20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property - $600,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Specified Service Income - $100,000</td>
<td>20%</td>
<td>17.5%</td>
<td>15%</td>
<td>12.5%</td>
<td>10%</td>
</tr>
<tr>
<td>Wages - $10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property - $200,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Significant Changes In Final Regulations

1. The new definition of “performance of services in the field of health” is no longer limited to those who provide medical services directly to a patient, which significantly broadens this definition. Examples in the Regulations indicate that medical services integrated with advice provided to doctors to assist them in treating patients will be considered services rendered in the field of health.

The IRS apparently thinks that pharmacies, adult congregate facilities, surgery centers and testing operations can escape SSTB services by not providing “health services” to patients, or by having independent parties provide the medical services associated with the facility or operation.

2. “Legal services” will not include stenography services, delivery, and presumably printing/copying activities, acting as Trustees or Personal Representatives, and perhaps educational services.

3. The presumption of being in the trade or business of being an “employee” was limited to a period of three years, and can be overcome by simply meeting the normal criteria for independent contractor classification.

4. Financial Services definition has been changed to clarify that taking deposits and making loans is not an SSTB service, but arranging lending transactions between lenders and borrowers is an SSTB service.
5. Dealing in Securities definition has changed. Previously, taxpayers engaging in negligible sales of loans were not considered to be dealing in securities. The new language states that performing services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is dealing in securities.

6. Hedging transaction income earned by manufacturers and farmers in the normal course of their business is not SSTB income.

7. Eliminated the 5% incidental SSTB limitation whereby SSTB’s providing products and/or services that were incidental to their SSTB trade or business would need to exceed 5% of the total combined gross receipts of the trade or business in order to be considered a separate trade or business and not be aggregated as part of the SSTB.

8. A trade or business with more than 50% common ownership with an SSTB will be considered to be an SSTB to the extent that the taxable income is derived from providing products and/or services to the SSTB. The Proposed Regulations had provided that a trade or business with at least 50% common related party ownership that provided more than 80% of its sales or services to an SSTB would be treated entirely as an SSTB.
9. The Final Regulations confirm that the SSTB limitation also applies to publicly traded partnerships (PTPs), but not real estate investment trusts (REITs).

- REIT income receives the deduction regardless of wages, qualified property, triple net leases, or whether the REIT may also own an SSTB.

- Publicly traded partnerships are treated the same way, except that the SSTB rules will apply to PTP income attributable to an SSTB owned by the PTP.

- Mutual funds holding REITs will now qualify provided that fund was held for at least 45 days during the 91 day period beginning 45 days prior to the ex-dividend date and ending 45 days after the ex-dividend date.

10. High earner taxpayers owning an SSTB can own 49% (with unrelated parties having 51%) of a separate entity that sells products to or provides services for the SSTB – their 49% share of the SSTB income is not subject to the SSTB limitation.

Get divorced and have your ex-spouse own 51% of a management company, especially if he or she likes to manage.

11. Consulting in the fields of architecture and engineering are not treated as being SSTB.

Consulting is defined as the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems.

Consulting does not include the performance of services other than advice and counsel, such as providing training and educational courses.

Consulting includes lobbying and other similar professionals performing services as consultants. Consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.

Most staffing services will not be treated as consulting, based upon an example added to the Final Regulations.
12. Life Insurance Agents selling commissioned-based sales of life insurance products are non-SSTB.

13. The Final Regulations allow a partnership to take into account basis adjustments using a modified version of Section 743(b) when a Section 754 election is in place, but any prior depreciation taken is not restored for UBIA purposes. The increase is allowed to the extent that it is attributable to an increase in the fair market value of the property from the original UBIA of the property, but not to the extent of depreciation that would be recaptured.

For example, A, B and C are equal partners in ABC partnership. A, B and C purchase a building for $900,000, and each partner’s share of the UBIA is $300,000.

A later sells his interest to D for $500,000 when the building is worth $1,500,000 and the tax basis of the building is $600,000 (assuming $300,000 of depreciation has been taken). Under a typical 743 basis adjustment, D would receive a basis adjustment of $300,000. However, for purposes of Section 199A, this adjustment is limited to $200,000, which is the difference between the purchase price ($500,000) and A’s original UBIA in the property ($300,000). The depreciated portion is not restored for UBIA purposes.

The $200,000 “excess 743(b) basis adjustment” is treated by D as a new item of qualified property that is placed into service on the day the partnership interest was transferred.
14. The Final Regulations corrected the taxpayer unfriendly position under the Proposed Regulations that the UBIA of property contributed to an S corporation or Partnership would be based upon the tax basis of the property on the date of contribution, which could result in a step-down in basis if property was depreciable.

The Final Regulations provide that the UBIA of contributed property will retain the basis of the property when it was first placed into service by the contributing partner or shareholder.

15. Siblings are now included in the definition of related parties under the Final Regulations. They were not included in the Proposed Regulations.

16. Income derived from “guaranteed payments” for the use of capital that is paid to a taxpayer by a partnership cannot be included in qualified business income. Guaranteed payments made to a partner as compensation continue to not be considered as wages for purposes of the 50% wage test or the 25% wage/2.5% Qualified Property test.

17. The Final Regulations confirm that Qualified Property that receives a new fair market value basis due to the death of the owner under IRC Section 1014 will have a fair market value date of death UBIA, and will be considered to have been newly placed in service on the date of death, with a new depreciation period having started.

Note that depreciation recapture may not be added to basis if the decedent held a general power of appointment but was not an “owner.” IRC Section 1014(b)(9).
18. The Final Regulations provide that a separately taxed trust that is “formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A” will be considered as aggregated with its contributor for Section 199A purposes.

19. The Final Regulations were also changed from referencing “Trusts formed or funded...” under the Proposed Regulations to “A trust formed or funded...,” meaning that this will definitely apply to the creation of a single trust. The word “disrespected” was deleted from the Final Regulations. (Aretha Franklin died on the day the Proposed Regulations were issued with this word.)

20. The Final Regulations allow trusts to take into account the DNI deduction for distributions to beneficiaries but DNI distributed to beneficiaries may be aggregated with the grantor’s income for purposes of applying the threshold limitation.

21. Multiple trusts will share a single tax bracket and threshold under the new Section 643(f) Regulations, if they have all three of: (1) a common grantor or grantors; (2) common beneficiaries that may benefit from each trust; and (3) a principal purpose of avoidance of income tax.
22. Electing Small Business Trusts will have one $157,500 threshold for the combined, but separately tracked, S corporation K-1 and non-S corporation income thereof.

23. The Treasury released IRS Notice 2019-7 which provides a safe harbor for real estate rentals that are not triple net leases to be considered a trade or business, if a 250-hour per year test is satisfied.

24. The Final Regulations confirm that any property leased to a 50% or more related entity taxed as an S corporation, partnership, or proprietorship which is an active trade or business will be considered an active trade or business, even if it is a very passive triple net lease. SSTB rules still apply if there is 50% or more common related party ownership.

25. The Final Regulations confirm that the deduction does not apply for self-employment or Net Investment Income Taxes (NIIT) purposes.
How Do Losses Impact The Section 199A Deduction?

A. The Final Regulations take a netting approach, so that a taxpayer who has a loss from one trade or business, but a net gain when all of them are netted together, must apportion the net loss among the trades or businesses relative to the amount of gain for each of them. The Wage and Qualified Property of the trade or business producing the net loss are not considered when applying the Wage/Property limitation unless an election is made to aggregate the trades or businesses.

Example - John has three businesses. Business A produces $1,000,000 of QBI, Business B produces $500,000 of QBI, and Business C has a $600,000 net loss. Unless an election is made to aggregate the trades or businesses, the $600,000 loss will be allocated two-thirds to Business A, reducing Business A's QBI to $600,000 ($1,000,000 - $400,000), and one-third to Business B, reducing Business B's QBI to $300,000 ($500,000 - $200,000). John would then apply the Wage/Property Limitation separately to Business A and Business B to determine John's Section 199A deduction.

If an aggregation election is made, then the QBI from all trades or businesses must be netted together to determine the taxpayer's total QBI.

B. Losses that have been suspended or carried forward from before 2018 will not reduce the 199A income deduction – and when previously suspended losses are released or carried forward from multiple years, the oldest comes out first.

C. Applies both to NOLs and passive losses.
Definition Of Wages

For taxpayers with more than $157,500 of taxable income (or $315,000, if married), the full deduction (or any deduction whatsoever if over $217,500/$415,000) is lost, if the Qualified Business Income entity has not paid sufficient wages and/or does not have sufficient “Unified Basis Immediately After Acquisition (“UBIA”) ” basis.

Assuming no Qualified Property, the 199A deduction from any given entity or activity is limited to 50% of the wages allocated to the taxpayer.

**Example** - If the taxpayer’s share of Qualified Business Income is $100,000, the maximum deduction would be $20,000, and wages paid by the entity would need to be at least $40,000 ($20,000 x 2 = $40,000). $40,000 divided by $140,000 is 28.6%.

Therefore, a client that has not paid wages and would otherwise have $100,000 of income, and is a high earner, will need to pay $28,700 in wages to have $71,300 in 199A Qualified Business Income to deduct.

**Note** - that certain separate trades or businesses can be aggregated for Wage and Qualified Property testing purposes.
Wages include all W-2 payments made by a Schedule C, E or F trade or business, an S corporation or a partnership, except as follows:

(b) An individual Schedule C, E, or F owner cannot pay herself wages (but can pay wages to her spouse).

**Note:** That S corporations are required to pay reasonable wages to shareholders/owners who render valuable services. Several comments were received by the IRS in response to the Proposed Regulations requesting some sort of safe harbor so that tax return preparers would not be subject to possible penalties if they signed off on tax returns where there was unreasonably low compensation paid to an S corporation shareholder. The Service concluded that providing additional guidance with respect to this was beyond the scope of the Final Regulations.

The Final Regulations retain the provisions related to employee leasing, professional employer organizations (PEOs) and common paymaster arrangements – for one company to pay wages for another under a common paymaster arrangement the employee must do some work for the common paymaster.
Definition Of Wages, Continued

Wages include all W-2 payments made by a Schedule C, E or F trade or business, an S corporation or a partnership, except that:

(a) Compensation paid by a partnership to a partner will not qualify and is instead called a “Guaranteed Payment.”

**Note:** While the definition of “guaranteed payments” in partnership tax includes payments for the use of capital, the IRS concluded that an individual or entity taxed as an S corporation or partnership that receives guaranteed payments for having provided capital to a partnership cannot characterize such income as trade or business income that will qualify for the Section 199A deduction.

For example, an S corporation or partnership that provides capital to a separate LLC taxed as a partnership and receives payments based upon 15% of such capital contribution amount will not be able to receive a 20% income tax deduction on such income.
### Chart 2 – W-2 Wages by Entity Chart

This chart simplifies who can be paid W-2 wages for the purposes of maximizing a Section 199A deduction from the standpoint of the flow-through entity:

<table>
<thead>
<tr>
<th>Which employees below can be paid W-2 wages by the business structures listed on the right?</th>
<th>Sole Proprietorship</th>
<th>Partnership</th>
<th>S Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owners/employees with ownership interest</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Non-owner employees</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Spouses (with no ownership interest)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Independent contractors</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

**Opportunity 1**

**TAXPAYER**

- **S CORPORATION**
  - Partnership pays wages to Taxpayer

**SPouse 1**

- **SCHEDULE C TRADE OR BUSINESS**
  - Pays wages to Spouse 2

**OTHER PARTNER**

Consider contributing Partnership interest to S corporation to allow wages to be paid to the Taxpayer from the Partnership/eliminate guaranteed payments.

Married proprietors may pay wages to a spouse, but not an owner.
<table>
<thead>
<tr>
<th>Age Group</th>
<th>Defined Contribution</th>
<th>Defined Benefit</th>
<th>Maximum Contribution for a Cash Balance Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee age 60</td>
<td>$62,000</td>
<td>$254,000</td>
<td>$261,000</td>
</tr>
<tr>
<td>Employee age 55</td>
<td>$62,000</td>
<td>$194,000</td>
<td>$203,000</td>
</tr>
<tr>
<td>Employee age 50</td>
<td>$62,000</td>
<td>$148,000</td>
<td>$158,000</td>
</tr>
<tr>
<td>Employee age 45</td>
<td>$56,000</td>
<td>$113,000</td>
<td>$123,000</td>
</tr>
<tr>
<td>Employee age 40</td>
<td>$56,000</td>
<td>$87,000</td>
<td>$96,000</td>
</tr>
</tbody>
</table>

Permanency Requirement – A defined benefit or cash balance plan must be “permanent”, which normally means that it will be in place at least five years, unless there are circumstances beyond the reasonable control of the Employer.

Anticipates 401(k) plan catch-up contributions.

Please note: The above numbers are approximations. Actual results will vary based on actual census data, plan assumptions and plan experience.

The presenters would like to thank Stephen Evers at Ascensus TPA Solutions for providing us with this slide.
JOHN SMITH
A Combination 401(k)/Profit Sharing/Cash Balance Plan
For the Plan Year 01/01/2017 - 12/31/2017
CONTRIBUTION REPORT - DETAIL

<table>
<thead>
<tr>
<th>P O H</th>
<th>Class</th>
<th>Last Name</th>
<th>First Name</th>
<th>AA</th>
<th>RA</th>
<th>Considered Earnings</th>
<th>Cash Balance</th>
<th>Profit Sharing</th>
</tr>
</thead>
<tbody>
<tr>
<td>***</td>
<td>A</td>
<td>SMITH</td>
<td>JOHN</td>
<td>56</td>
<td>65</td>
<td>270,000</td>
<td>196,369</td>
<td>8,100</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>JONES</td>
<td>TOM</td>
<td>27</td>
<td>65</td>
<td>22,724</td>
<td>909</td>
<td>1,332</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>DOE</td>
<td>JANE</td>
<td>37</td>
<td>65</td>
<td>28,948</td>
<td>1,158</td>
<td>2,461</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>WHITE</td>
<td>AMY</td>
<td>47</td>
<td>65</td>
<td>24,394</td>
<td>976</td>
<td>2,073</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>ADAMS</td>
<td>MARTHA</td>
<td>39</td>
<td>65</td>
<td>25,294</td>
<td>1,011</td>
<td>2,149</td>
</tr>
</tbody>
</table>

Legend: P-Principal, O-Owner, H-Highly Compensated Employee

CONTRIBUTION REPORT - SUMMARY

<table>
<thead>
<tr>
<th>Considered Earnings</th>
<th>Cash Balance</th>
<th>Profit Sharing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>Total Contribution</td>
<td>Employer</td>
<td>% of Total</td>
</tr>
<tr>
<td></td>
<td>Cost</td>
<td>% of Total</td>
</tr>
<tr>
<td>Principals</td>
<td>270,000</td>
<td>196,369 73.5</td>
</tr>
<tr>
<td>Non-Principals</td>
<td>101,350</td>
<td>4,054 4.0</td>
</tr>
<tr>
<td>Grand Total</td>
<td>371,350</td>
<td>202,423 54.5</td>
</tr>
</tbody>
</table>

agassman@gassmanpa.com
Employee Census

Name of Employer:

Provide complete information for all employees employed during the year, even if they have terminated.

<table>
<thead>
<tr>
<th>Employee Name</th>
<th>Date of Birth</th>
<th>Date of Hire</th>
<th>Date of Termination</th>
<th>Annualized W-2 Compensation</th>
<th>Hours per Week</th>
<th>Ownership %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>
Some Employees Should Become Independent Contractors And Some Independent Contractors Should Become Employees

An employee may prefer to be an independent contractor to qualify for the 20% deduction, but is it worth it after paying employment taxes, or will the employer pay extra in recognition of saving employment taxes?

An independent contractor may need to become an employee to allow the employer to have sufficient wages.

The statute indicates that income from services rendered “in the nature of an employee” will not qualify for the deduction.

The Final Regulations indicate that a person who was an employee will be presumed to be an employee for a period of three years after attempting to become an independent contractor or being employed by a separate entity that provides services to the original employer.

The taxpayer may rebut the presumption by providing records that are sufficient to corroborate the individual’s status as a non-employee for federal employment tax purposes. Records can include contracts and partnership or shareholder agreements.

Also, the Final Regulations contain an additional example in which an ex-employee has materially modified his contractual relationship with an employer to successfully rebut the presumption.

Consider the statutory employee status of life insurance agents.
(D) Example 4 to paragraph (d)(3). F is a financial advisor employed by a financial advisory firm, Advisory Firm, a partnership for Federal tax purposes, as a fulltime employee and is treated as such for Federal employment tax purposes. F has taxable income below the threshold amount. Advisory Firm is a partnership and offers F the opportunity to be admitted as a partner. F elects to be admitted as a partner to Advisory Firm and is admitted as a partner to Advisory Firm. As a partner in Advisory Firm, F shares in the net profits of Advisory Firm, is obligated to Advisory Firm in ways that F was not previously obligated as an employee, is no longer entitled to certain benefits available only to employees of Advisory Firm, and has materially modified his relationship with Advisory Firm. F's share of net profits is not subject to a floor or capped at a dollar amount. F is presumed (solely for purposes of Section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services F provides to Advisory Firm. However, F is able to rebut the presumption by showing that F became a partner in Advisory Firm by sharing in the profits of Advisory Firm, materially modifying F's relationship with Advisory Firm, and otherwise satisfying the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.

NOTE: A Form SS-8 can be filed with the IRS to request guidance in advance on whether an individual will be properly characterized as an independent contractor.

The Section 530 Safe Harbor allows independent contractor classification where a substantial part of the industry consists of independent contractors if certain other requirements are met.
Chart 4 – Employment Tax Rates Summary Chart

This chart gives the rates for the above employment taxes. For this chart, assume the employer is in the highest tax bracket, so the tax that the employer in the 37% tax bracket will pay 63% of the employment tax rate (after taking into account that the payments are tax deductible), which will be $6,189 on the first $128,400 of income ($128,400 x 4.82% is $6,189). Also, if the Employee is married the additional Medicare tax threshold will be $250,000, or $200,000 if the employee is single.

<table>
<thead>
<tr>
<th>Income</th>
<th>Employer (Deductible)</th>
<th>Employee</th>
<th>Combined</th>
<th>Self-Employed*</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>(63% x 7.65%) = 4.82%</td>
<td>7.65%</td>
<td>12.47%</td>
<td>12.47%</td>
</tr>
<tr>
<td></td>
<td>Cumulative Cost: $4,820</td>
<td>Cumulative Cost: $7,650</td>
<td>Cumulative Total: $12,470</td>
<td>Cumulative Total: $12,470</td>
</tr>
<tr>
<td>$128,400</td>
<td>(63% x 7.65%) = 4.82%</td>
<td>7.65%</td>
<td>12.47%</td>
<td>12.47%</td>
</tr>
<tr>
<td></td>
<td>Cumulative Cost: $6,189</td>
<td>Cumulative Cost: $9,823</td>
<td>Cumulative Total: $16,012</td>
<td>Cumulative Total: $16,012</td>
</tr>
<tr>
<td>$200,000</td>
<td>(63% x 1.45%) = 0.914%</td>
<td>1.45%</td>
<td>2.34%</td>
<td>2.34%</td>
</tr>
<tr>
<td></td>
<td>Cumulative Cost: $6,843</td>
<td>Cumulative Cost: $10,861</td>
<td>Cumulative Total: $17,684</td>
<td>Cumulative Total: $17,684</td>
</tr>
<tr>
<td>$250,000</td>
<td>(63% x 1.45%) = 0.914%</td>
<td>1.45%</td>
<td>2.34%</td>
<td>2.34%</td>
</tr>
<tr>
<td></td>
<td>Cumulative Cost: $7,300</td>
<td>Cumulative Cost: $11,586</td>
<td>Cumulative Total: $18,856</td>
<td>Cumulative Total: $18,856</td>
</tr>
</tbody>
</table>

*Self-employed taxpayers act as employer and employee, and can deduct one-half of their employment tax against their income tax.
What Is An Independent Contractor? Here’s Why It Matters Under the Trump Tax Law

Harsh consequences may befall those who mis-categorize themselves or others.

Individuals who work for themselves are treated differently than employees, but the distinction is sometimes very hard to make.

The IRS leans towards having individuals, in the interest of making sure that everyone is on the tax system with withholding and for the sake of watching out for the benefit of individual workers who have employment tax contributions, workers’ compensation, unemployment, and other benefits required by law.

The 2017 Tax Act includes new Internal Revenue Code § 199A, which provides that individuals who are independent contractors can qualify for a 20 percent tax deduction on their independent contractor income without further requirements being met as long as they are engaged in a trade or business and make less than $315,000.00 in taxable income with their spouse if they are married filing jointly, or $157,500.00 of taxable income if filing a single return. Individuals with higher incomes may still be able to take the deduction, in whole or in part, based upon whether they pay wages, and what trade or business they are in. This is covered very well in Tony Nitti’s article “IRS Provides Guidance on 20% Pass-Through Deduction, But Questions Remain” published on August 9th, 2018.

The IRS will be on the lookout for individuals who change from employee to independent contractor status to the extent that they can. In fact, new proposed regulations released on August 8th indicate that the IRS will presume that an individual who was an employee and changed to an independent contractor will continue to be treated as an employee and therefore deprived of a Section 199A 20 percent deduction, unless it can be proven that he or she is truly an independent contractor. Employee relationships will thus be viewed as “sticky” and not easy or safe to change or adapt.

Given the many factors that are taken into account in making a determination, and the significant latitude that courts have in determining what factors apply, even individuals with the best of intentions who restructure their relationships to meet the requirements of being an independent contractor cannot be absolutely sure how the IRS will treat them.
### Chart 18 – 3 Factors / 20 Factors Combination Chart

<table>
<thead>
<tr>
<th>Common Law Text Factor</th>
<th>Behavioral Control</th>
<th>Financial Control</th>
<th>Relationship of the Parties</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Compliance with Instructions</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Training</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Integration</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Services rendered personally</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Hiring, supervision, and paying assistants</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Set hours to work</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Full time required</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Doing work on employer’s premises</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>9 Order or Sequence Test</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Oral or written reports</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11 Payment by the hour, week, or month</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>12 Payment of business and/or traveling expenses</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>13 Furnishing tools and materials</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>14 Significant investment</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>15 Realization of profit or loss</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>16 Making services available to the general public</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>17 Continuing relationship</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>18 Working for more than one firm at a time</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>19 Right to discharge</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>20 Right to terminate</td>
<td></td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
## Employee vs. Statutory Employee vs. Independent Contractor

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>EMPLOYEE</th>
<th>STATUTORY EMPLOYEE</th>
<th>INDEPENDENT CONTRACTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition</td>
<td>Individual worker who follows explicit instructions of the employer as a traditional employee.</td>
<td>Individual worker classified as Independent Contractor under traditional tests, but treated as a “Statutory Employee” under Internal Revenue Code Section 3121(d)*.</td>
<td>Individual worker who is not an employee / not required to follow the instructions of the employer and compensation causes risk to be allocated to the contractor.</td>
</tr>
<tr>
<td>Are compensation payments treated as wages for the Wage/Qualified Property Test?</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>Is income received by the individual Section 199A “Qualified Business Income”?</td>
<td>NO</td>
<td>YES (If an active trade or business and other requirements are met).</td>
<td>YES (If an active trade or business).</td>
</tr>
<tr>
<td>Employer withholds income taxes.</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>Employer withholds Social Security and Medicare taxes.</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>(And employer pays one-half of FICA).</td>
<td>(But all FICA comes from Statutory Employee’s share).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are professional/employment related expenses deductible on Schedule C (above the line)?</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
</tbody>
</table>
The Qualified Property Test

The Qualified Property Test is that the 20% Qualified Business Income deduction for a high earner taxpayer cannot exceed 2.5% of the Unadjusted Basis Immediately After Acquisition (“UBIA”), assuming no wages are paid by the entity. For purposes of discussion, we will refer to this as “199A basis of qualified property” instead of referring to it as “UBIA”. Sorry if this is “acronymoneous”.

The Regulations also disallow including Qualified Property under the 2.5% test if it is purchased within 60 days of the end of the taxable year and disposed of within 120 days, if the trade or business does not use the property for at least 45 days prior to disposition, unless the principal purpose of the acquisition and disposition was for other than increasing the Section 199A deduction.

The UBIA is the original cost of depreciable assets. The Final Regulations provide that improvements are considered as separate assets with separate tracked lifetimes under the statute.

The UBIA disappears completely at the later of (1) 10 years after acquisition and placement into service; or (2) when the depreciation period for the particular asset ends.

Therefore, a building depreciated over 39 years will have its UBIA amount for the full 39 years.

An air conditioning system with a five or seven year life will have its UBIA for ten years.

Wage Interaction – The formula is to use 50% of wages, or the sum of 2.5% of UBIA plus 25% of wages.

Assuming no wages, the deduction is designed to be available for up to 2.5% of the value of UBIA – leveraging property to have interest expense will allow a higher percentage of the net income to qualify for the 199A deduction.

*It is important to remember that tax basis, original cost basis and UBIA may not always be the same. As a result, taxpayers will need to separately track basis for purposes of calculating UBIA under Section 199A.
<table>
<thead>
<tr>
<th>Type of Property</th>
<th>Depreciable Period</th>
<th>Depreciable Period For 199A Purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-residential Real Property (post-1986)</td>
<td>39 Years</td>
<td>39 Years</td>
</tr>
<tr>
<td>Residential Real Property</td>
<td>27.5 Years</td>
<td>27.5 Years</td>
</tr>
<tr>
<td>Office Furniture (Desks, files, safes, etc.)</td>
<td>7 Years</td>
<td>10 Years</td>
</tr>
<tr>
<td>Automobiles and Taxis</td>
<td>5 Years</td>
<td>10 Years</td>
</tr>
<tr>
<td>Light General Purpose Trucks</td>
<td>5 Years</td>
<td>10 Years</td>
</tr>
<tr>
<td>Information Systems (Computers, card readers, printers, etc.)</td>
<td>5 Years</td>
<td>10 Years</td>
</tr>
</tbody>
</table>
For non-residential real estate, there is still a 39-year depreciation life, so a $1,000,000 building may be depreciated at approximately $25,641 per year. The land value will not be depreciable.

The interest on a non-residential building loan will also be deductible.

Where the losses from the combined depreciation and interest expense exceed the net rent income, this “passive loss” cannot be used against other income unless or until the property is sold or the rent income exceeds the depreciation and interest deductions, unless the taxpayer or the taxpayer’s spouse is a “real estate professional,” and must meet the 500-hour or one of the 100-hour or other tests of “material participation.”

There are several different ways to satisfy the “real estate professional” definition, but for most non-working spouses, this means spending the majority of all working time and at least 750 hours on real estate endeavors.

The real estate sales course is a fantastic learning event, and the time taking the course should count towards these hours. After that, the spouse may wish to be a realtor, a property manager, or someone who buys houses, renovates them, and sells them.
Anti-Abuse Rule Related To Purchase Of Qualified Property Within 60 Days Of The End Of The Taxable Year.

The Regulations also disallow including Qualified Property under the 2.5% test if it is purchased within 60 days of the end of the taxable year and disposed of within 120 days, if the trade or business does not use the property for at least 45 days prior to disposition, unless the principal purpose of the acquisition and disposition was for other than increasing the Section 199A deduction.

Treatments Of Improvements Of Qualified Property Under Section 199A.

Improvements to Qualified Property are treated as a separate Qualified Property, with its own basis. Therefore, if a taxpayer buys a new air-conditioning system for a building in year 1, it would constitute Qualified Property through year 10, and then if the taxpayer adds additional components to the system in year 3, the cost of the additional components can be considered as Qualified Property until year 13. The recordkeeping impositions of the new Regulations and other rules under the statute will be quite difficult and costly for many taxpayers.

The End Of The Year Rule

The Qualified Property must be owned by the applicable entity on the last day of the year for its UBIA to be counted. If the asset is sold and creates ordinary income, the deduction may not apply or be limited because of insufficient UBIA.

Taxpayers may therefore consider retaining Qualified Property in the same year that other assets are sold, so that the ordinary income from the other assets can qualify for the Section 199A deduction – the taxpayer can sell ordinary income assets on December 31, and remaining buildings on the next day (January 1st of the next year).

It is also noteworthy that this rule applies to the end of the tax year and not necessarily December 31st. Therefore, an entity taxed as an S corporation, partnership or Complex Trust may sell all assets on the same day that it is liquidated (before December 31), so that the sale has occurred on the last day of the tax year.
Regulations Address Qualified Property Acquired In Like Kind Exchange

The Regulations provide that property that has been received in a like kind tax-free exchange will be considered as acquired when the property that it is replacing was acquired, and will also be considered to have the basis of the property that it is replacing. Section 1031 was cut back under the Tax Reform Act of 2017 to apply only to real estate, buildings and fixed improvements thereto. The older property traded away is called the “relinquished property”, and the new property acquired is called the “replacement property”. The holding period and basis of the relinquished property is what applies under Section 199A when applying this to the 2.5% Qualified Property hurdle. If the replacement property has excess basis (which is the difference between the current fair market value of the replacement property and the relinquished property), then such excess is treated as placed in service when the replacement property is acquired.

Taxpayers who have previously made elections under Code Section 168(f)(1) to exclude property from standard depreciation methods (depreciation based upon MACRS tables) and use an alternative method, such as depreciation based upon units of production, can make a new election under Treas Reg. 1.168(i)-6(i)(1) to bring the replacement property back under standard depreciation methods (MACRS) in a like kind exchange, in which event the basis in the replacement property would be treated as placed in service in the year the replacement property is acquired.

It is noteworthy that non-recognition provisions under Section 1031 are mandatory, and taxpayers do not have the option to elect out of Section 1031 to treat the transaction as a sale and purchase of replacement property in order to obtain a new stepped up basis in the replacement property. However, nothing prevents a taxpayer from structuring a transaction so that the exchange will not qualify as a Section 1031 exchange by exchanging non-like kind property or not meeting the deferred exchange requirements. Although the failure to meet the like kind requirements will cause any gain on the transaction to be recognized, the replacement property will have a basis equal to the purchase price, and a new holding period will apply for purposes of the Section 199A Qualified Property calculation. This may also be beneficial in situations where the taxpayer has an expiring loss carryforward that could be used to offset the gain on the exchange and result in a new basis for the replacement property.
Application Of Step-Up In Basis Upon Death Under Section 199A

If property is inherited and immediately placed in service by the heir, the basis in the property will generally be its fair market value at the time of the decedent’s death, and the Regulations confirm that Section 1014 applies for the purposes of Section 199A. This applies even if there is personal or other use of the property, not directly related to the applicable trade or business.

Property owned by a partnership will receive a step-up in basis upon the death of a partner or sale of a partnership interest, as the Regulations state that basis adjustments under Sections 734(b) and 743(b) (when a 754 election is in effect for the partnership) will be taken into account in determining the entity’s unadjusted basis Qualified Property under an adjusted Section 743(b) calculation.

Although further analysis is necessary, this may not result in a full step up in basis for a partnership owning appreciated property on a partner’s death or when there is a sale of a partnership interest.

Because many taxpayers will not benefit from discounts these entities afford for estate tax purposes while exemptions are high, it may be advantageous to change entities before a partner’s death, by giving voting stock or put rights that can be held by a partner on death, so that valuation discounts would not apply.

This could allow for various planning techniques where the partnership distributes the property to its partners before the death of a partner, or a combined sale of the partnership interest and the appreciated property. Some practitioners have indicated that the partnership should hold the property until after the death of a partner or sale of the partnership interest, and distribute the property immediately thereafter. This apparently would allow the appreciated property to receive a basis increase due to Section 1014 and the Section 754 election, and the heir can place the property back into the partnership with an increased basis for the purposes of Section 199A.
Real Estate Considerations

1. Real estate professionals, such as brokers, management companies, contractors and other individuals who engage in “active trades or businesses” relating to real estate will be treated like all other businesses. Broker and sales agent entities will not be SSTBs.

   Employee vs. independent contractor considerations will apply, as further discussed.

2. A Mortgage brokerage is an SSTB.

3. Lending is not an SSTB.

4. Consulting is an SSTB.

5. Teaching and workshop programs that do not constitute consulting and the sales of books and webinars and audio recordings are not SSTBs, assuming that this is not a performing art or endorsement income.

6. Developers are not SSTBs – “developers” who try to claim capital gains income will now have a rate differential of 29.6% vs. 20% if other requirements are met, in addition to state tax savings.
7. A management or other company that provides products or services to a 50% or more commonly owned (after related party rules) SSTB will be considered to be an SSTB to the extent of income derived from services and products sold to the SSTB.

8. Property sold before the last day of the year will not be included as qualified property because it is not owned on the last day of the taxable year. Developers will want to be sure that they can aggregate income from an entity that will no longer have the properties that it sold with other entities to have sufficient qualified property for wages to meet applicable tests. Also consider whether the entity can terminate and close the books on the date of the sale so that property is considered to have been owned on the last day of the taxable year.

8. When is a triple net lease or other leasing activity an “active trade or business?”– The courts know it when they see it.

9. The new Safe Harbor is described in the following pages for non-triple net leased property.

10. The Final Regulations confirm that any property leased to an entity taxed as an S corporation, partnership, or proprietorship which is an active trade or business with 50% or more related ownership will be considered to be an active trade or business with respect to the income derived from the lease with the SSTB, even if it is a very passive triple net lease.
The Five Special Leasing Rules Under Section 199A

RULE 1

A lease to an SSTB is considered to be an SSTB if the parties are related.

RULE 2

A triple net or passive lease from an active S corporation, partnership or proprietorship will be considered to be an active trade or business under Section 162, if the parties are related.
The Five Special Leasing Rules Under Section 199A, Continued

RULE 3

If the tenant is a C corporation, then after 2018, the landlord will not be an active trade or business, even if they are related.

Under the Proposed Regulations, the landlord could be an active trade or business for 2018, for taxpayers who follow the 199A Proposed Regulations on all issues for 2018 reporting.

RULE 4

Safe harbor rules allow a non-triple net lease arrangement to be considered as active, if the landlord, employees and agents spend at least 250 hours a year on enumerated tasks, and other requirements are met.

RULE 5

Can almost never aggregate commercial and residential properties, unless they are in the same building, for purposes of the aggregation / combination rules relating to:

A. Whether an active business can qualify for 199A deduction.
B. Whether it can be aggregated for wage / qualified property test.
C. Whether it can be aggregated for safe harbor / 250 hour test.
## Partnership vs. S Corporation - Which Is Better To Hold Real Estate?

<table>
<thead>
<tr>
<th><strong>PARTNERSHIP</strong></th>
<th><strong>S CORPORATION</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td><strong>and Disadvantages</strong></td>
</tr>
<tr>
<td>Partners receive basis for indebtedness incurred by the partnership.</td>
<td>DOI income insolvency exclusion is determined at the corporate level.</td>
</tr>
<tr>
<td>Active income subject to Self-Employment Taxes.</td>
<td>Active income not subject to Self-Employment taxes if reasonable salary is paid to shareholder that performs services for S-Corporation.</td>
</tr>
<tr>
<td>On the death of a partner, the partnership’s (inside) tax basis of its assets can receive a step-up in income tax basis, if a Section 754 election is in place for the partnership.</td>
<td>No similar basis adjustment mechanism applies to S corporations.</td>
</tr>
<tr>
<td>When a new partner buys into a partnership corporation, their depreciation write-off and underlying basis in their partnership interest will be based upon the price that they pay.</td>
<td>When a new shareholder buys into an S corporation, their depreciation write-off and underlying basis if and when the real estate is ever sold has to be based upon the historic basis and depreciation taken, versus being based upon the price they pay.</td>
</tr>
<tr>
<td>Appreciated real property can generally be distributed from the partnership tax-free to the partners.</td>
<td>Distributions of appreciated real property to the shareholders are treated as if the property was sold at its fair market value to the shareholders.</td>
</tr>
<tr>
<td>No restrictions apply as to who can own partnership interests.</td>
<td>S corporations can only be owned by certain individuals and trusts, and cannot be owned by non-resident aliens, corporations or partnerships</td>
</tr>
<tr>
<td>Partnerships can have more than one class of stock, and income and distribution preferences can be drafted in virtually any manner, so long as they have substantial economic effect. May swap between family members.</td>
<td>S corporations cannot have a “second class of stock,” and income allocation and distribution rights must be pro rata to ownership.</td>
</tr>
<tr>
<td>DOI income insolvency exclusion is determined at each partner’s level.</td>
<td>Shareholders do not receive basis for indebtedness incurred by the corporation, unless the loan is made by such shareholder.</td>
</tr>
</tbody>
</table>

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The Section 108 Income From Discharge Of Indebtedness Shuffle

What entity will help protect a solvent taxpayer from income when his or her entity becomes insolvent and discharges debt?

- **DISREGARDED LLC**
  - Income from discharge will be considered as having been received by the taxpayer/owner.

- **LLC TAXED AS PARTNERSHIP**
  - Income from discharge will flow through pro-rata to each partner with insolvency determined at the partner level.

- **LLC OR CORPORATION TAXED AS S CORPORATION**
  - Insolvency will be determined at the S corporation level and not flow through as K-1 income to the shareholder.

- **C CORPORATION**
  - Income will be limited to the S corporation – many S corporations will convert to C corporation status before insolvency related sales or other transactions.
Coordination Of Buildings And Businesses

Debt on building may protect assets of business equity.

Lease obligation to landlord company provides further protection.

TBE and charging order protection, along with cross-collateralization to protect a married couple's business and investment assets, and reduce federal estate tax.
Final Regulations Permit An Election To Aggregate Multiple Trades And Businesses For Purposes Of Wage And Qualified Property Testing Under Section 199A.

The Regulations create a new method of aggregation of trades and businesses so that taxpayers can combine multiple trades or businesses for the purposes of applying the wage and Qualified Property limitations and maximizing the deduction. In order to be aggregated, the businesses must meet the following 5 requirements:

1. The same person or group of persons directly or indirectly owns 50% or more of each trade or business; (although minority owners may aggregate if the 50% or more test is met by other owners – Each owner makes separate decision on what to aggregate – a minority owner may still aggregate if there is 50% or more common ownership with others.)
   For purposes of determining ownership under this subsection, ownership by spouses, as well as children, grandchildren, parents, brothers, and sisters can be attributed to each other;

2. The ownership existed for a majority of the tax year;

3. The items must be reported on returns within the same taxable year;

4. None of the businesses can be a Specified Service Trade or Business; and
5. The aggregated trades or business must also satisfy at least two of the following requirements:

a) The trade or businesses provide products or services that are the same or customarily offered together;

b) The trade or businesses share facilities or significant centralized business elements such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and

c) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chains interdependencies).
A series of eighteen well-written examples beginning at Section 1.199A-4(d) demonstrate that a taxpayer owning less than 50% of multiple entities when another taxpayer owns more than 50% of each entity, can elect to aggregate the taxpayer’s minority interests therein, if the other rules are satisfied.

Aggregation will allow wages and Qualified Property to be considered as paid for all of the entities, so that the deduction can be taken for an entity that has little or no wages or Qualified Property if another entity has sufficient wages and Qualified Property for both its own income and the income of affiliates. The examples point out that losses from an entity that could be aggregated must be netted against the aggregate profits of other applicable entities, if any aggregation occurs.

One example indicates that ownership of a sailboat racing team and a marina by separate companies would not be aggregated, but that ownership of a trucking company that delivers lumber and other supplies in one company, operation of a lumber yard in another company, and operation of a construction business that presumably uses lumber and other supplies, can be aggregated.

Once a taxpayer chooses to aggregate two or more trades or businesses, they must be consistently reported and aggregated for all subsequent taxable years, unless there is a change in facts and circumstance so that a taxpayer’s prior aggregation no longer qualifies for aggregation.

The implications of all of this to professional advisors can be daunting. In some instances, modeling the various options may be the only way to determine what the actual impact of various decisions might be. Practitioners should be cautious about providing conclusions to clients with specificity without the opportunity to perform the appropriate analysis. The costs of the level of detailed analysis that might be necessary in many instances will be a concern for many clients.
Under one example in the Final Regulations, an entity elected to aggregate a movie theater and a food service business at the movie theater for purposes of calculating the 199A deduction. This entity level aggregation prevented the aggregation of another commonly owned food service business with the combined movie theater and food service business. If the entity had not aggregated the movie theater and the food service business, then the taxpayer would have been able to aggregate the two food service businesses.

Food 1 and Food 2 cannot be aggregated by PRS1.

Food 1 and Food 2 can be aggregated by PRS1.
(When A Related Trade Or Business Becomes A Pseudo-SSTB)

SERVICE TRADE OR BUSINESS ILLUSTRATION CHART

**Green = Non-SSTB Income**

**Red = SSTB Income**

**Entity that provides property, services or products**

- **UNRELATED PARTIES**
  - 51%
  - 49%
  - 50% OR MORE
  - 50% OR LESS

**Specified Service Trade or Business (SSTB)**

- **DOCTORS**
  - Opportunity 4
  - 100%
  - (Partly SSTB Income)
  - (Non-SSTB Income)

**Treated as a separate SSTB to extent property, services or products are provided to commonly controlled SSTB.**

**Can be a 199A Qualified Trade or Business**

**Can be a 199A Qualified Trade or Business to extent property, services or products are provided to Non-SSTB**

**Non Specified Service Trade or Business (Non-SSTB)**

- **DOCTORS/INVESTORS/RELATED PARTIES**
  - 100%

- **Entity that provides property, services or products**
  - (Pays for property, services or products)
  - (provides property, services or products)
When A Related Trade Or Business Becomes A Pseudo SSTB

The Proposed Regulations had provided special rules for when a trade or business has 50% or more common ownership with an SSTB, and provides property or services to the commonly owned SSTB.

The Proposed Regulations provided that a trade or business that provided more than 80% of its property or services to an SSTB and had at least 50% common related party ownership would be treated as an SSTB. When there was at least 50% common ownership and less than 80% of the property or services were provided to the related party SSTB then the related entity would be considered to be an SSTB in proportion to the products and services provided to the SSTB.

The Final Regulations eliminate the 80% rule, and simply provide that if there is more than 50% or more common ownership, the portion of the trade or business providing property or services to the 50% or more commonly owned SSTB, will be treated as a separate SSTB, with the income attributable to the services provided to non-SSTBs being considered to be non-SSTB income.
Common Examples Of Pseudo SSTBs

Rent received by Building, LLC will be considered SSTB income.

Can also include intellectual property leasing/licensing.
Non-SSTB Company

Management or Real Estate, LLC (not-SSTB)

Provides management, marketing, and billing services or use of a building to the Doctors’ three separate practices.

Can be a 199A Qualified Trade or Business.
Non-SSTB Company

SSTB – Not eligible for deduction

Can all be a 199A Qualified Trade or Business.
Attribution Rules Under Section 267(b)

Section 267 disallows losses for the sale or exchange of property between related parties, and provides that the following persons are considered to be related:

1. Members of a family, as defined in subsection (c)(4), which includes brothers and sisters (whether by whole or half blood), spouses, ancestors, and lineal descendants (not in-laws, cousins, nephews, nieces, non-adopted step-children, step-parents).

2. An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.

3. Two corporations that are members of the same controlled group.

4. A grantor and a fiduciary of any trust.

5. A fiduciary of a trust and a beneficiary of such trust.

6. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts.

7. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts.
8. A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust.

9. A corporation and a partnership if the same persons own—
   A. More than 50 percent in value of the outstanding stock of the corporation, and
   B. More than 50 percent of the capital interest, or the profits interest, in the partnership.

10. An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

11. An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

12. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

13. A person and an organization to which Section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual.
Attribution Rules Under Section 707(b)

1. A partner and a partnership will be considered related if a person owns, directly or indirectly, more than 50% of the capital interest, or the profits interest, in such partnership.

2. Two partnerships will be considered related if the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests in both partnerships.
Special Rules Under 267(c)

Section 267(c) states that for purposes of applying 267(b) the following rules apply: 

1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

2. An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family.

3. An individual owning (otherwise than by the application of [number] (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner.

4. Stock constructively owned by a person by reason of the application of [number] (1) shall, for the purpose of applying [number] (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of [number] (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

PARTNERSHIP EXCEPTION - Sections 267(e)(3) and 707(b)(3) state that for purposes of determining ownership of a partnership, the principles of Section 267(c) shall apply except that Section 267(c)(3) shall not apply.
Section 267(c)(3) states that “An individual owning any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner.”

The Management Company is considered to be a more than 50% commonly owned by related parties.
Section 267(e)(3) states that for purposes of determining ownership of a partnership, the principles of Section 267(c) shall apply, except that Section 267(c)(3) shall not apply.

Section 267(c)(3) states that “An individual owning any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner.”

The Management Company is considered to be an unrelated Non-SSTB.
Brandon Ketron, J.D., CPA’s Related Party Planning Opportunity Tentative Conclusions

**SSTB Company Or Non-SSTB Company**

Section 267(c)(2) - An individual shall be considered as owning the stock/partnership interest owned, directly or indirectly, by or for his family.

The Management Company is considered to be more than 50% commonly owned.
The Management Company is considered to be more than 50% commonly owned, and thus an SSTB.
Separation Of SSTB & Non-SSTB Income Under Final Regulations

1. Small amount of specified service trade or business income will not taint a non-specified service trade or business.

The Final Regulations retained the *de minimis exception* that applies when income from a Specified Service Trade or Business is less than 10% of gross receipts, if the entity has $25,000,000 or less of annual receipts, or 5% of gross receipts if annual receipts are greater than $25,000,000.

For example, a consultant could join an engineering firm with less than $25,000,000 in annual receipts, and qualify non-employment income for the exemption, if the consulting revenue is less than 10% of total revenue. A 5% threshold will apply if the engineering firm has more than $25,000,000 a year of revenues.

2. Incidental Trade or Business under common ownership with an SSTB removed from Final Regulations.

Under the Proposed Regulations, if a trade or business shares wage and overhead expenses with an SSTB and is more than 50% commonly owned by the owners of the SSTB, then such trade or business will be treated as incidental to and thus a part of the SSTB unless the gross receipts from the trade or business exceeds 5% of the combined gross receipts of the SSTB and the incidental trade or business.

The Proposed Regulations provided the example of a dermatologist selling skin care products at the dermatology office. The sales from the skin care products would not be considered to be separate from the dermatology practice unless the gross receipts from the sale of skin care products exceed 5% of the combined gross receipts from the sale of the skin care products and the dermatology practice.

This was removed from the Final Regulations and presumably any incidental non-SSTB trade or business will be eligible for the Section 199A deduction regardless of gross receipts.
Separation Of Non-SSTB Income
De Minimis Rule Examples In Final Regulations
(Note: We have underlined important language.)

Example One - Landscape LLC sells lawn care and landscaping equipment and also provides advice and counsel on landscape design for large office parks and residential buildings. The landscape design services include advice on the selection and placement of trees, shrubs, and flowers and are considered to be the performance of services in the field of consulting under paragraphs (b)(1)(vi) and (b)(2)(vii) of this section. Landscape LLC separately invoices for its landscape design services and does not sell the trees, shrubs, or flowers it recommends for use in the landscape design. Landscape LLC maintains one set of books and records and treats the equipment sales and design services as a single trade or business for purposes of Sections 162 and 199A. Landscape LLC has gross receipts of $2 million.

$250,000 of the gross receipts is attributable to the landscape design services, an SSTB. Because the gross receipts from the consulting services exceed 10 percent of Landscape LLC’s total gross receipts, the entirety of Landscape LLC’s trade or business is considered an SSTB.

Example Two - Animal Care LLC provides veterinarian services performed by licensed staff and also develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinarian services are considered to be the performance of services in the field of health under paragraphs (b)(1)(i) and (b)(2)(ii) of this section. Animal Care LLC separately invoices for its veterinarian services and the sale of its organic dog food. Animal Care LLC maintains separate books and records for its veterinarian clinic and its development and sale of its dog food. Animal Care LLC also has separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products. Animal Care LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for purposes of Section 162 and 199A. Animal Care LLC has gross receipts of $3,000,000. $1,000,000 of the gross receipts is attributable to the veterinary services, an SSTB. Although the gross receipts from the services in the field of health exceed 10 percent of Animal Care LLC’s total gross receipts, the dog food development and sales business is not considered an SSTB due to the fact that the veterinary practice and the dog food development and sales are separate trades or businesses under Section 162.
## When Separate Books And Records Should Be Maintained When SSTB And Non-SSTB Activities Are Under One Entity

<table>
<thead>
<tr>
<th>Type of Business</th>
<th>Percentage of SSTB Gross Receipts When Divided by Total Gross Receipts</th>
<th>Are Separate Books and Records Maintained?</th>
<th>Tax Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mainly Non-SSTB</td>
<td>Under 10% with gross receipts under $25 million or under 5% with gross receipts over $25 million.</td>
<td>Does not affect treatment.</td>
<td>All income is treated as non-SSTB.</td>
</tr>
<tr>
<td><strong>De Minimis Rule</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mainly Non-SSTB</td>
<td>Over 10% with gross receipts under $25 million or over 5% with gross receipts over $25 million.</td>
<td>No</td>
<td>All income is treated as SSTB income.</td>
</tr>
<tr>
<td>Mainly Non-SSTB</td>
<td>Over 10% with gross receipts under $25 million or over 5% with gross receipts over $25 million.</td>
<td>Yes</td>
<td>The taxpayer is treated as an SSTB but may treat non-SSTB income as non-SSTB because “separable” books and records are kept.</td>
</tr>
<tr>
<td>Mainly SSTB</td>
<td>De Minimis Rule Not Applicable.</td>
<td>Yes</td>
<td>All non-SSTB income is treated as non-SSTB income.</td>
</tr>
<tr>
<td>Mainly SSTB</td>
<td>De Minimis Rule Not Applicable.</td>
<td>No</td>
<td>All income is treated as SSTB income.</td>
</tr>
</tbody>
</table>
Consider Putting Non-SSTB Activities Into A Separate Partnership Entity

Consider placing the non-SSTB activities into a partnership owned 95% by the entity and 5% by any person, so that this will come through on a K-1 and be from a “separate taxable entity”

Business entity provides the following services:
- Title Insurance
- Trustee Services
- Post Legal Work Copies
- Delivery Services
- Stenography Services
- Lecturing and Publishing
NOTE: Taxpayers with income less than the applicable 199A thresholds can still receive a 199A deduction, regardless of whether the entity is an SSTB or has sufficient wages or qualified property.
Limitation 3 - Anti-Abuse Regulations for Trusts

The Opportunity - Use of 678 Trusts

Certain trusts cannot be used to deflect income that would not be deductible by professionals or high income taxpayers.

Trusts which are separately taxed and held for the benefit of family members can be structured to receive income that is either accumulated or distributed, whereby the trust will pay tax on income accumulated, and the beneficiary or beneficiaries will pay tax to the extent of income distributed. When Section 199A was first passed, the estate planning community was ready to mobilize a great number of these trusts that would own interests in SSTBs, management companies and non-SSTB companies owned by high earner taxpayers, so that each separate trust could accumulate up to $157,500 of income and also spray out an amount sufficient so that each child and grandchild would have income of up to $157,500 (or $315,000 if married filing jointly), and articles describing this technique were published and mentioned in the Preamble to the Proposed Regulations.¹

The Final Regulations carry forth the intention of the Proposed Regulations by providing that a separately taxed trust that is “formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A” will be considered as aggregated with its contributor for Section 199A purposes.

The language of the Final Regulations was also changed from referencing “Trusts formed or funded...” under the Proposed Regulations to “A trust formed or funded...” under the Final Regulations, meaning that this not only applies to the creation of multiple trusts, but can also apply to the creation of a single trust as specifically stated in the Preamble to the Final Regulations.

For example, if a high earner married couple owning 50% of a manufacturing company that does not pay sufficient wages or have sufficient qualified property to allow them to receive a Section 199A deduction transfers part ownership of the S corporation to a trust for their daughter for no other purpose than to allow for the Section 199A deduction, then the income accumulated within the trust will not qualify for the Section 199A deduction as long as the father and the mother who fund the trust continue to be high income taxpayers, based upon their personal income and the income of the trust being aggregated.

The Proposed Regulations went even farther and provided that income distributed from the trust to a beneficiary of the trust would be considered to have stayed in the trust for the purposes of “disrespecting” the arrangement. While the Final Regulations now allow for the taxable income of the “tax avoidance trust” to be determined after taking into account the DNI deduction for income distributed to a beneficiary, it is unclear if the net income that is transferred from a separately taxed trust to a beneficiary will be treated as having been received by the beneficiary and not subject to aggregation under the Anti-Abuse provisions of the Final Regulations.

The Final Regulations did not impose any limitation on the use of Section 678 Trusts, which are irrevocable trusts which are considered as owned by the beneficiary or beneficiaries thereof.

In fact, Final Regulations specifically state that trusts that are considered as owned by a specific individual or individuals under the “Grantor Trust Rules”² will be “treated as owned by the grantor or other person,” and therefore appear to not be subject to these rules.

¹ Excerpt from LISI Newsletter #167, Published January 20, 2019

² FICPA Gulf Coast Conference
Creative Planning with 199A - 10.24.19
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**Grantor Trust**

Grantor treated as the owner for federal income tax purposes.

1. Taxed as a separate entity to the extent that income is not distributed
2. “Distributable Net Income” paid out can carry the income to lower bracket taxpayers
3. The trust has an effective tax rate of 24.1% on the first $12,500 of income and 37% above that.
4. Distributions made within 65 days of the next tax year can be considered to have been made in the previous tax year.
5. Distributions made to charity can carry income to the charity to in effect give a tax deduction without a 60% adjusted gross income limitation or itemized deduction considerations.
6. 3.8% Medicare tax begins to apply at $12,500+ of AGI.
7. Unlike a C Corporation - No tax upon liquidation of the trust.
8. Can shield Trustee and Beneficiaries from operational liability similar to a corporation depending upon state law.

**Complex Trust**

**Complex Electing Small Business Trust “ESBT”**

1. Can be owner of an S-Corporation.
2. Can allow a non-resident alien beneficiary to effectively be a member of an S-Corporation.
3. S-Corporation income taxed at the highest rate bracket, regardless of whether income is distributed to beneficiaries.
4. ESBTs may have multiple beneficiaries, and mandatory distributions of income are not required.
5. Distributions made to charity will be subject to the same rules that apply to individuals.
6. 3.8% Medicare tax begins to apply at $12,500+ of AGI.

**Beneficiary Defective Trust (aka BDIT or 678 Trust)**

Beneficiary treated as owner for federal income tax purposes.

**Qualified Subchapter S Trust “QSST”**

1. Can be owner of an S-Corporation.
2. Can have only one named beneficiary.
3. Must pay all “fiduciary accounting income” to trust beneficiary each year.
4. All S-Corporation K-1 income taxed to beneficiary of trust.
Refresher on Types of Entities That Can Hold S-Corporation Stock

Varieties of Grantor Trusts:
1. GRATs
2. Grantor SLATs
3. Grantor CLATs

Can make protective ESBT Election.

Grantor Trust

Disregarded LLC (May not be safe with non-community spouse married couples)

501(c)(3) Organization

Beneficiary Defective Trust (aka BDIT or 678 Trust)

Complex Electing Small Business Trust “ESBT” (Non-Resident Alien as beneficiary-ok)

Qualified Subchapter S Trust “QSST”

ABC COMPANY
(Taxed as S-Corporation)

S-Corporation
(Electing to treat Subsidiary as Q-SUB)

Single Person, owns 100% of LLC

The following entities will not qualify to own S corp stock:
1. Non-Resident Aliens
2. Partnerships
3. Charitable Remainder Trusts (CRATs and CRUTS)
4. IRS or pensions
5. Off-Shore Trusts
6. Elvis the dog

agassman@gassmanpa.com
**ESBTs ("Electing Small Business Trusts")**

(Explained in slides that follow.)

<table>
<thead>
<tr>
<th>If the Grantor is Living:</th>
<th>After the Grantor’s Death:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>If disregarded (Grantor Trust) –</strong></td>
<td>S corporation K-1 income taxed at highest bracket, even if distributed.</td>
</tr>
<tr>
<td>Income is taxed at Grantor’s individual income bracket.</td>
<td></td>
</tr>
<tr>
<td><strong>If Complex:</strong></td>
<td>Non S corporation K-1 income taxed at beneficiary’s bracket if distributed; if not income is taxed at compressed trust brackets.</td>
</tr>
<tr>
<td>1. S corporation income is taxed at highest income tax bracket, even if distributed.</td>
<td></td>
</tr>
<tr>
<td>2. Non-S corporation income distributed will be taxed at beneficiary’s bracket. Retained income will be taxed at compressed tax brackets.</td>
<td></td>
</tr>
</tbody>
</table>
ESBTs (“Electing Small Business Trusts”)

Under applicable tax laws, in order for a complex trust to be considered an eligible shareholder of S corporation stock, it must make an election to be treated as an Electing Small Business Trust (“ESBT”).

Once an ESBT election is made, Treasury Regulation Section 1.641(c)-1 requires that it be treated as having two separate trusts, one consisting of the portion of the trust which holds the S corporation stock, and the other consisting of assets that are not S corporation stock. After the death of the grantor, the S portion of the trust is taxed at the highest trust bracket. The Non-S portion is taxed under the traditional rules that apply to the taxation of complex trusts.

Many commentators thought that an ESBT would receive two thresholds under the Regulations—one for the S corporation portion of the trust, and another for the non-S corporation portion, but the Final Regulations provide that the S portion and non-S portion of an ESBT will be treated as a single trust for the purpose of determining the applicable 199A threshold amount.

An alien concept:

It is noteworthy that non-resident aliens can be beneficiaries of ESBTs – they cannot be shareholders in an S corporation, so this is an important change from the 2017 Act.

But beware of the Canadian tax that treats LLC interests as C corporations to double tax our friends north of the border.
Qualified Sub-Chapter S Trust ("QSST")

1. The trust must pay all “fiduciary accounting income” (i.e., trust accounting income) to the one named beneficiary of the Trust each year.

2. K-1 “taxable income” may be different than fiduciary accounting income.
   
   For example, the S corporation Schedule K-1 may show $75,000 in taxable income, but the S corporation may make a distribution of only $25,000. The fiduciary accounting income required to be distributed to the beneficiary, because of the QSST election, is only $25,000. However, the full $75,000 will be taxable to the beneficiary because the QSST election causes the portion of the Trust consisting of the S corporation stock to be treated as a grantor trust with respect to the beneficiary.

3. As a result, the beneficiary of the QSST pays income tax on the K-1 income, notwithstanding what distribution the beneficiary has actually received.

4. On the death of the income beneficiary, a separate QSST election must be made for each separate trust established for individual beneficiaries or the Trustee may decide to make an ESBT election at that time.
Flow Through Income Planning Considerations QSST Makes Payments to Disregarded LLC

- ABC FLOW THROUGH LLC
  - Income = 1,000,000
- XYZ, LLC (Blocker Entity)
- QSST Trust for Child 1

Note: The Trust will not be considered to have fiduciary accounting income until a distribution is made from XYZ, LLC.
Use Of Trusts To Avoid 199A Limitations Under Final Regulations

Trusts which are separately taxed and held for the benefit of family members can be structured to receive income that is either accumulated or distributed, whereby the trust will pay tax on income accumulated, and the beneficiary or beneficiaries will pay tax to the extent of income distributed.

• When Section 199A was first passed, the estate planning community was ready to mobilize a great number of these trusts that would own interests in SSTBs, management companies and non-SSTB companies owned by high earner taxpayers, so that each separate trust could accumulate up to the amount at which the limitation would kick in.

• The Final Regulations was also changed from referencing “Trusts formed or funded...” under the Proposed Regulations to “A trust formed or funded...” under the Final Regulations, meaning that this not only applies to the creation of multiple trusts, but can also apply to the creation of a single trust.

• The Final Regulations provide that a separately taxed trust that is “formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A” will be considered as aggregated with its contributor for Section 199A purposes, as discussed on the following slide.
What Is A “Primary Purpose”? 

The word “Primary” means “the most important” or perhaps the two or three most important, if there are two or three equal reasons for a particular action.

The word “A” implies that there can be multiple “Primary Purposes.”

If there are two or more main reasons for a particular action, they would have to be exactly equal for them to all be “primary purposes.”

It is only the purpose that has a greater score than any other purpose that can be a “primary purpose.”

See Ditter Bros Inc. v. Commissioner defining principal purpose as “first in rank, authority, importance, or degree.” 72 T.C. 896 (1979).

Pitcher v. Commissioner states that “the proper test for whether tax avoidance was a principal purpose is not, as respondent urges, whether a tax-avoidance purpose "figures prominently as a reason for the plan," or whether business reasons are "so overwhelming as to make tax avoidance a negligible concern," but rather whether the transaction had "as one of its 'first-in-importance' purposes the avoidance of Federal income taxes.” 84 T.C. 85 (1985).

See also Benjamin M. Willis A Principal Purpose: There Can Be Only One http://www.taxhistory.org/www/features.nsf/Articles/178104B57F0667F985257B8600468B3E?OpenDocument

Have Pre-Existing Trusts Buy Into Entities.

If a family has always funded trusts using the $15,000 per year annual exclusion and decides to fund a new trust for the same purpose that also saves money under Section 19A, what is the “primary purpose”?

Trusts that are formed on death or that were already formed and that preserve the inheritance of descendants and also facilitate Section 199A planning seem unlikely to be considered as formed and funded for a “primary purpose” of avoiding a relatively small amount of tax (usually $13,000 a year, at most) under Section 199A.
§1.199A-6(d)(2) Grantor Trusts. To the extent that the grantor or another person is treated as owning all or part of a trust under Sections 671 through 679, such person computes its Section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or other person.

It is noteworthy that “Grantor Trusts include the following:

1. A trust where the Grantor is considered to be the owner for income tax purposes.

2. A trust where a beneficiary is considered to be owner for income tax purposes:
   A. A Section 678 Trust.
   B. A Qualified Sub-Chapter S Trust (QSST) must pay all income it receives to a named beneficiary for the lifetime of that beneficiary, but may use a blocker subsidiary entity to eliminate the distribution of “state law income” to the trust.
   C. An Electing Small Business Trust (ESBT) considered as being owned by its Grantor.
Excerpt from LISI Newsletter #167, Published January 20, 2019

The only language in the Preamble to the Final Regulations which discusses this rule reads as follows:

**Section 199A Anti-Abuse Rule**

One commenter requested clarification on whether a trust with a reasonable estate or business planning purpose would be respected. Another commenter argued that the rule is overbroad and lacks clarity as to what would be abusive and what the consequences would be of not respecting the trust for Section 199A purposes. The commenter also stated that the rule is not needed because of §1.643(f)-1 and if both rules are retained, they should use the same test (principal versus significant purpose).

Finally, the commenter asked for clarification on whether the rule applies to a single trust and suggested it should apply on an annual basis. This last suggestion has not been adopted because the test goes to the creation of the trust, factors which would not change in later years. The final regulations clarify that the anti-abuse rule is designed to thwart the creation of even one single trust with a principal purpose of avoiding, or using more than one, threshold amount. If such trust creation violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under Section 199A.[Emphasis added].

This means that taxpayers who have trusts that were in existence before the law was passed in December of 2017, and have not contributed to such trusts since then, could use their existing assets, or perhaps debt taken on at arm’s-length, or purchase money debt, if sufficient net worth exists, to purchase ownership interests in SSTBs or entities that do not have sufficient wages or qualified property to allow the income to qualify for the Section 199A deduction. This can be accomplished by making capital contributions to the entity or purchasing interests owned by high income taxpayers who would not be eligible for the deduction.

In addition, trusts that are established under estate plans that were in place before Section 199A was enacted, and which will be funded under such plans without substantial change, should also be immune by the same rationale.

In many situations, trusts exist under state law that are disregarded for income tax purposes, with their assets considered to be owned by their grantors for income tax purposes. These trusts become complex trusts when the grantor dies or releases certain powers that exist over the trust. Time will tell whether such converted trusts may be considered to have been “formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A” when they existed as grantor trusts before Section 199A was passed, but are voluntarily, or involuntarily, converted to complex trusts thereafter.

Further, many taxpayers have, and will, fund separately taxed trusts without having any knowledge, or any family situation, that would give rise to the avoidance of income tax under Section 199A at the time of formation and funding.

When subsequent Section 199A opportunities arise or become apparent, and the trust can purchase interests in a business or entity by making a capital contribution or buying an interest therein, the anti-abuse rule would not seem to apply.

Read literally, a separately taxed trust which has been formed and funded before enactment of Section 199A cannot have been “formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount... under Section 199A,” and should therefore not be subject to the anti-abuse rules.
§1.643(f)-1 Treatment of Multiple Trusts.

(a) **General rule.** For purposes of subchapter J of chapter 1 of subtitle A of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if:

- such trusts have substantially the same grantor or grantors; and
- substantially the same primary beneficiary or beneficiaries; and
- if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax.

For purposes of applying this rule, spouses will be treated as one person.

(b) **Effective/applicability date.** The provisions of this section apply to taxable years ending after August 16, 2018.
FLOW THROUGH ENTITY DEDUCTION PLANNING EXAMPLE

**Opportunity 7**

- **DR. & DR. X**
- **CHILD (who runs company)**
- **DR. & DR. X**
- **TRUST FOR DESCENDANTS**

**MEDICAL PRACTICE CORPORATION**

- Transfers Accounts Receivable
- Factoring company has lien against all Medical Practice assets to assure that it will be repaid

**FACTORING COMPANY**

- Owns transferrable accounts receivable.
- Gives back 90% of face value

**FAMILY LIMITED PARTNERSHIP**

- Repays loans with interest to FLP

- Borrows money from FLP

**NOTE** - Transfer Pricing means what one related company charges another for goods and/or services, and must be "at arm's-length at fair market value."
(a) **GENERAL RULE** If—

1. substantially all of the services of a personal service corporation are performed for (or on behalf of) 1 other corporation, partnership, or other entity, and
2. the principal purpose for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available,

then the Secretary may allocate all income, deductions, credits, exclusions, and other allowances between such personal service corporation and its employee-owners, if such allocation is necessary to prevent avoidance or evasion of Federal income tax or clearly to reflect the income of the personal service corporation or any of its employee-owners.

(b) **DEFINITIONS** For purposes of this section—

1. **PERSONAL SERVICE CORPORATION** The term “personal service corporation” means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners.

2. **EMPLOYEE-OWNER** The term “employee-owner” means any employee who owns, on any day during the taxable year, more than 10 percent of the outstanding stock of the personal service corporation. For purposes of the preceding sentence, section 318 shall apply, except that “5 percent” shall be substituted for “50 percent” in section 318(a)(2)(C).

3. **RELATED PERSONS** All related persons (within the meaning of section 144(a)(3)) shall be treated as 1 entity.
Use of Management Company and Related Arrangements

Excerpt from LISI Income Tax Planning Newsletter #136, Published March 12, 2018

It is also important to note that by definition under Section 269A, a professional service company “means a corporation the principal activity of which is the performance of personal services, which are substantially performed by employee-owners.” An employee owner is “any employee who owns more than 10 percent of the outstanding stock of the personal service corporation on any day during the taxable year. For purposes of the preceding sentence, the section 318 relationship attribution rules apply, except that ‘5 percent’ is substituted for ‘50 percent’ in section 318(a)(2)(C).” Thus, if the IRS audits a PSC doing work on behalf of one customer, the IRS can reallocate income between the PSC and whatever entity it primarily performs services for, unless the PSC is structured to not have any 10 percent or greater owner or relative thereof act as an employee of the company.

The setting of payments between related entities in exchange for services rendered, assets leased, licensing rights and for products sold is called “transfer pricing.” The IRS has a long record of using its transfer pricing reallocation powers under Section 482 when auditors have concluded that payments were more or less than arm’s-length and to the tax advantage of the taxpayer. Section 269A gives the IRS more power than does Section 482 in that it enables the IRS to re-allocate all payments/income between related entities and not just those that do not satisfy the arm’s length test; therefore, it is preferable to structure the related entity so that Section 269A does not apply, as discussed above.

The IRS may allocate or impute the income received by the corporation to its employee-owner under Sections 269A and 482 (which does not have as many requirements as 269A) in order to put the employee-owner on a tax parity with uncontrolled taxpayers. The IRS can raise the argument that the employee-owner is taxable on the income paid to his or her corporation for personal services he or she rendered to another entity under the assignment of income doctrine because the employee-owner was able to control, and possibly manipulate, the characterization of income and expenses as between the related parties. As noted in FSA 1992-11162, “…the enactment of section 269A was not intended to preclude the Service from reallocating income under section 482.”
Planning for Section 199A could be problematic and challenged by the Service under the face of Section 269A where the company primarily performs services for one other company or other entity. Consider the following:

• Substantially all of the services of a PSC are performed for (or on behalf of) one other corporation, partnership, or other entity.

• While the principal purpose for forming the PSC is not the avoidance or evasion of Federal income tax by securing the benefit of a deduction (e.g., under Section 199A), which would not otherwise be available because the PSC pre-existed, a new entity (division, subsidiary or brother-sister entity) would have in fact been formed for this purpose.

• It may be argued that the new division or entity providing non-SSB services should not be a PSC, as its principal activity is not the performance of personal services, caution should be exercised as the Section 269A and 199A definitions of personal services are not the same.

• Most worrisome, perhaps, is that Section 269A permits the IRS to treat all related persons (within the meaning of Section 144(a)(3)) as one entity. Might that be interpreted to negate the bifurcation of non-SSB and SSB revenue sources? But if the future Regulations indicate that separate entities are not required and that accounting for non-SSB and SSB revenue sources internally under one entity will be sufficient then, perhaps, Section 269A has no bearing on the ultimate Section 199A tax result?
Income from trusts formed or funded for purposes of avoiding tax under 199A may be aggregated with the grantor even if income is distributed to a beneficiary for purposes of determining whether the income threshold limitation is met, as per the example on the following slide.

The Final Regulations state the following:

Treas. Reg. 1.199A-6(d)(3)(iv) - For purposes of determining whether a trust or estate has taxable income in excess of the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under Sections 651 or 661.

Treas. Reg. 1.199A-6(d)(3)(vii) - A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of Section 199A.

See surprising example on the next page.
**What IRS Personnel Said In May 2019 Webinars**

Example Used in April 4, 2019 ABA Webinar

- **ABC (SSTB)**
  - Mom - $200,000 of Income
  - Son - $200,000 of Income
  - Result - All eligible for 199A

- **Son**
  - Distributes $100,000 of Income
  - Retains $100,000 of Income

- **Complex Trust**
  - Earns $400,000 of Income
  - (Formed and funded by Mom to avoid tax under 199A)
  - Retains $100,000 of Income

- **Mom**
  - 50%
  - Earns $400,000 of Income
  - *but unclear whether Mom has $300,000 or $400,000 of SSTB income for measurement purposes

Mom - $200,000 of Income but $400,000 of Income for purposes of applying 199A threshold
Son - $100,000 of Income
Trust - $100,000 of Income
Result - NOT eligible for 199A
Use Of Section 678 Grantor Trusts

The Final Regulations did not impose any limitation on the use of Section 678 Trusts, which are irrevocable trusts which are considered as owned by the beneficiary or beneficiaries thereof. In fact, the Final Regulations specifically state that trusts that are considered as owned by a specific individual or individuals under the “Grantor Trust Rules” will be “treated as owned by the grantor or other person,” and therefore appear to not be subject to these rules.

• For example: a mother and father could place part ownership of their S corporation stock into a trust that is considered as owned by their daughter for income tax purposes.

• This is accomplished by special provisions in the trust that may give the daughter the right to withdraw the stock contributed to the trust within thirty days of when it is contributed thereto.

• The daughter will release the withdrawal power and have no further withdrawal or control rights, and an Independent Trustee who is replaceable by the parents (which may be the daughter) can determine if and when the trust will make distributions to the daughter.

• The K-1 income from the S corporation with respect to such stock will be reported on the daughter’s personal income tax return, to qualify for the Section 199A deduction, assuming that the daughter’s income is below the threshold levels.
Use Of Section 678 Grantor Trusts

• If a beneficiary of a trust is given the power to withdraw all contributions made to the trust, then the beneficiary is treated as the owner of the trust for federal income purposes under IRC Section 678(a)(1).

• Further, if the beneficiary's power lapses or if the beneficiary releases such power, and if the beneficiary otherwise has a grantor trust power (i.e., a power described in IRC Sections 671 though 677), then the beneficiary will nevertheless be treated as the owner of the trust for federal income purposes under IRC Section 678(a)(2).

• The beneficiary's withdrawal power can lapse or the beneficiary can release his or her withdrawal power each year to the extent of the greater of $5,000 or 5% of the value of the trust’s assets without the beneficiary being considered to have made a gift to the trust for federal gift tax purposes.

• Therefore, the beneficiary's withdrawal power could be expected to lapse or be completely released prior to the beneficiary's death, which would cause the trust assets to not be included in the gross estate of the beneficiary upon his or her death, notwithstanding that the beneficiary is treated as the owner of the trust for federal income tax purposes (and could therefore enter into an installment sale with the trust without recognizing income taxes related to the sale).
AHCA Approved Holding Structure

Each of the four 678 Trusts would receive $150,000 of Section 199A income which will be taxed at 29.6% minus $1,000.

Annual Expected Savings of 7% of $600,000 = $42,000 per yr.
Each of the four 678 Trusts would receive $150,000 of Section 199A income which will be taxed at 29.6% minus $1,000.

Annual Expected Savings of 7% of $600,000 = $42,000 per yr.
Combined Section 199A And Estate Tax Savings

Charitable and SALT Trust Alternative Conceptual Chart

Dr. T

Owes Payment Rights

GRANTOR RETAINED ANNUITY TRUST ("GRAT")

Trustee

100%

HOLDING LLC

Owes Note

COMPLEX TRUST (INCLUDES CHARITABLE BENEFICIARIES)

CHILD 1 678 TRUST

CHILD 2 678 TRUST

CHILD 3 678 TRUST

CHILD 4 678 TRUST

MANAGEMENT, MARKETING & BILLING COMPANY

MEDICAL PRACTICE

60% NV

10% 10% 10%

1% V 39% NV

Annual Expected Savings Exceeds $72,000 per year

agassman@gassmanpa.com
U.S. Code § 678. Person other than grantor treated as substantial owner

(a) General rule
A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception where grantor is taxable
Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom Section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.
Use Of Section 678 Grantor Trusts

• When read literally, the Statute may be viewed to require that either (1) the beneficiary continues to have the power to “withdraw income or corpus,” or (2) the beneficiary has “partially released” or “otherwise modified” the right to receive “income or corpus.”

• Taking the first alternative above, (“(1) that the beneficiary continues to have the right to withdraw the income or corpus”), there is uncertainty as to whether the words “income or corpus” mean that the beneficiary has to have the right to withdraw both all income and all corpus, or whether the power to withdraw all income, but not corpus, would be sufficient. Commentators have differed on which interpretation would be accurate.

• There have, however, been a number of Private Letter Rulings that have concluded that a complete release is deemed to meet the requirements that the power has been “partially released or otherwise modified.” For example, in PLR 200104005, a wife created a trust for the benefit of her husband, and granted him the non-cumulative power to withdraw principal in an amount of up to the greater of $5,000 or 5% of the trust property. The IRS concluded that the husband “will be deemed to have partially released the power to withdraw the portion of the trust corpus subject to that power under 678(a)(2),” even though there was a full release of the power in relation to the amount that the beneficiary could have withdrawn that year.

• The greater of 5% or $5,000 of trust assets should generally be calculated based on the entire value of the trust, and not solely on the income of the trust. In Revenue Ruling 66-87, the IRS clarified that a beneficiary who had the power to withdraw the greater of $5,000 or 5% of trust income was only a deemed owner of 5% of the trust’s income, because the power to withdraw the greater of 5% or $5,000 only applied to the trust’s income.
Section 678 Trusts and Creditor Protection

• One downside to the use of Section 678 Trusts is that if the 678 trust is established by giving a beneficiary the right to withdrawal all assets of the trust and then releasing such power (or allowing the power to lapse), the beneficiary will be considered the grantor of the trust for state law purposes. As a result, the trust will be subject to the beneficiary’s creditors.

• Most states do not consider the beneficiary as making a transfer to the trust to the extent that the lapsed or released withdrawal power does not exceed the greater of $5,000 or 5% of the trust’s assets.

• Can the Beneficiary Deemed Owner Trust (BDOT) be used to allow for Section 678 taxation but also allow for some creditor protection for the beneficiary?

  1. The beneficiary’s withdrawal power covers the greater of the (1) net taxable income of the trust or (2) 5% of the corpus.

  2. If net taxable income is less than 5% of the corpus then the beneficiary will not be considered the grantor of the trust for state law purposes. If net taxable income is greater than 5% of the corpus then the beneficiary could withdrawal the excess and spend the money or if it would not be considered a fraudulent transfer invest it into some other creditor protected asset (IRA, variable annuity, life insurance, etc.). The trust could also provide a hanging power if net income exceeds 5% of the corpus and release all or a portion of the hanging power in years that income is less than 5%.

  3. Since the beneficiary has the power to withdraw all income of the trust annually, Section 678(a)(1) applies to treat the beneficiary of the trust as the owner for income tax purposes.

The presenters thank Ed Morrow for his excellent writings on the BDOT which can be found at LISI Estate Planning Newsletter #2587 (September 5, 2017).
Limitation 3 - Anti-Abuse Regulations for Trusts

The Opportunity - Use of 678 Trusts

Certain trusts cannot be used to deflect income that would not be deductible by professionals or high income taxpayers.

Trusts which are separately taxed and held for the benefit of family members can be structured to receive income that is either accumulated or distributed, whereby the trust will pay tax on income accumulated, and the beneficiary or beneficiaries will pay tax to the extent of income distributed. When Section 199A was first passed, the estate planning community was ready to mobilize a great number of these trusts that would own interests in SSTBs, management companies and non-SSTB companies owned by high earner taxpayers, so that each separate trust could accumulate up to $157,500 of income and also spray out an amount sufficient so that each child and grandchild would have income of up to $157,500 (or $315,000 if married filing jointly), and articles describing this technique were published and mentioned in the Preamble to the Proposed Regulations.¹

The Final Regulations carry forth the intention of the Proposed Regulations by providing that a separately taxed trust that is "formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A" will be considered as aggregated with its contributor for Section 199A purposes.

The language of the Final Regulations was also changed from referencing "Trusts formed or funded..." under the Proposed Regulations to "A trust formed or funded..." under the Final Regulations, meaning that this not only applies to the creation of multiple trusts, but can also apply to the creation of a single trust as specifically stated in the Preamble to the Final Regulations.

For example, if a high earner married couple owning 50% of a manufacturing company that does not pay sufficient wages or have sufficient qualified property to allow them to receive a Section 199A deduction transfers part ownership of the S corporation to a trust for their daughter for no other purpose than to allow for the Section 199A deduction, then the income accumulated within the trust will not qualify for the Section 199A deduction as long as the father and the mother who fund the trust continue to be high income taxpayers, based upon their personal income and the income of the trust being aggregated.

The Proposed Regulations went even farther and provided that income distributed from the trust to a beneficiary of the trust would be considered to have stayed in the trust for the purposes of "disrespecting" the arrangement. While the Final Regulations now allow for the taxable income of the "tax avoidance trust" to be determined after taking into account the DNI deduction for income distributed to a beneficiary, it is unclear if the net income that is transferred from a separately taxed trust to a beneficiary will be treated as having been received by the beneficiary and not subject to aggregation under the Anti-Abuse provisions of the Final Regulations.

The Final Regulations did not impose any limitation on the use of Section 678 Trusts, which are irrevocable trusts which are considered as owned by the beneficiary or beneficiaries thereof.

In fact, Final Regulations specifically state that trusts that are considered as owned by a specific individual or individuals under the "Grantor Trust Rules"² will be "treated as owned by the grantor or other person," and therefore appear to not be subject to these rules.

¹ Excerpt from LISI Newsletter #167, Published January 20, 2019

² Opportunity 8
My recent blog post on the discriminatory nature of Section 199A makes mention of having high-income taxpayers falling under the SSTB (Specified Service Trade or Business) category consider the use of management, billing, marketing, and intellectual property entities held at arm’s length to reduce taxes, and discusses that if the proposed regulations that were issued on August 8, 2018 become final, then such entities will be aggregated with the affiliated SSTB and thus ineligible for the Section 199A deduction if the owner’s taxable income exceeds the $207,500/$415,000 levels, or phased out ratably for income exceeding $157,500 for single filers and $315,000 for married filers. Therefore, taxpayers with income above these levels may shift ownership of such entities to trusts that can be held for descendants, parents, and other lower-bracket taxpayers (those with income below the $157,500/$315,000 levels).

The same applies for high income taxpayers that have income from Specified Trades and Businesses that do not have sufficient wages or qualified property to allow for the full, if any Section 199A deduction.

For example, Joe Accountant owns an S corporation that operates his very successful accounting firm, and may wish to establish an arm’s-length management company that provides billing, management, marketing, and other services for his accounting firm.

Joe’s arm’s-length management company may be owned one-third (33%) each, by separate trusts for his three children, who each earn less than $157,500 but then Joe loses control of the ownership interests and might not want the income to actually be paid to the children or they may give the interests to people Joe does not like or lose them in a divorce. Instead of using direct ownership or non-grantor trusts, which are taxed as separate entities that are disfavored under the new proposed regulations, Joe may choose to use what are called “Section 678 Trusts,” which are treated as being owned by one or more of the beneficiaries of the trust for income tax purposes, but allow a trustee selected by Joe to use the trust income and assets for such purposes and people as the trustee determines to be appropriate.

Many advisors will recommend the use of “non-grantor” complex trusts which are taxed on their own retained income and can also provide significant tax savings, which include the ability to take the Section 199A deduction as a taxpayer with taxable income of less than $157,500, avoidance of approximately $2,000 a year in taxes on the first $12,500 of retained income that is taxed at lower brackets and immune from the 3.85 Medicare tax, the ability to have what is equivalent to a charitable deduction for amounts distributed to charities, the ability to deduct up to $10,000 of property taxes when personal use property or owned by the trust, and the ability to retain or pay moneys or investments as determined by the trustee each year.

Disadvantages of non-grantor trusts include the need to file an annual income tax return, the need to determine how much income to retain and how much to pay out, and that the proposed regulations that were released on August 8 provide that the Section 199A advantages will not apply for these trusts when they are used for the purpose of avoiding Section 199A taxes, although it is not clear whether the IRS has the authority to issue this type of rule. The proposed regulations also provide that multiple complex trusts will be aggregated into being considered to be only one trust when they are formed by one grantor or a grantor’s spouse and each can benefit the same beneficiaries to avoid taxes. This rule can be avoided by simply having separate trusts established for the lifetime benefit of separate individuals even if common beneficiaries may benefit after the death of the lifetime beneficiaries.
FACTS:
A summary of the rules that apply to trusts and associated planning is summarized as follows, and can be used in conjunction with our LISI newsletter titled Section 199A Final Regulations Leave Open Many Avenues for Tax Planning.

Complex Trusts
Complex Trusts are trusts which pay income tax on “distributable net income” that is not distributed to beneficiaries. The Proposed Regulations had provided that the $157,500 threshold that applied to complex trusts would not be reduced by distributions made to beneficiaries that carry-out “distributable net income” for income tax purposes. For example, a complex trust with $300,000 of distributable net income that distributes $150,000 to a beneficiary having no other taxable income would not have been able to take a 199A deduction on its remaining $150,000 of income from an entity that pays no wages and has no qualified property under the Proposed Regulations, and the beneficiary of the trust would also not be able to take a Section 199A deduction on the income that was distributed from the trust to the beneficiary.

This provision of the Proposed Regulations was appropriately criticized, and the Final Regulations appropriately confirm that distributions that carry out distributable net income will reduce taxable income for purposes of determining to what extent, if any, the taxable income for a trust or estate exceeds the $157,500 threshold amount. In the example above, both the trust and the beneficiary would receive the full 20% deduction on the $150,000 respectively, assuming that the avoidance rules described below for trusts established or funded with a primary purpose of avoiding tax under Section 199A do not apply.

The Proposed Regulations relating to the allocation of depreciation deductions under a trust as between the trust itself and beneficiaries were criticized as being incorrect. The Final Regulations include a revised example to clarify the allocation of qualified business income and depreciation as between a trust and its beneficiaries, and continue to require that a trust or estate allocate qualified business income, including any negative losses, among the trust and its beneficiaries based on the relative portions of DNI distributed or retained.

Anti-Abuse Rules
The Proposed Regulations had unusual language which provided that certain trusts would be “disrespected” for Section 199A purposes if they were established for the purpose of avoiding tax under Section 199A. The Final Regulations clarify that the anti-abuse rule is designed to “thwart the creation of even one single trust with a principal purpose of avoiding, or using more than one, threshold amount.”

The Final Regulations indicate that if the trust creation is for a principal purpose of avoiding tax under Section 199A, then the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the Section 199A deduction.

Specifically, the Permanent Regulation provision for this reads as follows:

\[ \text{Anti-abuse rule for creation of a trust to avoid exceeding the threshold amount: A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of Section 199A.} \]

The Final Regulations provide no examples to give any further guidance with respect to this.
Complex Trusts Under The Final Regulations

The Proposed Regulations indicated that distributable net income coming from a Complex Trust would be subject to a single $157,500 limit, even if distributed to beneficiaries who would be under the limit.

The Final Regulations fortunately recognize that the limit applied at the trust level will be based upon the distributable net income that remains after distributions are made.

**Example:** Separately taxed trust has $300,000 of distributable net income (“DNI”).

It distributes $150,000 to grandchild, who has no other income, and retains $150,000.

Grandchild can take the Section 199A deduction, even if this is SSTB income or income from a business that pays no wages and has no qualified property.

However the trust may be aggregated with the Grantor if the “primary purpose was to avoid tax under Section 199A.” If aggregated, both the income retained by the trust and the income distributed will not be eligible for the deduction if the combined income exceeds the threshold amounts.
As discussed in a previous slide, if the trust was formed or funded with a primary purpose of avoiding tax under Section 199A, then its taxable income will be aggregated with the taxable income of its grantor for threshold limitation purposes.

From example above - If Grantor is single with $100,000 of taxable income, and a trust has $150,000 of taxable income (DNI) remaining, then they are over the $207,500 threshold, and receive no DNI deduction.

If each of them had one-half of the above respective taxable income amounts, then they would each have a Section 199A deduction.

**Planning Tip.**

Trusts that were formed before the enactment of Section 199A in December of 2017, were clearly not formed or funded with a primary purpose of avoiding Section 199A.

These trusts may invest in SSTBs, or Pseudo SSTBs, and receive the deduction.
Complex Trust Advantages

1. **Charitable Distributions.** If the Trust Agreement authorizes distributions to charity, then such distributions can carry otherwise taxable income out to the charity that is not taxed. The family therefore gets the equivalent of a charitable deduction that might not otherwise be available because of the high itemized deduction threshold that now applies to individuals ($12,200 for single individuals and $24,400 for married couples filing jointly). For example, a $20,000 charitable contribution made by a 37% tax bracket individual will commonly not result in any tax deduction whatsoever because of the $24,000 standard deduction that now applies.

Charitable contributions can be made by the end of a calendar year and still count to reduce the income of the trust for the previous year, assuming an election to do so is filed on the trust’s amended tax return for the previous year. For example, if a trust makes a charitable contribution in Year 2, it can elect to have the contribution treated as if it was made in Year 1 as long as the election is made on an amended tax return for Year 1, which can be filed as late as the deadline for Year 2’s tax return on April 15 of Year 3, or October 15 if extended. The distribution can reduce the trust’s taxable income for Year 1 or Year 2, as decided by the Trustee.

If the trust does not specifically provide for charitable distributions it may place assets into a legitimate entity taxed as a partnership and receive a deduction for its share of the partnership’s charitable contributions.

2. **State and Local Tax (SALT) Deduction.** Complex trusts can deduct up to $10,000 of state and local taxes each year, including real estate taxes, so that they can own personal use real estate and receive a tax deduction that the grantor and other family members may not be eligible for because of the $10,000 per year, per taxpayer limit on the deductibility of state and local taxes, even if the trust is set up for the purpose of obtaining such a deduction. For example, a vacation home that is subject to $30,000 a year in property taxes could be owned one-third each by three separate trusts for the primary benefit of each separate child of a married couple, to enable all of the property taxes to be deductible, assuming that each of the trusts has $10,000 or more of otherwise taxable income.
3. **Spraying and Allocation Flexibility.** The trustee can decide which beneficiaries receive how much each year. The trustee may exert polite pressure on the beneficiaries or even pay expenses on their behalf instead of outright to them to influence behavior in a way that can be far superior to letting them have direct ownership in a management or intellectual property company. This provides significant flexibility that is not available for S corporations and partnerships because of the second class of stock and substantial economic effect rules.

4. **65 Day Look Back.** In addition, distributions made during the first 65 days of the calendar year can be considered to have been made in the previous calendar year for income distribution purposes. This allows the trustee and family members to confer with their tax advisors after December 31st to determine where income can best be allocated for the previous year. This extends for a full year for charitable distributions, meaning that a trustee can elect to treat distributions to charity as being made in the previous tax year if made before December 31 of the current tax year under Section 642(c)(1).

5. **Reduced Chance of Audit.** Having income payable to a trust and distributed to low bracket taxpayers can reduce the chances of audit. Complex trusts file a Form 1041, and 1041 audits are very rare, if existent at all. Audits of low bracket taxpayers occur at a much lower frequency than the audits of high bracket taxpayers.
6. **Tax-Free Distributions of Appreciated Assets.** Appreciated assets can be transferred out of a trust to beneficiaries without triggering income tax that would apply if a trust were taxed as a corporation, or as a partnership if certain “mixing bowl” and related rules apply.

7. **New Income Tax Fair Market Value Basis on Death of Power Holders.** Assets held in a trust can receive a new income tax basis to avoid payment of capital gains tax on appreciation that occurs up through the date of the grantor’s death, if the grantor has what is known as general Power of Appointment over appreciated trust assets. Court Orders or non-judicial reformation agreements may provide an individual with a short life expectancy with the right to direct how trust assets might pass within reasonable parameters, which can result in a new fair market value date of death income tax basis as if the Power Holder was the owner of the assets. This would include a power to appoint assets to creditors of the estate of the Power Holder, even if such Power is only exercisable with the consent of an independent party. This would be consistent with the intention of a grantor who set up a trust for estate tax purposes and now wants to assert a reasonable degree of control because estate tax is no longer an issue, and the situation among family members may have changed.

Depreciation recapture amounts do not “step-up” if the holder of the general Power of Appointment does not own the asset, pursuant to Section 1014(b)(9).
Complex Trust Disadvantages

1. **Formation and Annual Carrying Costs.** Costs and possible repercussions of forming or changing irrevocable trusts should of course be considered. This includes consideration of the cost of forming a trust or changing a disregarded trust to a complex trust, filing of income tax returns, and associated formalities.

2. **Loss of 179 Deductions.** Unlike a “special allocation partnership,” depreciation and Section 179 deductions are not available for trusts, or for beneficiaries who receive trust distributions in the year that Section 179 property is acquired. Trusts may have to write off furniture, equipment, and other acquired business property under the Section 168 rules, which will, in many cases, give them the same deduction, but sometimes over a longer period of time.

Fortunately, the Section 168(k) bonus depreciation will often be as good as the Section 179 deduction until January 1, 2023. The Tax Cut and Jobs Act expanded Section 168(k) to enable taxpayers to immediately expense 100% of qualified business property placed in service between September 27, 2017 and January 1, 2023. Although, the percentage of qualified business property that may be immediately expensed begins to decrease after 2023, and is eliminated after 2027, Section 168(k) bonus depreciation provides temporary relief from the inability of trusts to take a Section 179 deduction.

For example, if a construction business purchases trucks for its workers to use, the company can choose to depreciate the property all at once (because it has a life of less than 20 years). A trust could have part-ownership in the company and be able to claim the deduction on its Form 1041 income tax return, assuming the company is a flow-through entity. In addition to the immediate deduction the company will get in the first year, the owners, including the trust, can continue to use the trucks as Qualified Property under Section 199A for at least 10 years.
Complex Trust Disadvantages, Continued

3. **Partnership Taxation May Apply.** Trusts that engage in business may be taxed as partnerships instead of complex trusts if the case law that existed before the “check the box” regulations were issued in 1997 would have caused the trust to be considered to be an “association” under the Supreme Court decision of *Morrissey v. Commissioner*, and the subsequent Section 7701 Regulations. There are no known cases where this has occurred after 1997, and the result would be that the beneficiaries of the trust will be considered to be partners, and thus taxable on the retained income of the trust that would have otherwise been taxed at the trust level.

4. **Disclosure and Fiduciary Duty Differences.** The Trustee of a trust normally has a duty to account annually, disclose trust actions, and to act for the best interest of the beneficiaries. These fiduciary duties will commonly exceed the duties that a general partner has under a partnership, or that a manager has under an LLC, but may be altered by agreement with adult beneficiaries, and selecting an appropriate situs (“state or country of formation”) for a given trust.

Clients with irrevocable trusts currently in place that are treated as disregarded for income tax purposes should review the situation and discuss whether structures in place should be altered to take advantage of the income tax planning opportunities that may exist.
## Comparison Of 678 Trusts To Complex Trusts

<table>
<thead>
<tr>
<th>Complex Trusts</th>
<th>678 Trusts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. May spray taxable income among multiple beneficiaries.</td>
<td>1. All taxable income considered as taxed to one beneficiary who may receive limited or no distributions.</td>
</tr>
<tr>
<td>2. Will need a separate tax return and must pay income before 65 days after the end of each calendar year to carry out DNI, if desired.</td>
<td>2. No separate tax return has to be prepared for the trust.</td>
</tr>
<tr>
<td>3. Ability to retain up to $12,750 of income to be taxed at lower brackets to save up to $2,127 if Medicare tax applies. (2019 amounts)</td>
<td>3. If beneficiary has less than $157,500 of taxable income, including 678 income, full 199A deduction may be taken on SSTB or income otherwise limited by wage/replacement property requirements.</td>
</tr>
<tr>
<td>4. Up to $157,500 of retained income may qualify for the Section 199A deduction for SSTB or low wage/qualified property income if trust not formed or funded primarily to avoid tax under 199A.</td>
<td>4. Section 121 deduction may also apply to primary residence of withdrawal power beneficiary to exempt up to $250,000 of capital gains income on the sale of a primary residence.</td>
</tr>
<tr>
<td>5. May pay income to charity to avoid tax if specified under Trust Agreement, or through subsidiary partnership even if not specified.</td>
<td>5. The trust may benefit a spouse, descendants and other individuals – spouse may only receive benefits with consent of adverse party while grantor is living.</td>
</tr>
<tr>
<td>6. May pay up to $10,000 per year in property taxes to receive deduction.</td>
<td>6. Deemed owner/beneficiary may deduct up to $10,000 per year in property taxes cumulatively.</td>
</tr>
<tr>
<td>7. Medicare and employment tax savings may also apply.</td>
<td>7. Spouse or another individual may have a testamentary power of appointment while grantor is living to divest the withdrawal power beneficiary and/or others.</td>
</tr>
</tbody>
</table>
Significant Limitations Apply With Respect To Income Received From Specified Trades Or Businesses

For taxpayers with less than $157,500, or $315,000 of taxable income, if married, income from a Specified Trade or Business qualifies for the full Section 199A deduction.

Taxpayers with income above those levels have a phase-out or complete elimination of the deduction.

The Specified Trades and Businesses are as follows:

1. Health
2. Law
3. Accounting
4. Actuarial Services
5. Performing Arts
6. Consulting
7. Athletics
8. Financial Services
9. Brokerage Services
10. Investing, Trading, or Dealing in Securities, Partnership Interest or Commodities
11. Any Business where the Principal Asset is the Reputation or Skill of one or more of its Employees or Owners
Final Regulations Change Definition of SSTB Services, As Follows:

• **Health Services** definition has been changed to no longer require services to be provided directly to patients. This expands the application of the definition of health services.

• **Legal Services** definition was modified to reflect that SSTB income will only apply to legal services. It is unclear whether this will have any significant impact because the Proposed Regulations already clarified that stenography and delivery services were not considered SSTB activities.

• **Closing Agents** may be treated as accountants.

• **Architects and engineers, and consultants providing services with respect to architecture and engineering,** are specifically excluded from the definition of SSTB services.

• **Life Insurance Agents** selling commissioned-based sales of life insurance products is non-SSTB.

• **Financial Services** definition has been changed to clarify that taking deposits and making loans is not an SSTB service, but arranging lending transactions between lenders and borrowers is an SSTB service.
Final Regulations Change Definition of SSTB Services, As Follows:

- **Dealing in Securities** definition has changed. Previously, taxpayers engaging in negligible sales of loans was not considered to be dealing in securities. The new language states that performing services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is dealing in securities.

- The definition of **trading** no longer specifically exempts manufacturers or farmers who engage in hedging transactions as part of their trade or business of manufacturing or farming.

The IRS apparently thinks that **pharmacies, adult congregate facilities, surgery centers** and **testing operations** can escape SSTB services by having independent parties provide the medical services associated with the facility or operation.
Health Services SSTB Under Final Regulations

The Proposed Regulations defined health services as:

• “the field of health means the provision of medical services by individuals such as physicians......and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient).”

The Final Regulations removed the bolded words above, which will cause many more health care activities to be treated as SSTBs.

• The Treasury and the IRS decided that proximity to patients is not a necessary component to providing services in the field of health, and that rendering services to doctors who assist them in treatment of patients may be considered an SSTB.

• “the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing or manufacture and/or sales of pharmaceuticals or medical devices.”

*NOTE – Is research a health service, when the physician has active interaction and treatment of patients being monitored?

• The Treasury and the IRS provided the following examples in an attempt to clarify what is a health service although some of the examples may not be realistic due to applicable healthcare laws.
• **Stem Cell and PRP Injection Therapies** – One commentator argued that gene therapy and stem cell therapy should be treated the same as selling pharmaceuticals so that their manufacture and production is not considered to be a health service. Due to the fact that these therapies are generally provided by a physician who examines the patient, handles or oversees the extraction, and handles or oversees the re-injection, which is often done with ultrasound or other x-ray style guidance, these treatments will likely be treated as health services.

• **Veterinarian Services** – There is a lengthy discussion to explain that veterinary medicine is a health service. Apparently, veterinarians lobbied hard to be excluded, and this was not successful.

• **Physical Therapists** – Despite significant lobbying, the IRS declined to exclude physical therapists from being health care professionals.
A Note On Consulting

Consulting is defined as the provision of professional advice and counsel to clients to assist in achieving goals and solving problems.

Consulting includes lobbying and other similar professionals performing services as consultants.

Consulting does not include the performance of services other than advice and counsel, such as providing training, education and educational workshops.

Consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.

Services within the fields of architecture and engineering are not treated as consulting services.

A new example shows that most staffing services will not be treated as consulting.
Where The Principal Asset Of The Trade Or Business Is The Reputation Or Skill Of One Or More Employees Or Owners

The final category of a Specified Service Trade or Business involves a situation where the principal asset of the trade or business is the reputation or skill of one or more employees or owners. Many advisors were concerned with the potential breadth of this “catch all” provision.

Fortunately, under the Regulations, the Treasury chose to narrowly construe this category, and it will not apply unless one of the following three items exist:

(A) Fees or other compensation is received for endorsement of products or services;

(B) License or fees are received for the use of an individual’s image, likeness, name, signature, voice, trademark, or any other symbols associated therewith; or

(C) Compensation is received for appearing at an event or on radio, television, or other media.
Does Rental Income Qualify For The New 20% Section 199A Deduction?

Alan Gassman, Contributor
Estate, Tax, and Retirement
I write about tax, estate and legal strategies and opportunities.

Why Landlords With Triple Net Leases Are Likely Punished Under the New Tax Law

Section 199A was added to the Internal Revenue Code under the Tax Cuts and Jobs Act of 2017 to provide taxpayers with a 20% deduction from income attributable to qualifying trades or businesses.

One immediate question under the new law was whether the definition of a “trade or business” would include a landlord who is in the business of collecting rent and performing only incidental duties under a Lease Agreement.

This will make a big difference for landlords who have a net profit because rent income exceeds depreciation, interest and operating deductions.

New Proposed Regulations were issued on August 8th which provide some degree of guidance, but also confusion.

The new Proposed Regulations indicate that if a taxpayer has an active business, like a factory or an engineering firm, and directly or indirectly leases property to the firm, then the net income from the leasing arrangement will be considered to be an active trade or business for Section 199A purposes.

On the other hand, where the tenant under an arrangement is not an active business that is affiliated by at least 50% ownership with the landlord, then by the terms of the Proposed Regulations a definition of “trade or business” which comes from Internal Revenue Code Section 162 will be used. Section 162 dates back to 1926, and controls when a taxpayer can take deduction for expenses incurred in an “active trade or business.”

The court cases interpreting Section 162 have not always been kind to landlords. In particular, there needs to be something more than a long-term triple net lease where a landlord just collects rent and does very little else in order to qualify as being a trade or business.

A landlord that provides active management relating to a particular building, or at least administers common area expenses, should probably be able to take the Section 199A deduction, but someone who simply bought a building that is triple net leased to a large company where the large company does everything and simply sends a check to the property owner will probably not qualify, although this is not clear.

One example in the Proposed Regulations provides that an individual who manages and leases vacant property to an airport is able to take the deduction.

The primary focus of this example was not whether this landowner was in a “trade or business,” but it seems like the only reason the IRS would have had to mention that the landlord manages the airport property would be to show that it must be an active trade or business.

A second example in the Proposed Regulations provides the same language for a parking garage rental.

Based upon these examples, it appears that taxpayers who have passive triple net leases and are not otherwise active in the leasing business will not qualify for this 20% deduction, although landlords under triple net lease arrangements might be engaged in continuous due diligence, negotiating, and buying and selling properties that are triple net leased and therefore be considered to be in an active trade or business for the purposes of this deduction.
When Is A Triple Net Lease Considered To Be Active Under The Final Regulations?

A triple net or other “passive lease” from a landlord related to the owners of an S corporation, partnership, or individuals operating an active trade or business (even if an SSTB) will be considered active.

Example 1 – a triple net lease of real estate owned by a lawyer’s children to an S corporation law firm that is an active trade or business will be considered to be an active trade or business activity for the landlord.

Example 2 – an otherwise nonactive triple net lease to a C corporation will not be considered to be active.

Planning Strategy – A triple net lease landlord can offer to provide significant services to a tenant for less than it would cost the tenant to provide those services for itself in order to qualify the landlord for the 199A deduction.

Businesses that have multiple leased business locations can approach landlords with this idea.

Will the cost of services be compensated for by the tax savings? Can the clause be reversible?
More On When Real Estate Leasing Will Be Considered To Be An Active Trade Or Business

- Income from flow-through entities, such as S corporations and entities taxed as partnerships (based upon K-1 reporting without regard to cash distributions), and income from disregarded entities. Schedule C entities such as sole proprietorships, and Schedule E entities that are “effectively connected” with conduct of a trade or business within the United States.

- In order to qualify for the deduction, the flow-through entity must be a trade or business as defined under Section 162.

- The Courts have primarily focused on three factors to determine if there is a “trade or business”:
  
  1. Whether there is a profit motive.
  2. Whether the activity was performed regularly or continuously.
  3. The scope of the activities performed.

  a) Neil v. Comm’r 46 BTA 197 (1942) – The mere collection of rent does not involve sufficient management activity to constitute a trade or business. Similarly, the mere ownership of a patent without exploiting it does not constitute a trade or business.


  c) DeAmadio v. Comm’r 34 T.C. 894 (1960) – A taxpayer that contracts with various real estate firms to collect rent from properties, make repairs, and acquire tenants is considered to be engaged in a trade or business because the activities carried on by his agents are considerable, continuous, regular and beyond the scope of mere ownership of property.
Relevant Factors In Determining Whether A Rental Real Estate Activity Is A Section 162 Trade Or Business

(i) the type of rented property (commercial real property versus residential property)

(ii) the number of properties rented

(iii) the day-to-day involvement by the owner and agents of the owner (including time spent by employees and independent contractors)

(iv) the types and significance of any ancillary services provided under the lease, such as janitorial, maintenance and labor intensive common area amenities

(v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).
Each LLC pays management fee to Management Co., LLC that employees workers to maintain properties.

Management Co., LLC will rise to the level of a trade or business, and also have sufficient wages to take maximum Section 199A deduction.

Rental properties each held under separate LLC that does not rise to the level of a trade or business, or does not have sufficient wages or Qualified Property.
Part III – Administrative, Procedural, and Miscellaneous
Section 199A Trade or Business Safe Harbor: Rental Real Estate

- Provides that real estate rented or leased under a triple net lease is **not** eligible under the Safe Harbor.

- Defines a triple net lease to include an agreement that requires:
  - tenant to pay taxes, fees and insurance, and to be responsible for maintenance in addition to rent and utilities.
  - includes leases that require the tenant to pay common area maintenance expenses.

The definition leaves open the possibility of avoiding triple net lease status by holding the tenant responsible for some portion of the maintenance, taxes, fees, insurances and other expenses that would normally be payable by a landlord.

- **Revenue Procedure 2019-38 removed** language that stated that a triple net lease includes lease agreements that require a “tenant or lessee to pay a portion of the taxes, fees, and insurance.”
(IRS Notice 2019-7, Continued)

• Many landlords will be well advised to offer significant rent reductions to tenants who are willing to pay for some part of one or more items, so that the landlord can fit within the Safe Harbor to reduce the effective tax rate on taxable income from 37% to 29.6%, in addition to whatever may be saved in state income taxes and sales taxes.

• Safe Harbor cannot be used on a taxpayer’s personal residence that is leased for part of the year.

• Rental Real Estate Enterprise under Safe Harbor -
  
  • Defined as an ownership interest in real estate that is rented, and may consist of one or more properties.
  
  • An individual relying upon the Safe Harbor, or a partnership or S corporation entity must own the real estate directly or through another entity that is disregarded for income tax purposes (i.e. a single member LLC).

**NOTE** – A tax advisor should be consulted if the individual or the entity taxed as an S corporation or partnership does not directly own the applicable real estate to see if the disregarded entity rules will apply.
• Each individual taxpayer, estate or trust can elect to treat each separate party as a separate enterprise, or all similar properties as a single enterprise, for purposes of applying the Safe Harbor rules, except for commercial and residential real estate, which cannot be considered as part of the same enterprise for testing purposes.

• The following requirements must be satisfied during each year to qualify under the Safe Harbor:

1. Separate books and records must be maintained to reflect the income and expenses for each enterprise.

2. Contemporaneous records created to include time reports, logs or similar documents which are kept regarding the hours of all services performed, the description of all services performed, the dates upon which the services are performed and who performed the services, with respect to tax years beginning January 1, 2019.
3. For years 2018 through 2022, 250 or more hours of rental services must be performed each year to qualify the property for the Safe Harbor.

**250 hours divided by 52 weeks is 4.8 hours a week, or approximately 21 hours each month.**

Rental services include:

- Time spent by owners, employees, agents and independent contractors of owners, which can include management and maintenance companies who have personnel who keep and provide such contemporaneous records.

**NOTE:** Time spent by computers that have artificial intelligence will not apply, so taxpayers may elect to use low cost offshore call room and similar workers to effectuate many tasks that may add to the time spent to facilitate reaching 250 hours per year, i.e. providing tenants with additional services that can be provided by inexpensive call center employees to schedule periodic inspections, insect treatments, insurance renewals and the condition of building systems, etc.

- Advertising to rent or lease the properties.

- Negotiating and executing leases.

- Verifying information contained in tenant applications.
Rental services include:

- Collecting rent.
- Daily operation, management and repair.
- Management of the real estate.
- The purchase of materials.
- Supervision of employees and independent contractors.

“Rental services” does not include the following:

- Doing due diligence on prospective properties and purchasing properties;
- Studying and reviewing financial statements or operational reports;
- Planning, managing or constructing improvements;
- Traveling to and from the real estate;
- Or other financial or investment management activities.
Revenue Procedure 2019-38

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• Collecting rent.

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• Management of the real estate.

• The purchase of materials and supplies.

• Supervision of employees and independent contractors.

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• Doing due diligence on prospective properties and purchasing properties;

• Studying and reviewing financial statements or operational reports;

• Planning, managing or constructing improvements;

• Traveling to and from the real estate;

• Other financial or investment management activities; or

• Improving property under § 1.263(a)-3(d) (Amounts Paid to improve tangible property)
Revenue Procedure 2019-38

Notable changes vs. Rev. Proc. 2019-07:

1. The use of the word “similar” was clarified

   • Prior to Rev. Proc. 2019-38, it was unclear whether commercial and residential properties were inherently not similar, or that an assessment of similarity within the two categories was required.

   • New language:
     • “For purposes of applying this revenue procedure, properties held for the production of rents are similar if they are part of the same rental real estate category. The two types of rental real estate categories for the purpose of combining properties into a single rental real estate enterprise are residential and commercial. Thus, commercial real estate held for the production of rents may only be part of the same enterprise with other commercial real estate, and residential properties may only be part of the same enterprise with other residential properties.”
Revenue Procedure 2019-38

Notable changes vs. Rev. Proc. 2019-07 (cont.):

2. **Mixed-use Property Inclusion**

   • Mixed-use Property was not addressed in Rev. Proc. 2019-07.

   • New language:
     • “An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. For purposes of this revenue procedure, mixed-use property is defined as a single building that combines residential and commercial units. An interest in mixed-use property, if treated as a single rental real estate enterprise, may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property.”
Notable changes vs. Rev. Proc. 2019-07 (cont.):

3. **Separate Books and Records Requirement (A)**

- Prior to Revenue Procedure 2019-38, 2019-07 required separate books and records to be maintained for each entity.

- Now, if an enterprise includes more than one property, this requirement may be satisfied if the taxpayer maintains income and expense information statements for each property, then consolidates them.

  - This change alleviates some extra unnecessary legwork that Rev. Proc. 2019-07 called for because taxpayers typically maintain their books on a property-by-property basis.
Notable changes vs. Rev. Proc. 2019-07 (cont.):

4. Single Trade or Business Requirement (B)

2019-07:
For taxable years beginning:

• Prior to January 1, 2023 – 250 or more hours of rental services performed per year
• After December 31, 2022 – 250 hours or more hours of rental services performed in any 3/5 consecutive taxable years

2019-38
For rental real estate enterprises that have been in existence for:

• Less than 4 years – 250 or more hours of rental services performed per year
• At least 4 years – 250 or more hours of rental services performed in any 3 of 5 consecutive taxable years

<table>
<thead>
<tr>
<th>“Rental Services” Definition</th>
<th>Revenue Procedure 2019-07</th>
<th>Revenue Procedure 2019-38</th>
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<tbody>
<tr>
<td>Includes:</td>
<td>• Collecting rent.</td>
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<td>• Daily operation, management and repair.</td>
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<td>• Management of the real estate.</td>
<td>• Management of the real estate.</td>
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<td></td>
<td>• The purchase of materials.</td>
<td>• The purchase of materials and supplies.</td>
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<td></td>
<td>• Supervision of employees and independent contractors</td>
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<td>Doesn’t Include:</td>
<td>• Doing due diligence on prospective properties and purchasing properties;</td>
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</tr>
</tbody>
</table>

| How will mixed-use property be treated? | Unknown/Silent | “An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. For purposes of this Revenue Procedure, mixed-use property is defined as a single building that combines residential and commercial units. An interest in mixed-use property, if treated as a single rental real estate enterprise, may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property. “ |

| What Constitutes as “Similar” property? | Unknown/Silent | “For purposes of applying this Revenue Procedure, properties held for the production of rents are similar if they are part of the same rental real estate category.” |
| (i.e. Residential or Commercial) |

| Single Trade or Business Hour Requirement | For taxable years beginning: | For rental real estate enterprises that have been in existence for: |
|                                         | • Prior to January 1, 2023 – 250 or more hours of rental services performed per year | • Less than 4 years – 250 or more hours of rental services performed per year |
|                                         | • After December 31, 2022 – 250 hours or more hours of rental services performed in any 3 of 5 consecutive taxable years | • At least 4 years – 250 or more hours of rental services performed in any 3 of 5 consecutive taxable years |
The issuance of new Proposed Final Regulations on August 8th answers many questions and raises others about how these rules impact real estate and real estate professionals, while presenting both planning opportunities and traps for the unwary that need to be considered by real estate investors, developers, and companies that are in real estate, or real estate-related trades or businesses. The Proposed Regulations are sure to change to some degree before they become final, but can be relied upon by taxpayers until then. On the other hand, parts of the Regulations that would hurt taxpayers need not be followed until they are made final, but reflect how the IRS is looking at the statute and how it may be interpreted.

The Final Regulations retained many of the rules under the Proposed Regulations related to real estate, but also provided taxpayers with a safe harbor under which real estate investors can qualify as an active trade or business if certain requirements are met which will be discussed in more detail below.

The Proposed Final Regulations tell us that a "trade or business" will exist if the “active trade or business” requirements of Internal Revenue Code Section 162 are met. The Section 162 rules have been around since 1926 and basically allow expenses to be deducted when incurred for a legitimate and active trade or business.

There is a valuable exception, however, under that was retained in the Proposed Final Regulations which permits even passively held triple net leased property to be considered as an active business activity to the extent that the property is leased to another active trade or business that taxpayer has direct or indirect ownership, if the taxpayer and/or parties related by family attribution or common ownership of the business tenant own more than 50 percent of the business tenant. If the income comes from multiple tenants, one being a related party and the other an unrelated party, then only the portion attributable to the related party will automatically be considered an active trade or business, and the landlord will have to do more than just collect rent from the unrelated party in order for that portion to be considered an active trade or business and eligible for the Section 199A deduction.
In addition, the Treasury released IRS Notice 2019-7 which provides a safe harbor for real estate investors to be considered an active trade or business and eligible for the deduction if certain requirements are met. In order to qualify as an active trade or business under the safe harbor, the taxpayer must spend 250 or more hours on rental services during the tax year, which includes negotiating and executing leases, verifying information contained in applications, advertising to rent or lease properties, collecting rent, daily operation management and repairs, the purchase of materials, or the supervision of employees and independent contractors. The safe harbor requires that each individual taxpayer maintain contemporaneous records to document the amount of time spent on the activity during the tax year, and without written evidence of such records, then the taxpayer will not be eligible for the safe harbor.

While the real estate safe harbor specifically provides that triple net leases will not be eligible under the safe harbor, a taxpayer who has an active business of entering into and selling triple net leases may still be considered to be sufficiently active to qualify as a trade or business and thus eligible for the Section 199A deduction under case law defining a trade or business under Section 162.

Fortunately, real estate professionals, including brokers, agents, developers and property managers are not considered to be SSTBs, although if the real estate is used and rented by an SSTB and is 50% or more commonly owned by owners of the SSTB and the landlord, then the real estate and the income attributable to rent received from a commonly controlled SSTB are aggregated and both will be treated as SSTB income and ineligible for the Section 199A deduction if their income exceeds the above thresholds. Another blog post that I have recently posted describes what the Specified Trades or Businesses are, and what can be done for those who are under this limitation.
Consider Adjusting Rental Arrangements

- Increase or decrease rent to take into account the 3.8% Medicare tax, 6.8% sales tax, and passive loss rules.

- Consider combining real estate with business operations by having separate companies under the same tax identity to attempt to eliminate sales tax and the 3.8% Medicare tax.

- Be sure that lease agreements have appropriate provisions to help insulate the landlord from potential liability caused by tenant usage.

- Many taxpayers will not be able to deduct interest and depreciation from rental activity that would otherwise be available because of the passive activity loss rules. IRC § 469(c)(7) may nevertheless permit these deductions where a “tenant entity” and the real estate owner entity have generally identical ownership, and the real estate is used in the tenant’s trade or business.
Rental Real Estate Passive Loss Rules

IRC Section 469, and regulations and case law, basically provide that net losses from rental real estate activities cannot be deducted unless one of the following three requirements are satisfied:

1. The taxpayer has Adjusted Gross Income (“AGI”) below $150,000 (a phase-out applies between $100,000 and $150,000 of AGI), owns at least 10% of the rental property, and makes management decisions, or has others make management decisions.

   The above taxpayer can deduct up to $25,000 of passive losses without meeting the further requirements.

2. The individual or his or her spouse is a Real Estate Professional, and together the spouses meet one or more of the seven Material Participation Tests described on the following slides.

3. Rentals are for an average of seven days or less.

**NOTE** – The most common trap for the unwary in the passive loss rules is that the individual (or spouse) must be a Real Estate Professional, unless the lower AGI/$25,000 exception applies.

For example, an individual with AGI exceeding $150,000 may spend 550 hours on a rental property, but not qualify as a Real Estate Professional, so that the real estate rental losses cannot be taken. As described in the next slides, a spouse’s time spent on a particular rental property can be counted, but one spouse or the other must individually have at least 750 hours (and more than half of his or her personal services) as a Real Estate Professional.
The Real Estate Professional Requirement

Under Internal Revenue Code Section 469, real estate rental activities are considered “per se” passive unless the individual qualifies as a Real Estate Professional, and meets both of the following two requirements:

a. **More than one-half of the personal services performed** by the taxpayer in a trade or business must be performed in real property trade or business(es) in which the taxpayer materially participates, and

b. The taxpayer **performs more than 750 hours of service** during the year in real property trades or businesses in which the taxpayer materially participates.

This is above and beyond having to meet one or more of the seven tests for Material Participation (such as the standard 500-Hour Test or the 100-Hour Test), which apply also to non-real estate passive activities. Therefore, Real Estate Professionals are required to meet a much higher standard than taxpayers engaged in non-real estate passive activities.

**Classification as a Real Estate Professional avoids the per se passive classification for rental real estate activities.**
Generally, a taxpayer who has a non-real estate related full time job, will not qualify as a Real Estate Professional because a Real Estate Professional is required to spend over 50% of his or her professional time on real estate related activities. [40 Hours x 50 Weeks is 2,000 Hours.]

As mentioned in a prior slide, the time that a spouse spends working on real estate matters cannot be used by the other spouse to meet the 750-Hour Real Estate Professional requirement, although a spouse’s time will count towards the general 500-Hour Test and the 100-Hour Test.

- This is an important distinction because a Real Estate Professional needs to Materially Participate in real estate activities in order to deduct real estate losses against ordinary income. From our research it appears that there is a lot confusion in this regard.

For Example: If a taxpayer works 2,000 hours a year as an attorney and spends over 750 hours on rental real estate endeavors, that taxpayer will not qualify as a Real Estate Professional because more than 50% of that taxpayer’s professional time is spent on the practice of law.

If a taxpayer spends all of his or her professional time working on real estate rental activities but only works 749 hours, that taxpayer will not meet the 750 hour requirement, and will thus not qualify to be a Real Estate Professional.
How A Real Estate Professional Can Be Considered As “Materially Participating” In A Real Estate Activity (The Seven Tests)

Under Treas. Reg. 1.469-5T(a), a Real Estate Professional taxpayer is treated as a material participant, and thus an active owner not subject to the 3.8% Net Investment Income Tax.

Special Rule for Limited Partnerships – Only items 1, 5 and 6 can be applicable to limited partners – a limited partner meeting tests 2, 3, 4 or 7 will nevertheless be considered passive - so that the passive loss rules will apply, or 3.8% Net Investment Income Tax will be imposed if there is income:

1. The taxpayer participated for more than 500 hours during the tax year. (The 500 Hour Test)

2. The taxpayer’s participation constitutes “substantially all” of the participation in the activity by all individuals during the tax year.

3. The taxpayer participated for more than 100 hours during the tax year and no other individual participated more than the taxpayer’s number of hours in the activity during the tax year. (The 100 Hour Test)

4. Treated as a material participant in all Significant Participation Activities (SPAs) if the taxpayer’s aggregate participation in the SPAs exceeds 500 hours during the tax year. SPAs are defined as activities in which the taxpayer would not be a materially participant under any of the other six tests and the taxpayer spends more than 100 hours in during the tax year.

5. The taxpayer was a material participant in 5 of the last 10 tax years. (If the taxpayer is a limited partner, then Sections 1 or 6 must have been satisfied for five of the last 7 years).

6. The taxpayer was a material participant in a personal service activity (health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) in three of the last six years. (DOES NOT ASSIST WITH REAL ESTATE)

7. Based on all the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year. While this test would seem to be available, any time that less than 500 hours or 100 hours are spent, the regulations state that this standard can only be met if the taxpayer participates for over 100 hours per year. Regulation Section 1.469-5T(b)(2)(ii). 

agassman@gassmanpa.com
Relevant Factors To Determine If Taxpayer Is A Real Estate Dealer Or Investor Eligible For Capital Gains Treatment

1. The nature and purpose of the acquisition of the property.

2. The duration of ownership.

3. The extent and nature of sales efforts.

4. The number, extent, and continuity and substantiality of sales.

5. The extent of subdividing, developing and advertising to increase sales.


7. The taxpayer’s control over sales representatives.

8. The amount of time and effort habitually devoted to selling.

STRUCTURING REAL ESTATE DEVELOPER DEALS TO MAXIMIZE CAPITAL GAINS TREATMENT

DONNY DEVELOPER

REAL ESTATE HOLDING COMPANY, LLC

Owns undeveloped land that has appreciated in value.

Sales undeveloped land to development company in exchange for low interest promissory note payable upon eventual sale of property to third party. Sale is eligible for capital gains.

REAL ESTATE DEVELOPER, LLC

Develops land and sells to third parties or Real Estate Investment, LLC. Income from sale treated as ordinary income.

REAL ESTATE INVESTMENT, LLC

Holds developed land until eventual sale. Post sale appreciation eligible for capital gains treatment.

KEY CONSIDERATIONS:

1. Must have bona fide sale between Holding Company and Development Company.

2. Sales price is based upon fair market value at time of sale, based upon appraisal of property.

3. Independent business purpose behind formation and use of Development LLC.

4. Limiting liability in connection with development of the land is considered to be an independent business purpose.


KEY CONSIDERATIONS:

1. Sales price based upon appraisal and strictly on arm’s-length basis.

2. Best to have a down payment in cash, with remainder secured by mortgage on purchased property.

3. Should not have contract to sell developed land prior to transfer to Real Estate Investment, LLC.

4. Investment LLC should be capitalized with sufficient assets to support and make payments.

5. Parties should follow formalities of a customary real estate transaction, including recording of the deed and mortgage, and payment of any applicable documentary stamp taxes.
How To Structure Real Estate Holding Company to Avoid Large Taxable Gift

(Current Ownership)

CLIENT

FAMILY REAL ESTATE HOLDINGS, LLC

REAL ESTATE 1, LLC
REAL ESTATE 2, LLC
REAL ESTATE 3, LLC
REAL ESTATE 4, LLC

(Ownership After 199A Planning)

CLIENT

SECTION 678 TRUSTS

FAMILY REAL ESTATE HOLDINGS, LLC

REAL ESTATE 1, LLC
REAL ESTATE 2, LLC
REAL ESTATE 3, LLC
REAL ESTATE 4, LLC

 Owes $2,000,000 note secured by mortgage on properties; note is payable on demand at 1.68% interest ($35,800

Value of gift to Section 678 Trust now $1,000,000 less applicable discounts.

Income allocated to low income 678 beneficiaries, eligible for Section 199A deduction, even if real estate is fully depreciated assuming that 678 beneficiary is below the 199A threshold limitations.

Owes $180,000 net rental income
- $33,800 interest expense
$146,200 of income
$146,200
x 90% $29,240 Section 199A

Owes various real estate worth $3,000,000. Receives approximately $180,000 of net rental income each year.

Real estate is almost fully depreciated, and the entity pays little to no wages, and taxpayer would like to shift ownership to a low income child to take advantage of the Section 199A deduction.

agassman@gassmanpa.com
Overview Of Self Employment Tax (Section 1402)

Under Internal Revenue Code Section 1402 “net earnings from self-employment” includes:

1. Gross income from any trade or business carried on by an individual.

2. The individual’s distributive share of income from a trade or business carried on by a partnership in which the individual is a partner.

Certain items are specifically excluded from the tax on Self Employment Income, most notably:

1. Rental income (except for real estate dealers).

2. Dividends and interest (except for dealers in stocks or securities).

3. Gains/Losses on the sale of capital assets.

4. Retirement payments to partners.

5. Distributive share of partnership income to Limited Partners.
Overview Of Net Investment Income Tax a.k.a. Medicare Tax (Section 1411)

Under Internal Revenue Code Section 1411 a 3.8% tax is imposed on an individual’s “Net Investment Income” if the individual’s income exceeds $200,000 ($250,000 for taxpayers married filing jointly).

Net Investment Income includes:

1. Interest, dividends, annuities, royalties, and rents (unless received in the ordinary course of a trade or business).

2. Gross income from a passive activity.

3. Net gain from the disposition of property in a passive activity.

4. Net gain from the disposition of property held in a for-profit activity that is not a trade or business (i.e. investment type assets).

A passive activity is defined under Section 469(c)(1) as any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate.

Rental income from property rented to taxpayer’s business in which the taxpayer materially participates is not subject to Net Investment Income Tax, or if the rental activity is “grouped” with the trade or business and the taxpayer materially participates.
### Net Investment Income (Medicare 1411)/Self-Employment Tax Planning

<table>
<thead>
<tr>
<th>Medicare Tax – 3.8% - Imposed upon most kinds of “passive income” for taxpayers above the $200,000/$250,000 single/married net income and $12,500 Trust income</th>
<th>Self-Employment Taxes 15.3% on first $128,400, 2.9% up to $200,000/$250,000, and 3.8% thereafter – Imposed upon actively procured income – by a pseudo employee or independent contractor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Most well-known aspects</strong></td>
<td><strong>Most well-known aspects</strong></td>
</tr>
<tr>
<td>1. Not imposed on S corporation dividends</td>
<td>1. Does not apply to legitimate S corporation dividend income</td>
</tr>
<tr>
<td>2. Not imposed where taxpayer is “active” in a pass through business entity (500 hours test and six others)</td>
<td>2. Does not apply to real estate rental or sale income unless you are a “real estate professional”</td>
</tr>
<tr>
<td>3. Not imposed upon real estate rental activity income if rented to trade or business in which the taxpayer materially participates</td>
<td>3. Applies to Independent Contractors and all Schedule C Entities</td>
</tr>
</tbody>
</table>
Should You Be A Groupie When It Comes To Rental Arrangements?

• IRC § 469(c) directs that activities may be treated as a single activity if they constitute an appropriate economic unit for the measurement of gain or loss for purposes of § 469. If the rental activity can be grouped to the taxpayer’s trade or business activity, they can avoid the passive loss rules which limit deductibility.

• Treas. Reg. § 1.469-4(c)(2) lists five nonexclusive factors which are to be given the greatest weight in determining whether activities constitute an appropriate economic unit: (i) Similarities and differences in types of trades or businesses; (ii) The extent of common control; (iii) The extent of common ownership; (iv) Geographical location; and (v) Interdependencies between or among the activities.
Should You Be A Groupie When It Comes To Rental Arrangements?

• Section 1.469-4(d)(1)(i) further provides that even where a rental activity and a trade or business activity constitute an appropriate economic unit, they may be grouped together only if one of the following three elements are met: (A) The rental activity is insubstantial in relation to the trade or business activity; (B) The trade or business activity is insubstantial in relation to the rental activity; or (C) Each owner of the trade or business activity has the same proportionate ownership in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

• The authors are not sure why the word “insubstantial” is contained in the regulation, or what it is intended to mean. The Treasury Regulations do not define the term “insubstantial” and there is very little case law addressing this issue. In Candelaria v. United States, 518 F.Supp.2d 852 (W.D. Tex. 2007), the court attempted to craft a definition of this term and found that in determining insubstantiality, the analysis should focus on “pertinent factors” including the following: the relationship of income between the rental activity and business activity (using the 80/20 rule); whether the entities work together as a single business unit rather than two distinct entities; and whether the rental activity was created solely for the other business entity’s benefit.

<table>
<thead>
<tr>
<th>Circumstance</th>
<th>Net Investment Income (aka Medicare) Tax</th>
<th>Self-Employment Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary Theme</strong></td>
<td>Not to apply when the taxpayer is “active” in the activity</td>
<td>Not to apply unless the taxpayer is personally active in the activity</td>
</tr>
<tr>
<td>1</td>
<td>Income from entities taxed as partnership, with partnership interest held by non-active spouse</td>
<td>Active spouse’s hours are attributable to non-active owner spouse</td>
</tr>
<tr>
<td>2</td>
<td><strong>Multiple Entity Activity Situations</strong> - Over 500 hours in combined non-S corporation entities as Schedule C – under 500 hours in each separate trade or business – NOTE that all hours spent may be counted for employment taxes, but only hours spent that are beyond overseeing the business and engaging in non-important activities will be counted for Net Investment Income Taxes</td>
<td>Hours are aggregated, so 500 total hours in the aggregate can be immunized from Net Investment Income Tax (Medicare Tax)</td>
</tr>
</tbody>
</table>
Taxpayer aggregates/groups all non S Corp activities for purposes of testing under passive activity rules and exceeds 500 hours in the aggregate so not considered passive activity subject to NIIT.

Not subject to NIIT if Taxpayer spends 500 or more hours in year on aggregated group.

Hours spent are not aggregated for Self-Employment Tax testing, so if Taxpayer spends less than 500 hours on each activity, the Taxpayer will not be subject to Self-Employment taxes.

Not subject to SE Tax if Taxpayer spends less than 500 hours on each entity.
Income from partnership will be subject to Self-Employment taxes for husband.

Neither Husband nor Wife subject to Net Investment Income Tax because husband’s and wife’s hours are aggregated for Net Investment Income Tax purposes.

Income from partnership will not be subject to Self-Employment taxes because wife is not an active owner.

Neither Husband nor Wife subject to Net Investment Income Tax because husband’s and wife’s hours are aggregated for Net Investment Income Tax purposes.
# Tax Treatment Of Vacation Home Rentals

## Vacation Home Tax Treatment

<table>
<thead>
<tr>
<th>Tax Consideration</th>
<th>Rented for less than 14 days</th>
<th>Rented for More than 14 Days but Personal Use Exceeds 10% of Rental Days</th>
<th>Rental Days Exceed Greater of 15 Days or 10% of Personal Use Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Taxes</td>
<td>Can deduct up to a total of $10,000 (limit applies to all state and local taxes combined).</td>
<td>Allocate between rental portion and personal.</td>
<td>Allocate between rental portion and personal.</td>
</tr>
<tr>
<td>Mortgage Interest</td>
<td>Can deduct mortgage interest on up to $750,000 of combined principal for first and second home.</td>
<td>Allocate between rental portion and personal.</td>
<td>Allocate between rental portion and personal Reg. 1.163-10T(p)(3)(iii).</td>
</tr>
<tr>
<td>Selling Home for a Gain</td>
<td>If you lived in the home for 2 out of the last 5 years you could benefit from the $250,000 capital gains exclusions ($500,000 per couple).</td>
<td>If you lived in the home for 2 out of the last 5 years you could benefit from the $250,000 capital gains exclusions ($500,000 per couple).</td>
<td>Capital gains taxes would apply based on the sales minus the basis, as adjusted for depreciation previously taken on the rental home.</td>
</tr>
<tr>
<td>Selling Home for a Loss</td>
<td>No deduction available.</td>
<td>Law is unclear but it appears that losses can be taken pro rata subject to depreciation recapture.</td>
<td>Can deduct losses to the extent the loss in value occurred after the conversion of the home to a rental. Subject to depreciation recapture.</td>
</tr>
</tbody>
</table>
With the passage of the new Tax Cuts and Jobs Act (TCJA), many taxpayers may consider converting personal residences to business or income producing property.

Under prior law, taxpayers could deduct interest paid on mortgages that were up to $1,000,000 of debt. Under the new TCJA, taxpayers are limited to interest paid on mortgages incurred after December 15, 2017 on up to only $750,000 of indebtedness.

Further, under the new TCJA the deduction for state and local income, sales and property taxes is capped at $10,000.

To avoid these limitations, vacation residences with mortgages can be converted to income producing property so that the interest limitation and the property tax limitation no longer apply and become deductible as a business expense. Further, if the rental arrangement is profitable and can be considered a trade or business under new Section 199A, then it may qualify for the 20% deduction from the taxable income thereof.

If the taxpayer uses the residence for personal use for more than the greater of (1) 14 days or (2) 10% of the number of days the residence is rented during the year at “fair rental” value, then the taxpayer can only deduct expenses to the extent of gross income received from the residence. Rental of the property to a tenant related to the taxpayer counts as personal use even if the rental is for fair market value, unless the tenant uses the property as his or her principal residence.

Therefore, taxpayers converting their personal home to a rental property will want to assure that they do not use the residence for personal use, or rent part time to a related party, for more than the greater of 14 days or the 10% limit to avoid being subject to the loss disallowance rules of Internal Revenue Code Section 280A.

Taxpayers cannot deduct the loss on the sale of a personal residence; but are generally able to deduct the loss on the sale of a rental or income producing property.

As a result, taxpayers with homes that have decreased in value may consider converting the home to a rental property prior to selling the home so that the loss will be deductible; however, there are special rules that apply in this situation that may prevent the taxpayer from being able to deduct the loss.
SHOULD YOU CONVERT YOUR VACATION HOME TO A BUSINESS RESIDENCE?—THE RULES ADVISORS NEED TO KNOW

BY MARTIN SHENKMAN, BRANDON KETRON & ALAN GASSMAN

The first rule relates to the taxpayer’s burden to establish that the property has been converted from a personal property to a rental property. This is based on a facts and circumstances test and involves more than simply renting the property for a month prior to the sale.

For example, in the case of Christensen v. Christensen the taxpayers were not allowed to deduct a loss on the foreclosure of the home even though the taxpayers tried to rent the property for a few months prior to the foreclosure.

Further, in Murphy v Commissioner, the Tax Court held that a month-to-month lease at below fair market value was “entirely ancillary to efforts to dispose of the property.” The Tax Court also stated that the rental of the property was simply “a ‘care taking arrangement pending the sale’ and did not establish the necessary profit-motivated purpose for the conversion of the property to a rental property.

In other words, the taxpayer must rent the property at fair rental value for a sufficient period of time prior to the sale in order for the property to be considered a rental property. It is unclear what length of time the property must be rented in order to satisfy this test.

The second rule relates to the calculation of gain or loss on the sale of the rental property. As a general rule, the taxpayer’s gain is equal to his or her amount realized minus basis in the property.

If rental property is converted from personal property and sold for a loss then the taxpayer’s basis is equal to the lesser of (1) adjusted basis or (2) the fair market value of the property at the time of the conversion. If the property is sold for a gain then the taxpayer’s basis is his or her adjusted basis in the property.

As a result, the taxpayer is only able to deduct a loss if the property loses value after it has been converted to a rental property, and the taxpayer is prohibited from deducting any loss that is attributable to the time period that the property was held as personal property.

For example, assume that John purchased his home for $250,000 and converted the home to a rental property when the fair market value of the home was $240,000. If John were to sell the home for $235,000, then John’s basis would be limited to the fair market value of the home at the time of the conversion ($240,000), and John would have a deductible loss of $5,000 ($235,000 amount realized - $240,000 basis).

Therefore, if the taxpayer is considering converting his or her primary residence into a rental property, and the property has increased in value, the taxpayer may consider selling the property to a related entity. The taxpayer would then be able to exclude up to $500,000 of gain for taxpayers married filing jointly or $250,000 of gain for single filers on the sale, and the related party can then lease the property.

For example, John purchased a home for $200,000 more than two years ago and the value of the home is now $250,000. John is considering purchasing a new home and renting his previous home until he is able to sell it. If John were to sell his prior home after the conversion of the home to rental property then John would owe tax on $50,000 of gain, assuming the home sold for $250,000. Instead, John could set up a LLC, that is not disregarded for income tax purposes, to purchase his prior home for the $250,000, rent the home under the LLC until it sold and would be able to exclude the $50,000 of gain on the sale. If the home eventually sold to a third party for $250,000 after renting the home then John would report no gain or loss from the sale because the LLC’s basis in the property would be $250,000.

It is also noteworthy that the taxpayer’s depreciable base for purposes of calculating depreciation on the converted property is also limited to the lesser of (1) adjusted basis or (2) the fair market value of the property at the time of the conversion.

The same sale of the property to a related entity described above can also allow the taxpayer to use the current fair market value of the property as the depreciable base for purposes of calculating depreciation after conversion instead of the taxpayer’s prior basis in the property.

The conversion of property to rental property can provide tax advantages that simply holding a property as personal property cannot; however, the above limitations and traps for the unwary need to be understood and navigated to achieve the proper result. A great many taxpayer will be best served by checking with a qualified CPA and running numbers to see what the outcome of each scenarios is.

If John were to sell the home for $260,000 then John would report a $10,000 gain ($260,000 Amount Realized - $250,000 Basis).

A conflict between the two rules arises if John were to sell the home for $245,000 after the conversion. Under this scenario if John followed the loss rules for calculating his basis then his basis would be equal to $240,000 and he would report a $5,000 gain. However, if John were to follow the gain rules for calculating basis, then his basis would be equal to $250,000 and he would report a $5,000 loss.

Since both calculations produce incorrect results, most commentators agree that the appropriate treatment is to report neither a gain or a loss and explain the position via a disclosure statement on the return.

It is noteworthy that if the property is sold for a gain after the conversion of the property to income producing property, the taxpayer is no longer eligible for the exclusion of gain on the sale of a principal residence under Internal Revenue Code Section 121. This applies even if the sale occurs during a five-year period during which the taxpayer lived there for 2 years.
Let’s talk now about strategies as opposed to the 199 technical points that we could spend the rest of our time reviewing.

These strategies are “take it back to the office and apply it” items that can save solid tax dollars for your clients, and give you a useful checklist for what your law firm or CPA firm can do to help clients qualify for the strategy.

Taking into account that single taxpayers with under $157,500 in taxable income and married taxpayers with under $315,000 can take the deduction for any specified trade or business, and without reference to whether wages or qualified property levels apply:

a. **Don’t Use S Corporations for Low Income Taxpayers.**

Do not use an S corporation for these clients, unless you have to have wages to justify a pension plan or can put part ownership under someone other than the taxpayer or the taxpayer’s spouse that files a joint return with the taxpayer.

If there is no significant pension plan, and a married contractor can earn $315,000 as a Schedule C taxpayer, do so without going into an S corporation, so that she does not have to pay herself reasonable wages under Revenue Ruling 74-44 and the long line of case law requiring S corporation shareholders to pay themselves reasonable compensation because the wages do not qualify for the Section 199A deduction.
Section 199A Strategies, Continued

b. **Use S Corporations for High Income Taxpayers.**

If your client is well over the $217,500, or $415,000 if married, threshold, then the business is probably best suited to be an S corporation to avoid employment taxes and to enable the person to pay himself or herself sufficient wages to qualify.

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**Opportunity 9**

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c. **Minimize or Eliminate Guaranteed Payments From Partnerships.**

Your clients who derive income from entities taxed as partnerships should minimize guaranteed payments that they receive, because this income does not qualify for the Section 199A deduction.

If your client is receiving a guaranteed payment that needs to be wages, then convey the partnership interest to the S corporation if debt does not exceed basis, and the compensation paid to the individual owner of the S corporation does not have to be classified as a guaranteed payment.

Remember that hot assets (ordinary income assets) from the sale of a partnership interest qualify for the 199A deduction.

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**Opportunity 1**

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d. **Asset Sales Yielding Ordinary Income Can Qualify Under Section 199A.**

The Final Regulations specifically confirm this for situations where a partner’s sale of a partnership interest triggers “hot asset” income (from accounts receivable and appreciable items).

This should also apply where there is a sale of assets and ordinary income form the sale of accounts receivable, and depreciation recapture. Section 1231 business property that qualifies for capital gains will not qualify for the 199A deduction.
Section 199A Strategies, Continued

e. **Reduce Income.**

Do whatever you can to get the individual or married couple income below the $315,000/$157,500 levels if this will save considerable taxes:

1. Defined benefit or cash balance pension planning.

2. 199A asset acquisitions.

3. Shelter capital gains in Charitable Remainder Unitrusts or by using deferred exchanges under 1031, which now only applies to investment or business real estate.

4. Oil and gas investments (100% deduction for individual’s intangible drilling costs (IDC)).

5. Conservation easements.

6. Put other family members to work and on the payroll to reduce taxpayer’s income and increase wages.

7. Pay past due and prior earned amounts to others in 2018.

8. Defer sale of capital gain asset to next year if sale will increase income above the threshold levels.
Section 199A Strategies, Continued

f. **Establish Arm’s-Length Compensation and Sales Arrangements.**

A specified trade or business owned by a high-earner taxpayer may pay arm’s-length management, marketing, billing and factoring fees to a separate company whose income will not be Specified Trade or Service Business income until the Final Regulations come out.

When the Final Regulations come out, the separate company can be owned by children and/or 678 Trusts which are considered as owned by the beneficiary who had a withdrawal right over all assets. Google Gassman Forbes 678 to see an article on this.

The ownership can be under complex trusts, which should receive a $157,500 threshold at both the trust level and at the level of each beneficiary until the Final Regulations come out.

If the Final Regulations restrict use of complex trusts convert the complex trust into a 678 trust, so for each young child, you will have $157,500 times 7% savings.

g. **Plan for Wages.**

Remember that the wages need to be 28.57% of what the income without wages would otherwise be, and include not only wages themselves, but also pension contributions and employer paid health benefits.

You may, therefore, already have significant “wages” but may not know it.
Section 199A Strategies, Continued

h. Decide **what income to aggregate** between related companies and what you can do to prevent aggregation in later years. Remember you can’t aggregate SSTBs.  

i. **Separate life insurance agency** income from investment advisory and annuity sales income.  

j. **Restructure celebrities and well known professionals** so that their earnings come from business operations and not from royalties or endorsements.  

k. Make **real estate rentals and other “passive” activities** active in order to qualify such activities for the Section 199A deduction.
Section 199A Strategies, Continued

I. **Pay off loans** to eliminate interest expenses to qualify for a larger deduction, or maintain debt if interest expense will reduce income below the high earner thresholds.

Taxpayers who have made debt decisions based in part upon the deductibility of interest may wish to reconsider normal assumptions, given that the interest deduction attributable to a trade or business that generates income qualifying for the Section 199A deduction will be saving income tax at a lower bracket.

For example, a 37% bracket taxpayer who has an active business that pays $100,000 a year of interest on debt will be saving $29,600 in income taxes instead of $37,000 in income taxes as the result of the interest paid.

If the same taxpayer has a separate trade or business or investment arrangement that is taxed in the 37% bracket, why not pay down the debt owed on the business that qualifies under Section 199A to receive an additional $7,000 in tax savings from the interest deduction?

Under the 2017 Tax Cuts and Jobs Act, businesses with more than $25 million in average annual gross receipts for three preceding tax years cannot deduct interest expenses to the extent that such expenses exceed 30% of their adjusted taxable income.

m. Remember that **1231 property income** – capital gains income from the sale of business property – will not qualify, but losses will reduce 199A income. (See Section 1231 Summary Chart on next slide.)

The Section 1239 rules also apply.
The characterization of gain or losses from Section 1231 property applies in a consistent manner for purposes of Section 199A. Section 1231 property is defined as property used in a trade or business that (1) is subject to Section 167 depreciation held for more than one year, and (2) real property used in the trade or business held for one year.

All Section 1231 property gains and losses are netted. If the result is a net gain, then such gain is taxed as a long-term capital gain, and if the result is a net loss, then such loss is treated as an ordinary loss.

QBI does not include any “item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.” Section 1231 property is considered Qualified Property, which can be used to help eliminate limitations on the Section 199A deduction. Section 1231 Property sold for a net gain will not be considered QBI, but will be taxed at the more favorable capital gains rates, which peak at 20%.

Section 1231 is not to be confused with Section 1239 which converts capital gains into ordinary income if depreciable property is sold to a related party.

**Chart 9 – Section 1231 Summary Chart**

The following chart demonstrates how the netting system under Section 1231 works:

<table>
<thead>
<tr>
<th>Net Gain of 1231 Property</th>
<th>Net Loss of 1231 Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>Gain/Loss</td>
</tr>
<tr>
<td>Property 1</td>
<td>$5,000</td>
</tr>
<tr>
<td>Property 2</td>
<td>$(5,000)</td>
</tr>
<tr>
<td>Property 3</td>
<td>$5,000</td>
</tr>
<tr>
<td>Net Gain</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

**Taxed as Long-Term Capital Gain**

**Treated as Ordinary Loss**
n. Check **Alternative Minimum Tax**, although the Section 199A deduction is not a preference item for AMT tax purposes.

<table>
<thead>
<tr>
<th>Item Included in Taxable Income</th>
<th>Included in Alternative Minimum Taxable Income?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard Deduction</td>
<td>Not Allowed</td>
</tr>
<tr>
<td>State and Local Taxes</td>
<td>Not Allowed</td>
</tr>
<tr>
<td>Depreciation Deductions</td>
<td>Allowed (Some Restrictions Apply/Subject to Different calculation Method)</td>
</tr>
<tr>
<td>Itemized Medical Expenses</td>
<td>Allowed (To the extent exceeding 10% of Adjusted Gross Income)</td>
</tr>
<tr>
<td>Intangible Drilling Costs</td>
<td>Allowed (Some Restrictions Apply)*</td>
</tr>
<tr>
<td>Gain/Loss From Sale or Exchange of Property</td>
<td>Allowed</td>
</tr>
<tr>
<td>Section 199A Deduction</td>
<td>Allowed</td>
</tr>
<tr>
<td>Mortgage Interest Payment Deduction</td>
<td>Allowed (Except upon home equity loans)</td>
</tr>
<tr>
<td>Net Operating Losses</td>
<td>Allowed (but may not exceed 90% of AMTI)</td>
</tr>
</tbody>
</table>
o. Have **marijuana-related businesses** in flow-through entities that have plenty of wages or qualified property to receive the 20% deduction.

**CHART 11 – SECTION 280E EFFECT CHART.** This chart displays the effect of Section 280E on business deductions.

<table>
<thead>
<tr>
<th>Deductible</th>
<th>Revenue</th>
<th>Cost of Goods Sold (COGS)</th>
<th>Gross Income</th>
<th>Expenses (any amount paid or incurred during the taxable year)</th>
<th>Net Income</th>
<th>Other Deductions (Ex: 199A)</th>
<th>Taxpayer’s Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>$1,000,000.00</td>
<td>$900,000.00</td>
<td>$100,000.00</td>
<td>$50,000.00</td>
<td>$50,000.00</td>
<td>$22,000.00</td>
<td>$28,000.00</td>
</tr>
<tr>
<td>No</td>
<td></td>
<td></td>
<td></td>
<td>$50,000.00</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**280E Applies!**

Thanks for ‘hashing’ this out!
P. Get Married or Divorced, depending upon the circumstances.

1. Marry someone with large net operating losses to reduce income when filing jointly as married to meet $315,000 threshold.

2. Marry someone who can receive wages from a Schedule C business owned by their new spouse to reduce the threshold of the wage paying spouse if filing separate.

3. Get divorced and have your ex-spouse own 51% of the management company, especially if he or she likes to manage.

4. Other considerations are shown on the chart on the next two slides:
<table>
<thead>
<tr>
<th>Consideration</th>
<th>Single Status</th>
<th>Married Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of primary residence (Section 121 (b))</td>
<td>Capital gain is excluded up to $250,000</td>
<td>Capital gain is excluded up to $500,000</td>
</tr>
<tr>
<td>Federal estate tax exemption</td>
<td>Can only shield assets up to $11.2 million from estate, gift, and generation-skipping tax</td>
<td>Can shield assets up to $22.4 million from estate, gift, and generation-skipping tax</td>
</tr>
<tr>
<td>Marital Tax Penalty and Bonuses</td>
<td>High-earning individuals may be better separate from a financial standpoint</td>
<td>Two high-earning individuals who get married may be subject to an increase in tax; one high-earner and one low-earner getting hitched may create tax savings</td>
</tr>
<tr>
<td>Medicare surtax threshold (additional 0.9% tax above the threshold)</td>
<td>$200,000 per person threshold</td>
<td>$250,000 per married couple threshold (a $150,000 threshold loss)</td>
</tr>
<tr>
<td>Tax on Social Security benefits</td>
<td>Can earn up to $25,000 and not be taxed on Social Security benefits</td>
<td>Can earn up to $32,000 and not be taxed on Social Security benefits</td>
</tr>
<tr>
<td>Transferability of assets upon death</td>
<td>Subject to estate tax if decedent is over $11,180,000 exemption amount on death</td>
<td>Surviving spouse can receive assets tax-free upon the death of the first spouse</td>
</tr>
<tr>
<td>Social Security survivorship benefits</td>
<td>Unmarried children under 18 can receive benefits; possibly parents where the deceased provided at least half of their parent’s support</td>
<td>Spouses can receive partial benefits if they are under retirement age, and may be eligible for 100% of the deceased’s benefit if they have reached retirement age</td>
</tr>
<tr>
<td>Government and Employer Pension Plan survivorship benefits</td>
<td>No surviving spouse benefits if not married</td>
<td>Potentially eligible for survivorship benefits</td>
</tr>
<tr>
<td>Transferability of assets upon divorce</td>
<td>N/A</td>
<td>Tax-free passing of assets upon divorce</td>
</tr>
</tbody>
</table>
### Section 199A Strategies, Continued

#### Chart 17 – Marital Considerations Chart, Continued

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Single Status</th>
<th>Married Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ability to roll over an IRA on the death of a spouse</td>
<td>Cannot treat it as one’s own IRA; cannot make continued contributions to the IRA</td>
<td>Allowed to roll over the IRA upon death without a tax hit; can treat the IRA as the surviving spouse’s own; can continue to make contributions to the IRA</td>
</tr>
<tr>
<td>Net operating losses (NOL)</td>
<td>Cannot transfer to others</td>
<td>If losses are accumulated during marriage, they can be used against the joint income of the couple. If they are accumulated while single, it may be possible for one spouse to hire the NOL spouse and pay them a wage, which would be deductible depending on how large the NOLs are.</td>
</tr>
<tr>
<td>Related Party Losses (Section 167e)</td>
<td>Can take the losses on the sale to another individual</td>
<td>Can take the losses on the sale to his spouse</td>
</tr>
<tr>
<td>Medical and Nursing expenses (to the extent they exceed 10% of Adjusted Gross Income)</td>
<td>May not be able to be claimed because of too high income (where the expenses fall under 10% of adjusted gross income) or too low, where much of a potential deduction is wasted</td>
<td>Large medical expenses are more likely to impact the marital income, and may save thousands in taxes</td>
</tr>
<tr>
<td>Sharing Capital Loss Carryforward (the excess of $3,000 is carried forward into future years)</td>
<td>N/A</td>
<td>An unmarried individual with loss carryforward from capital losses can marry someone with capital gains, and use the loss carryforward to reduce their capital gains liability</td>
</tr>
<tr>
<td>Tax Brackets</td>
<td>Enters the highest bracket of 37% at $500,000 of taxable income</td>
<td>Enters the highest bracket of 37% at $600,000 of taxable income</td>
</tr>
<tr>
<td>Standard Deduction</td>
<td>Able to claim a $12,000 standard deduction</td>
<td>Able to claim a $24,000 standard deduction or two $12,000 standard deductions if filing separately</td>
</tr>
</tbody>
</table>
Section 199A Strategies, Continued

q. **Warn about Substantial Understatement Test** – a single dollar of Section 199A eligible deduction causes the substantial understatement test to go from the greater of $5,000 or 10% of the tax required to be shown, to 5% of the tax, for no apparent reason.  

r. **If W-2 Wages and UBIA of Qualified Property is not reported, then the taxpayer’s share of such items will be presumed to be zero!**

The Final Regulations clarified that if one item is not reported then it will not result in other items being presumed to be zero.

The Final Regulations also added a provision that would allow unreported items to be reported on an amended or late filed return for any open tax year.

s. **Reconsider Entity Selection**, based on Section 199A Factors.

(See chart on next slide.)
<table>
<thead>
<tr>
<th>Issue/Factor</th>
<th>Sole Proprietorship</th>
<th>Partnership</th>
<th>S Corporation</th>
<th>C Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Rates</strong></td>
<td>Owners are taxed at individual rates for salary and income of the company.</td>
<td>Owners are taxed at individual rates for salary and income of the company.</td>
<td>Owners are taxed at individual rates for salary and income of the company.</td>
<td>Entity taxed for income at 21%; shareholders taxed for dividends and distributions</td>
</tr>
<tr>
<td><strong>Double Taxation</strong></td>
<td>Not subject</td>
<td></td>
<td></td>
<td>Dividends or distributions taxed separately</td>
</tr>
<tr>
<td><strong>Availability of Section 199A deduction</strong></td>
<td>Available (depending on limitations)</td>
<td>Available (depending on limitations)</td>
<td>Available (depending on limitations)</td>
<td>Cannot qualify for Section 199A</td>
</tr>
<tr>
<td><strong>Accumulated Earnings</strong></td>
<td>Taxed to owner as reported on their Form K-1, regardless of whether distributions are made</td>
<td>Taxed to owner as reported on their Form K-1, regardless of whether distributions are made</td>
<td>Taxed to owner as reported on their Form K-1, regardless of whether distributions are made</td>
<td>Taxed at 21% corporate rate; beware of accumulated earning tax issues</td>
</tr>
<tr>
<td><strong>Guaranteed payments</strong></td>
<td>N/A</td>
<td>Excluded from QBI; Not considered to be W-2 wages</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Owner provides services (reasonable compensation issues)</strong></td>
<td>Self-Employed (no W-2 wages); currently not subject to reasonable compensation</td>
<td>Self-Employed (no W-2 wages); currently not subject to reasonable compensation rules</td>
<td>W-2 Wages; excluded from QBI and subject to reasonable compensation rules</td>
<td>W-2 Wages; subject to reasonable compensation rules</td>
</tr>
<tr>
<td><strong>Business is a Specified Service Trade or Business</strong></td>
<td>Eligible if owner’s taxable income is under lower-income thresholds; Limited if in between lower- and higher-income thresholds; Lost if taxable income is greater than higher-income thresholds</td>
<td>Eligible if owner’s taxable income is under lower-income thresholds; Limited if in between lower- and higher-income thresholds; Lost if taxable income is greater than higher-income thresholds</td>
<td>Eligible if owner’s taxable income is under lower-income thresholds; Limited if in between lower- and higher-income thresholds; Lost if taxable income is greater than higher-income thresholds</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>High Income earner as owner</strong></td>
<td>May be limited if Wage/Property Hurdle is not met</td>
<td>May be limited if Wage/Property Hurdle is not met</td>
<td>May be limited if Wage/Property Hurdle is not met</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Employees (W-2 Wages)</strong></td>
<td>Consider impact on Wage/Property Limitation, adjust if necessary</td>
<td>Consider impact on Wage/Property Limitation, adjust if necessary</td>
<td>Consider impact on Wage/Property Limitation, adjust if necessary</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Independent contractors</strong></td>
<td>Hurts in application of Wage/Property Hurdle; Compensation not considered W-2 wages</td>
<td>Hurts in application of Wage/Property Hurdle; Compensation not considered W-2 wages</td>
<td>Hurts in application of Wage/Property Hurdle; Compensation not considered W-2 wages</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Qualified property basis</strong></td>
<td>Consider impact on Wage/Property Limitation, adjust if necessary</td>
<td>Consider impact on Wage/Property Limitation, adjust if necessary</td>
<td>Consider impact on Wage/Property Limitation, adjust if necessary</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>State and local tax deductions</strong></td>
<td>Deduction Limited</td>
<td>Deduction Limited</td>
<td>Deduction Limited</td>
<td>Fully Deductible</td>
</tr>
<tr>
<td><strong>Medical expenses and plans deductions</strong></td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>Premiums and medical reimbursement plans are deductible</td>
</tr>
</tbody>
</table>
CREATIVE PLANNING
WITH 199A

Presented to the
FICPA Florida Gulf Coast University Accounting & Tax Conference
Embassy Suites Fort Myers in Estero, FL

Thursday, October 24, 2019
2:05 PM to 2:55 PM ET (50 minutes)

THANK YOU FOR PARTICIPATING!

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