



# The Section 199A Passthrough Deduction

## Tax Reform Guidance

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# Agenda

- 1 Section 199A Overview
- 2 Qualified Business Income
- 3 W-2 and Unadjusted Basis of Qualified Property Limitations
- 4 Aggregation
- 5 Specified Service Trade or Business
- 6 Special Rules for RPEs, PTPs, Trusts and Estates

# Section 199A Overview

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# Section 199A – Overview:

- Provides a deduction of up to 20% from passthrough income
  - Potentially reduces the highest tax rate on eligible business income from 37% to 29.6%
  - The purpose of the new deduction is to provide a rate cut for passthrough businesses in response to the reduction in the corporate tax rate from 35% to 21%
  - Deduction is limited to 20% of taxable income, less net capital gain

The 20% deduction is also subject to other limitations that will be discussed later

# Section 199A – Overview:

- Who is permitted to take the Section 199A deduction?
  - Individuals and some trusts and estates are allowed to take a deduction of up to 20% of income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate
    - Excludes passthrough income from a specified service trade or business (SSTB)

C corporations are not entitled to the Section 199A deduction.

# Section 199A – Overview:

- If taxable income exceeds certain thresholds the deduction is further limited to the lesser of:
  - 20% of Qualified Business Income (**QBI**), or
  - Greater of:
    - 50% of the total W-2 wages paid by the business (**W-2 wage limitation**), or
    - Sum of 2.5% of unadjusted basis immediately after acquisition (UBIA) of qualified property plus 25% of W-2 wages (**UBIA of qualified property limitation**)

Phase in for W-2 wage limitation and UBIA of qualified property limitations begins when taxable income exceeds \$315,000 for married taxpayers and \$157,500 for other taxpayers

# Section 199A – Overview:

- Although the inputs for the deduction are calculated at the entity level, the deduction itself is calculated at the owner level
- Owners below the taxable income threshold are NOT
  - Subject to the W-2 or W-2/UBIA of qualified property limitations
  - Prevented from claiming the deduction on SSTB income
- Section 199A deduction does NOT reduce AGI and is not considered in determining NII tax.

# Section 199A – Overview:

- Individuals and some trusts and estates are also allowed to take a deduction of up to 20% of their combined qualified real estate investment trust (**REIT**) dividends and qualified publicly traded partnership (**PTP**) income, including qualified REIT dividends and qualified PTP income earned through passthrough entities.

**This component is not subject to W-2 wages or UBIA of qualified property limitations, but still subject to 20% of taxable income limitation when combined with the QBI component.**

# Qualified Business Income

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# What constitutes QBI?

- Items of income, gain, deduction, or loss that are effectively connected with the conduct of a trade or business within the U.S. (within the meaning of Section 864(c) with some adjustments) **and** included or allowed in determining taxable income for the taxable year
  - Previously disallowed losses or deductions under Sections 465, 469, 704(d), and 1366(d) are allowed in taxable year taken (except for carryovers from taxable years ending before January 1, 2018)

# Items Included in QBI

- Gain or loss attributable to assets of a partnership giving rise to ordinary income under Section 751(a) or 751(b) ("hot assets") in sale of partnership interest or partnership distribution
- In change of accounting method situations, Section 481(a) adjustments, whether positive or negative, to the extent that they arise after December 31, 2017
- Partnership related deduction for guaranteed payments and Section 707(a) payments to partner in nonpartner capacity
- NOL deduction to the extent disallowed under Section 461(l)

# Items Not Included in QBI

- Capital gains or losses (including Section 1231 gains and losses treated as capital gains or losses)
- Dividend or income equivalent to a dividend
- Interest income other than that allocable to a trade or business
- Amounts received from an annuity not in connection with a trade or business
- Qualified REIT dividends or qualified PTP income
- Guaranteed payments for services or the use of capital (Section 707(c))
- Payments received by partner in nonpartner capacity under Section 707(a) for services rendered
- Reasonable compensation paid by an S corporation for services rendered to shareholders
- NOL deductions (except for amount disallowed under Section 461(l))

# Performing Services as an Employee

- No items of income, gain, loss, and deduction from the trade or business of performing services as an employee constitute QBI.
  - Refers to all wages and other income earned in capacity as employee
- Former employees that provide substantially the same services to the former employer (or related person) as an independent contractor **are presumed to be in a trade or business as an employee**
  - Similar rule for former employees that become a partner in the partnership or a related partnership (but can be rebutted if promotion to partners as a career milestone, etc.)

# Defining Trade or Business

**Trade or Business** –Section 162(a) is the most appropriate definition.

- Prop. Regs extend the definition beyond Sec.162 in one circumstance
- Rental or licensing of tangible or intangible property to a related trade or business is treated as **trade or business** if the rental or licensing and other trade or business are commonly controlled under Prop. Reg. §1.199A-4(b)(1)(i).
  - Allows taxpayers to aggregate their trades or businesses with associated rental or intangible property if all requirements of Prop. Reg. §1.199A-4 (aggregation rules) are met.

**Relevant passthrough entity (RPE)** – Used to describe passthrough entities that directly operate the trade or business or pass through the trade or business items from lower-tier RPEs to the individual

# Loss Rules

- If the net amount of **QBI** is less than zero, such amount shall be treated as a loss from a **separate** qualified trade or business in the succeeding year.
- If overall QBI is positive, but QBI from one or more trade or businesses is negative, then losses must be apportioned among the trade or businesses with positive QBI.
- Separate loss carryforward rules for **qualified REIT dividends and PTP income**

# W-2 Wages

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# W-2 Wages Attributable to a Trade or Business

- The amount of the Section 199A deduction allowed will depend on the amount of W-2 wages paid by the qualified trade or business.
  - Guaranteed payments vs. reasonable compensation
- Generally follow rules under former Section 199
- An individual or RPE may take into account any W-2 wages paid and reported by another person, provided that the W-2 wages were paid to its common law employees or officers of the person for employment by the individual or RPE.
  - Certain wages paid by third party payers can be included by the individual or RPE assuming other requirements are met.

# W-2 Wages Attributable to a Trade or Business (continued)

- Unlike Section 199, the W-2 wage limitation applies separately for each trade or business
  - If W-2 wages are allocable to more than one trade or business, the portion of W-2 wages allocable to each trade or business is determined in same proportion as deductions associated with those wages.
  - A partner or shareholder's share of W-2 wages paid by an RPE is determined in the same manner as its allocable share of wage expense.
- **Notice 2018-64**
  - Provides three methods for calculating W-2 wages

# UBIA of Qualified Property

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# UBIA of Qualified Property

## Key definitions

- **“Immediately after acquisition”** – Date that the property is placed into service
- **Qualified property** – Depreciable tangible property that is held by, and available for use in, a trade of business at the close of the taxable year, and which is used in the production of QBI, and for which the depreciable period has not ended before the close of the taxable year
  - Improvements and additions are treated as separated qualified property
- **Depreciable period** – Period beginning on the date the property is first placed in service by the taxpayer and ending the later of:
  - 10 years after the placed in service date or
  - The last day of the last full year in the applicable recovery period

# Allocation of UBIA of Qualified Property by RPEs

- Each partner or shareholder's share of UBIA of qualified property is determined based on its proportionate share of **tax depreciation** over the entity's total tax depreciation attributable to the property for the year.
- Qualified property with no tax depreciation during the year
  - Held by partnership - Each partner's share is based on how gain would be allocated to the partners pursuant to Sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for FMV.
  - Held by S corporation – Each shareholder's share is based on number of shares held by shareholder over total number of shares.

# UBIA and Non-recognition Transfers

- The proposed rules regarding the UBIA of qualified property acquired by an RPE in a non-recognition transfer contain a potential trap for the unwary!
  - While the placed in service date with respect to the property continues to be the date it was originally placed in service by the transferor, the UBIA in the hands of the transferee is equal to the **adjusted basis at the time of transfer**
- Taxpayers should consider the impact on UBIA of qualified property that could occur if property is transferred to a new RPE, especially if they are subject to the UBIA of qualified property limitation
  - Important to determine the treatment of transfers of property to an RPE as a part of a larger integrated transaction

# Aggregation

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# Aggregation Rules

- Trades or businesses (operated directly or through an RPE) can be aggregated by an individual only if all of the requirements of a six-pronged test are met
  - Aggregation not available to RPEs and also trusts or estates (to the extent QBI and other items are allocated to beneficiaries)
- Section 469 grouping rules not adopted as approach to aggregate trades or businesses for Section 199A purposes

Aggregating allows taxpayers to combine their trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations.

# Six-Prong Test

1. Each trade or business must itself be a trade or business
2. The same person or group of persons, directly or indirectly, owns at least 50 percent of each trade or business
  - Trade or business owned by S corporation: at least 50 percent of issued and outstanding shares of the corporation
  - Trade or business owned by partnership: at least 50 percent of capital or profits in the partnership
3. The ownership described in 2 above exists for a majority of the taxable year in which the items attributable to each trade or business are included in income

# Six-Prong Test (continued)

4. All of the items attributable to each trade or business are reported on returns with the same taxable year, not taking into account short taxable years.
5. None of the aggregated trades or businesses can be an SSTB
6. The trades or businesses meet at **least two** of three factors demonstrating they are a part of a larger integrated business
  - a) The businesses provide products and services that are the same or that are customarily provided together
  - b) The businesses share facilities or share significant centralized business elements
  - c) The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group

# Operating Rules, Reporting, and Consistency

## Individuals

- The combined QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses is used to apply the W-2 wage and UBIA of qualified property limitations.
- Once multiple trades or businesses are aggregated into a single trade or business, individuals must consistently report the aggregated group in subsequent years
- Statement required for each taxable year identifying each aggregated trade or business

## RPEs

- Must compute QBI, W-2 wages, and UBIA of qualified property separately for each trade or business
- Must provide its owners their allocable share of QBI, W-2 wages, and UBIA qualified property

# Specified Service Trade or Business

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# Effect of an SSTB

- General rule that an SSTB is not a qualified trade or business
  - Exception: SSTB exclusion from definition of qualified trade or business does not apply for taxpayers with taxable income below the threshold amount of \$315,000 (married) / \$157,500 (single) OR to extent rules under phase-in range apply
  - RPEs often unaware of whether owners are below threshold, so may need to perform calculations and report information related to SSTBs
    - Each RPE must determine whether it conducts an SSTB and disclose that information to its partners, shareholders, or owners.
- If a trade or business is an SSTB, none of its items are taken into account for purposes of determining a taxpayer's QBI
- In the case that a SSTB is conducted by an RPE, none of the income flowing to the owner is QBI, regardless if the owner is passive or participates in the SSTB

# Definition of an SSTB

An SSTB is any trade or business involving the performance of services –

- In the **fields** of:
  - Health
  - Law
  - Accounting
  - Actuarial science
  - Performing arts
  - Consulting
  - Athletics
  - Financial services
  - Brokerage Services;
- Where the principal asset of such trade or business is the **reputation or skill** of one or more of its employees or owners; or
- That consist of:
  - Investing and investing management
  - Trading
  - Dealing in securities
  - Partnership interests
  - Commodities

# De Minimis Rule

- A trade or business is not considered an SSTB merely because it provides a small amount of services in a specified service activity.
- The trade or business is not an SSTB if less than **5 percent** of the gross receipts (**10 percent**, if total gross receipts of \$25 million or less) are attributable to the performance of services in a field described in the definition of an SSTB
  - Includes the performance of any activity incident to the actual performance of services in the field

# Listed SSTBs

## Health

- Provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to patients.
- Excludes services not directly related to medical field, even though the services may relate to health of the service recipient

## Law

- Provision of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity.
- Excludes services that do not require skills unique to the field of law

## Accounting

- Provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals in their capacity.
- Meant to capture the common understanding of accounting, which includes tax return and bookkeeping services regardless the level of education or training.
- Excludes include payment processing and billing analysis

# Listed SSTBs (continued)

## Actuarial Science

- Provision of services by actuaries and similar professionals in their capacity.
- Excludes the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

## Performing Arts

- Performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity
- Excludes services that do not require skills unique to the creation of performing arts

## Consulting

- Provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems
- Includes providing advice and counsel with the intention of influencing decisions made by a government or governmental agency to influence legislators and other officials
- Excludes the performance of services other than advice and counsel and the performance of services embedded in and ancillary to sale or goods if no separate payment

# Example – Bicycle Sales & Repair

- G owns 100% of Corp, an S corporation, which operates a bicycle sales and repair business. Corp has 8 employees, including G. Half of Corp's net income is generated from sales of new and used bicycles and related goods, such as helmets, and bicycle-related equipment. The other half of Corp's net income is generated from bicycle repair services performed by G and Corp's other employees. Corp's assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Several of the employees and G have worked in the bicycle business for many years, and have acquired substantial skill and reputation in the field.
- Customers often "consult" with the employees on the best bicycle for purchase.
  - **G is in the business of sales and repairs of bicycles and is not engaged in an SSTB.**
  - See Prop. Reg. §1.199A-5(b)(3), Example 7.

# Listed SSTBs (continued)

## Athletics

- Performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing.
- Excludes services that do not require skills unique to athletic competition.

## Financial Services

- Services typically performed by financial advisors and investment bankers
- Includes financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, wealth transition plans and advising in similar services regarding valuations, mergers, acquisitions, dispositions, restructuring, and raising financial capital
- Excludes services such as taking deposits or making loans

## Brokerage Services

- Provision of services in which a person arranges transactions between a buyer and seller with respect to securities
- Excludes the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

# Listed SSTBs (continued)

## Investing and Investment Mgmt

- Means a trade or business that earns fees for investment, asset management services, or providing advice with respect to buying and selling investments
- Includes trades or businesses that receive either a commission, a flat fee, or investment management fee calculated as a percentage of assets under management.
- Excludes directly managing real property

## Trading

- Means a trade or business of trading in securities, commodities, or partnership interests
- Factors considered relevant to determining whether someone is a trader include the source and type of profit generally sought from engaging in the activity

## Dealing

- Regularly purchasing and selling securities, commodities, and/or partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or terminate positions in the ordinary course of business

# Listed SSTBs (continued)

## Reputation or skill

- Principal asset is reputation or skill of its employees or owners
- Individual is engaged in the trade or business of the following:
  - Receiving income for endorsing products or services
  - Licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark, or other symbols associated with the individual's identity
  - Receiving appearance fees or income
    - (including fees or income to reality performers on TV, social media, radio, and other media hosts and video game players)

## Example – Reputation or Skill

- H is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to H's skill and reputation as a chef, H receives an endorsement fee of \$500,000 for the use of H's name on a line of cooking utensils and cookware.
  - **H is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB.**
  - **H is also in the trade or business of receiving endorsement income. H's trade or business consisting of the receipt of the endorsement fee for H's skill and/or reputation is an SSTB.**
  - See Prop. Reg. §1.199A-5(b)(3), Example 8.

# Services or Property Provided to an SSTB

- An SSTB includes any trade or business that provides 80 percent or more of its property or services to an SSTB if at least 50 percent common ownership (Prop. Reg. §1.199A-5(c)(2)(i))
  - If a trade or business with at least 50 percent common ownership with an SSTB provides any services or property to the SSTB, the portion provided will be treated as part of the SSTB
- If a trade or business provides less than 80 percent of its property or services to an SSTB and there is 50 percent or more common ownership, then portion treated as part of SSTB (Prop. Reg. §1.199A-5(c)(2)(ii))
  - **Example** – A, a dentist, wholly owns a dental practice and also wholly owns an office building. A rents half the building to the dental practice and the other half to unrelated persons. The half rented to the dental practice will be treated as an SSTB

**Common ownership test includes direct and indirect ownership by related parties within meaning of Sections 267(b) or 707(b)**

# Incidental to an SSTB

- If a trade or business not otherwise treated as a SSTB:
  1. has 50 percent or more common ownership with an SSTB, including related parties and
  2. has shared expenses, including wages or overhead expenses, with the SSTB,
    - then the trade or business is treated as **incidental to** and part of the SSTB, if the trade or business represents 5 percent or less of the combined gross receipts of the trade or business and SSTB



# Special Rules for RPEs, PTPs, Trusts and Estates

Prop. Reg. §1.199A-6

# RPE and PTP Reporting

- RPEs
  - Required to include on each owner's Schedule K-1 their allocable share of QBI, W-2 wages, the UBIA of qualified property, qualified REIT dividends, and PTP income for each trade or business and whether any trade or businesses are SSTBs.
    - Information must be provided regardless of whether the owners are above or below the threshold
- PTPs
  - Required to report on each partner's Schedule K-1 their allocable share of QBI for each trade or business and report any qualified REIT dividends or PTP income/loss received from an RPE, REIT, or another PTP.
  - Not required to report W-2 wages or the UBIA of qualified property

# Excerpts from Draft Form 1065 and Sch. K-1

## Draft Form 1065 Instructions

**Schedule K-1—Qualified business income deduction (codes Z through AD).** In the case of a partnership, the qualified business income deduction is determined at the partner level. To allow partners to correctly figure qualified business income deduction, the partnership must attach a statement to its Schedules K-1, separately identifying each trade or business and identifying any specified service trade or business. For each trade or business, the partnership must state, using the same box numbers as shown on Schedule K-1, the amount of the following.

## Draft Schedule K-1 Instructions

### Box 20. Other Information

- Box 20, new codes have been added for the qualified business income deduction: code Z, section 199A income; code AA, section 199A W-2 wages; code AB, section 199A unadjusted basis; code AC, section 199A REIT dividends; code AD, section 199A PTP income.

# Application to Trusts, Estates, and Beneficiaries

- Grantor Trust - To the extent that a grantor or another person is treated as owning all or part of a trust, the owner will compute its QBI as if the QBI had been received directly by the owner
- Non-grantor trust or estate – QBI and expenses allocable to the business must be allocated among the trust or estate and its beneficiaries
- Section 199A deduction and threshold amount is determined at the trust level without taking into account any distribution deductions
- Anti-abuse rule added to prevent taxpayers from forming or funding trusts for the significant purpose of received a Section 199A deduction.
  - Grants the Secretary authority to treat 2 or more trusts as a single trust if (1) the trusts have substantially the same grantors and substantially the same primary beneficiaries and (2) a principal purpose of such trusts is the avoidance of federal income tax

# Final Considerations

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# Final Considerations

- Should passthrough businesses consider converting to C corporations?
- The Section 199A information requirements present a significant compliance challenge to businesses, taxpayers, and tax preparers
- Determining trades or businesses
  - SSTBs?
  - Rental activity?
  - Possible restructuring?

# Any final questions?



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