

Keeping a Pulse on Section 199A

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Overview of Section 199A



- Effective Dates:
 - Effective for tax years beginning after December 31, 2017;
 - Without legislative action, IRC § 199A terminates on December 31, 2025.
- Applicability:
 - Section 199A provides non-corporate taxpayers a deduction for qualified business income (“QBI”);
 - Therefore, the § 199A deduction is for QBI from partnerships, S-corporations, or sole proprietorships.

Overview of Section 199A - Continued

- Income Tax and AMT:
 - Section 199A is a “from AGI” or “below the line” deduction. However, the deduction can be taken by taxpayers who do not itemize. IRC §§ 62, 63(b)(3).

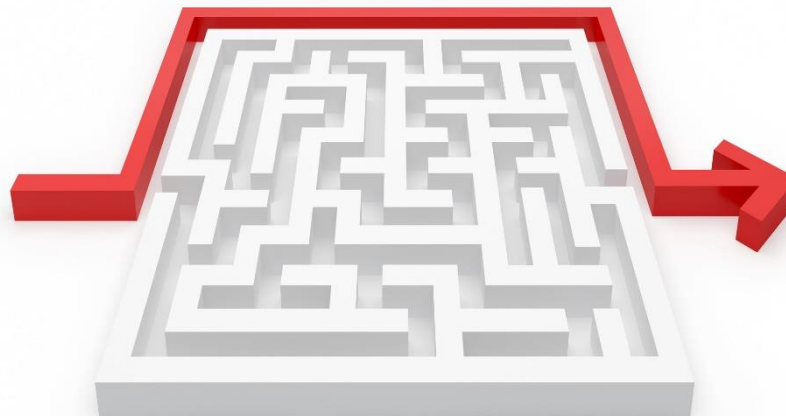


Overview of Section 199A - Continued

- The deduction applies only for income tax purposes. IRC § 199A(f)(3). Therefore, the 199A deduction does not apply when determining self-employment taxes;
- For AMT purposes, QBI is determined without regard to IRC §§ 56-59 adjustments.

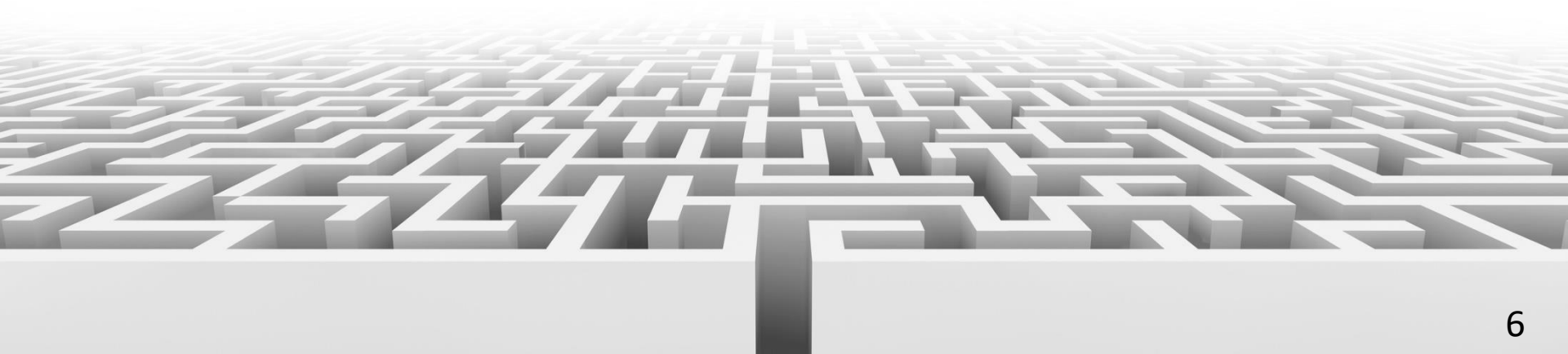
Overview of Section 199A - Continued

- The Basic Calculation Appears Simple:
 - At its most basic level, the 199A deduction is 20% of the net amount of items of income, gain, deduction, and loss with respect to the taxpayer's non-corporate trades or businesses.



Simple Does Not Mean Easy

- Section 199A is subject to multiple exclusions, thresholds, and limitations.
- For instance, certain types of investment-related items are excluded from QBI, e.g., capital gains or losses, dividends, and interest income (unless the interest is properly allocable to the business).



Simple Does Not Mean Easy

- Employee compensation and certain guaranteed payments to a partner or S-corporation shareholder are also excluded from the QBI calculation.
- Taxpayers whose taxable income exceeds threshold amounts are also subject to limitations based on W-2 wages paid by the business and the business' unadjusted basis in acquired qualified property.

Tax Rate Comparison

- The Tax Cuts and Jobs Act (“TCJA”) reduced the corporate tax rate to a flat 21%. Qualified dividends are taxed at a 20% rate, and can be subject to an additional net investment income tax of 3.8%. The combined corporate rate is therefore approximately 39.8%.
 - Combined corporate rate: $[21\% + [(100\% - 21\%) * (20\% + 3.8\%)]] = 39.8\%$.

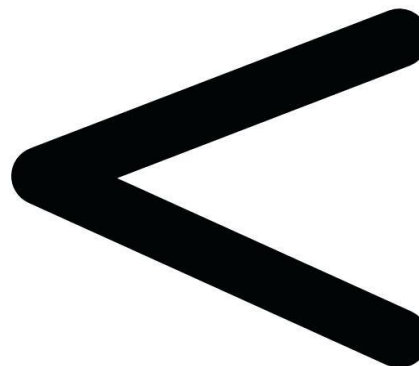


Tax Rate Comparison

- Owners of pass-through entities are subject to a maximum 37% individual tax rate;
- The 199A deduction helps return the tax gap between corporations and pass-through entities to something close to pre-TCJA levels. Assuming a maximum 37% individual rate, an individual's top combined tax rate using a partnership structure would be 29.6%.
 - Pass-through marginal rate with 199A: $[(100\% - 20\%) * 37\% = 29.6\%]$.

Deduction Mechanics

- Deductible Amount. The amount of the deduction is the lesser of:
 - The taxpayer's “combined qualified business income” amount, or
 - An amount equal to 20% of the excess of the taxpayer's taxable income over any net capital gain.



Deduction Mechanics Continued

$$\begin{array}{l} \text{The taxpayer's} \\ \text{"combined} \\ \text{qualified business} \\ \text{income" amount} \\ \text{for the tax year} \end{array} = \begin{array}{l} \text{The deductible} \\ \text{QBI determined} \\ \text{for each trade or} \\ \text{business (or} \\ \text{aggregated trade} \\ \text{or business)} \\ \text{carried on by the} \\ \text{taxpayer*} \end{array} + \begin{array}{l} \text{20\% of the aggregate} \\ \text{amount of the} \\ \text{taxpayer's qualified} \\ \text{REIT dividends and} \\ \text{qualified publicly} \\ \text{traded partnership} \\ \text{income} \end{array}$$

* The focus of this discussion is on part 1 of the Combined Qualified Business Income calculation.

Deduction Mechanics Continued

- “Deductible QBI” is required to calculate “combined qualified business income”:
 - “Deductible QBI” for each trade or business is generally equal to the lesser of:
 - (1) 20% of the taxpayer's QBI with respect to the trade or business, or
 - (2) the W-2 wage limitation:
 - Amount of the W-2 Limitation. The W-2 wage limitation is equal to the greater of:
 - (1) 50% of the W-2 wages with respect to the trade or business, or
 - (2) the sum of
 - (a) 25% of the W-2 wages with respect to the trade or business, plus
 - (b) 2.5% of the unadjusted basis, immediately after acquisition (UBIA) of all qualified property. See IRC § 199A(b)(2)(B); Treas. Reg. § 1.199A-1(d)(2)(iv)(A).
 - Application of the W-2 Limitation. The W-2 wage limitation is phased in in an amount equal to: (1) 20% of QBI minus the W-2 wage limitation, multiplied by (2) the ratio of (i) taxable income in *excess of the threshold amount*, to (ii) \$50,000 (\$100,000 for joint filers). See IRC § 199A(b)(3)(B); Treas. Reg. § 1.199A-1(d)(2)(iv)(B). In other words, the phase-in trigger is TI exceeding the IRC § 199A thresholds.

Deduction Mechanics Continued

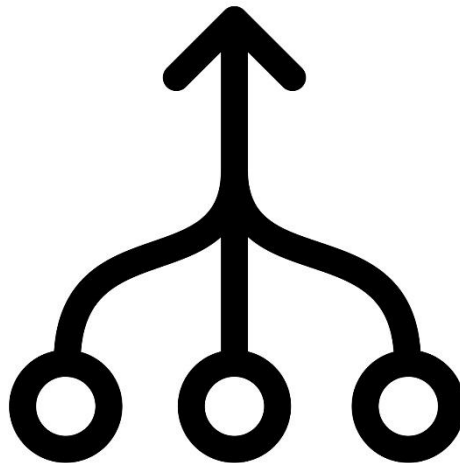
- Unpacking the W-2 Wage Limitation.
 - “W-2 wages” are the total wages (as defined in IRC § 3401(a) via cross reference from IRC § 6051(a)(3)) subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to its employees during the calendar year ending during the tax year of the taxpayer. IRC § 199A(b)(4)(A);
 - A shareholder in an S corporation and a partner in a partnership take into account only their allocable share of the W-2 wages paid by the business before applying the 50% limitation. IRC § 199A(f)(1)(A)(iii).

Additional 199A Restrictions

- Trade or Business.
 - The taxpayer must have an active “trade or business” under a traditional IRC analysis in order to use Section 199A.
 - This generally requires a profit motive to exist and the taxpayer holds himself or herself out to others as offering goods or services. *See, e.g., Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933); and *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).
 - Special rules apply to rental real estate. *See* Notice 2019-7.

Additional 199A Restrictions

- Aggregation.
 - Complex aggregation rules apply to 199A.
 - A taxpayer can aggregate related trades or businesses if the same person or group owns directly or by IRC §§ 267(b) or 707(b) attribution 50% or more of each trade or business to be aggregated.



Additional 199A Restrictions

- Employees.
 - Persons who are employees cannot use IRC § 199A.
 - The policy is that the IRC will not allow a standard W-2 employee to deduct 20% of his or her wages.
 - Anti-abuse rules apply to prevent employee / contractor gaming.

Notice 2019-7 – Rental Real Estate Safe Harbor

- Notice 2019-7 contains a proposed Revenue Procedure;
- The IRS offered a safe harbor in determining when a rental real estate enterprise will be treated as a trade or business solely for purposes of section 199A.



Notice 2019-7 – Rental Real Estate Safe Harbor



In general the new safe harbor requires a taxpayer to:

- Maintain separate books and records for each rental activity (or the combined enterprise if aggregated together), and demonstrate that 250 hours or more of rental services were performed.

Specified Service Trade or Business

- Specified Service Trade or Business (“SSTB”). SSTB’s are provided for by statute in IRC § 199(d)(2). Listed SSTBs are set forth in Treas. Reg. § 1.199A-5(b)(1) and include any trade or business involving the performance of services in:
 - Health,
 - Law,
 - Accounting,
 - Actuarial science,
 - Performing arts,
 - Consulting,
 - Athletics,
 - Financial services (includes investment management, trading, or dealing in securities, partnership interests, or commodities),
 - Brokerage services, or
 - Where the principle asset of such trade or business is the reputation or skill of one or more of its employees or owners.

Specified Service Trade or Business

- “Reputation or skill” SSTB. Limited by regulation to a trade or business which consists of receiving fees, compensation, or other income for: endorsing products or services; licensing an individual's image, likeness, trademark, or other symbol associated with identity; or appearing at an event or on television or other media. See Treas. Reg. § 1.199A-5(b)(2)(xiv).



Specified Service Trade or Business

- De minimis rule for SSTB: a trade or business is not an SSTB if less than 10% of the gross receipts are attributable to a specified service activity and the trade or business has \$25 million or less in gross receipts. If the trade or business has more than \$25 million in gross receipts, the de minimis rule is reduced to less than 5% of gross receipts. *See* Treas. Reg. § 1.199A-5(c).



SSTB Threshold

SSTB Threshold: For 2018, if taxable income (“TI”) does not exceed \$315,000 (MFJ), or \$157,500 (all other taxpayers), the deduction is generally the lesser of:

- (i) 20% of QBI from all trades plus 20% of qualified REIT dividends and PTP income; or
- (ii) 20% of TI.
 - The SSTB exclusion phases in based on the ratio of TI in excess of the threshold amount to \$100,000 (MFJ) and \$50,000 (all other taxpayers). Therefore no deduction is allowed for income from an SSTB if TI is more than \$415,000 (MFJ) or \$207,500 (all other taxpayers).

Effect of SSTB Threshold

- Using 2018 figures:
 - If TI is less than \$315,000 (MFJ)/\$157,500 (All other taxpayers), full 20% of QBI deduction is possible;
 - If TI is above \$315,000/\$157,500 but below \$415,000/\$207,500, a partial 199A deduction is possible;
 - If TI is greater than \$415,000/\$207,500, no deduction is allowed.

Basic SSTB Example 1

- SSTB - No Disallowance Example: Doc Larry is a California native who files a joint tax return with his wife Shasta. Their TI is \$300,000, with \$200,000 of SSTB income. Larry's share of the W-2 wages of the business is \$20,000.



Basic SSTB Example 1

- Because TI is less than \$315,000, Larry is entitled to a deduction equal to $\$200,000 * .2 = \$40,000$. The SSTB prohibition and W-2 limitations do not apply at this level of TI.

Basic SSTB Example 2



- SSTB - Disallowance Example: Bentley and Estella are married and file jointly. Estella's TI is \$700,000, which includes \$500,000 of SSTB income from her medical practice.

Basic SSTB Example 2

- Because TI is greater than \$415,000 and income is from an SSTB, no 199A deduction is allowed.

SSTB Partial Deduction Example

Leopold and Molly are married and file jointly. Leopold's TI is \$375,000 with \$285,000 of income from a performing arts SSTB. The W-2 wages of the SSTB are \$120,000.

SSTB Partial Deduction Example

- Because TI is greater than \$315,000 but less than \$415,000, only a partial 199A deduction is available. The 199A calculation first requires Leopold to determine his applicable percentage of QBI income and W-2 wages: $[100\% - ((\text{TI of } \$375,000 - \text{MFJ threshold of } \$315,000) / \$100,000) = 40\%]$. Leopold's share of QBI income is $40\% * \$285,000 = \$114,000$ and share of W-2 wages is $40\% * \$120,000 = \$48,000$. The 199A deduction is equal to the lesser of 20% of QBI income or 50% of the share of W-2 wages, so here, the deduction is $20\% \text{ of } \$114,000 = \$22,800$.

QTB Threshold

Qualified Trade or Business (“QTB”):

- A QTB is any trade or business other than SSTBs or the trade or business of being an employee;
- For 2018, the threshold is \$315,000 (MFJ) / \$157,500 (all other taxpayers);
- As noted, the W-2 phase in starts when TI is \$315,000 (MFJ) / \$157,500 (all other taxpayers).

Basic QTB Example 1

- TI Above Threshold – With W-2 Wages.
Jonathan and Mina are married taxpayers who file jointly. Mina's and Jonathan's TI is \$500,000; included therein is QTB income (not from an SSTB) of \$300,000 from Mina's business. Mina's share of W-2 wages from the business is \$100,000.

Basic QTB Example 1

- TI exceeds \$415,000, so Mina is entitled to a deduction of 20% of QTB income of \$60,000, limited by the greater of: (i) 50% of W-2 wages, here \$50,000; or (ii) 25% of W-2 wages, here \$25,000 plus 2.5% of the unadjusted basis of qualified property, here \$0, for a total of \$25,000. The IRC §199A deduction is \$50,000.

Basic QTB Example 2

- Additional QTB Example. Jake and Brett are married and filed jointly. Brett has TI of \$350,000. Brett's QTB income (not from an SSTB) is \$310,000. Brett's share of W-2 wages of the business is \$100,000.

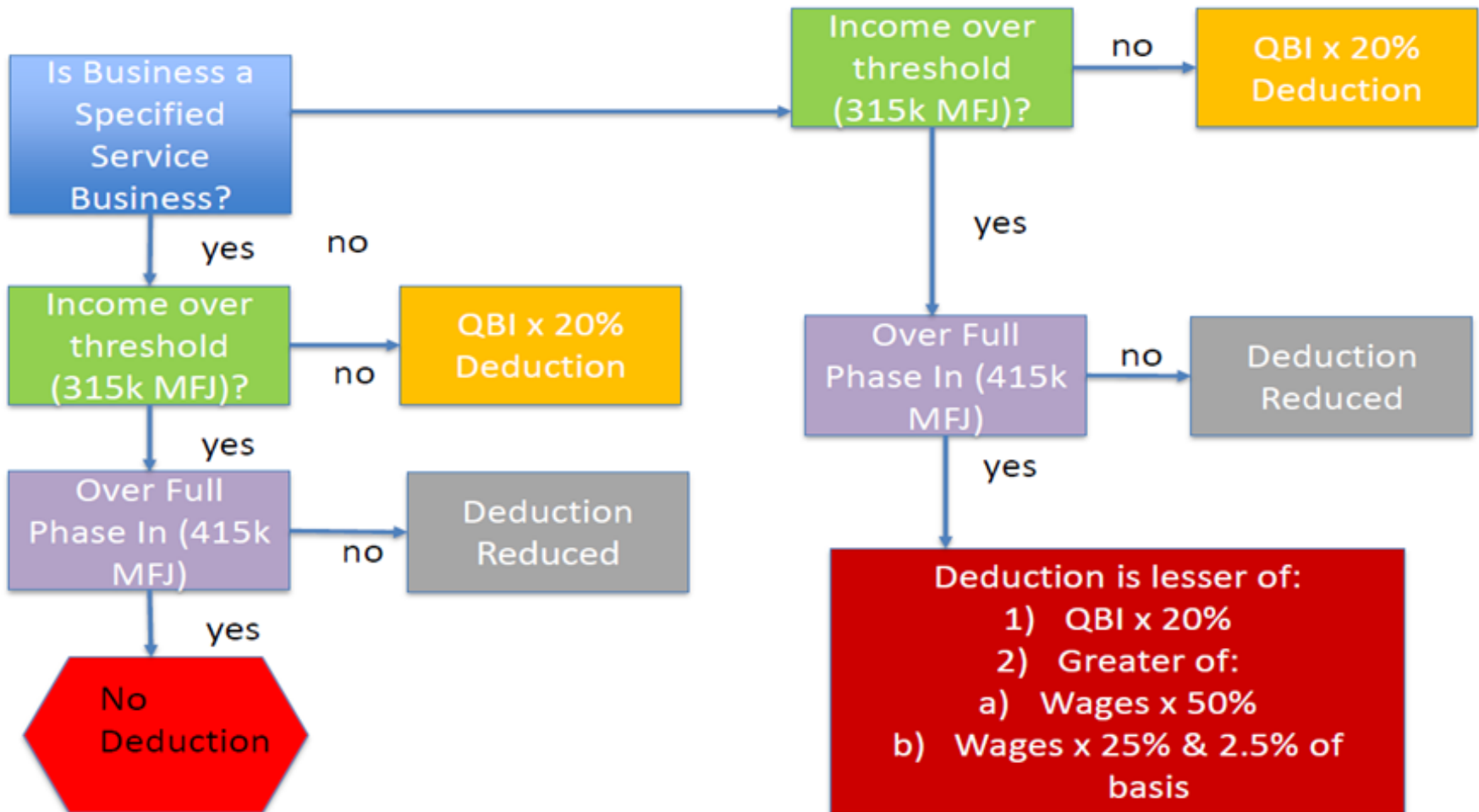
Basic QTB Example 2

- TI is less than \$415k but greater than \$315k so only a partial deduction is available. Brett must reduce her “excess amount”. The “excess amount” is the amount by which 20% of QBI from the QTB exceeds the greater of: (i) 50% of W-2 wages or (ii) 25% of W-2 wages plus 2.5% of unadjusted basis in qualifying property. Here, 20% of QBI is \$62,000. There is not qualifying property, so 50% of W-2 wages is \$50,000, and the “excess amount” is \$62,000 less \$50,000 = \$12,000. The excess amount is reduced by a percentage, which is the amount by which TI exceeds the minimum threshold, divided by \$100,000. Here TI is \$350,000 less the \$315,000 MFJ threshold, = \$35,000, divided by \$100,000 = 35%. Brett therefore reduces her “excess amount” by 35% * \$12,000 = \$4,200.00. Brett takes a QBI deduction of \$62,000 less \$4,200 = \$57,800.

Basic Order of QBI Approach

1. Does the entity at issue qualify to use 199A (not a C-corp., etc.)? If no, stop.
2. Does taxpayer have taxable income (not all capital gain income)? If no, stop.
3. Is entity an SSTB or a QTB?
 - SSTB.
 - If TI is greater than thresholds, no deduction;
 - If TI is between thresholds, partial deduction is possible;
 - If TI is below thresholds, 20% deduction is possible.
 - QTB.
 - If TI is greater than thresholds, limit deduction to wage/investment limits;
 - If TI is between thresholds, partial deduction may be allowed after wage/investment limit phase-in;
 - If TI is less than thresholds, 20% deduction is possible.

Note: the foregoing assumes no cooperative dividends, PTP income, or REIT dividends. References to the full 20% deduction are still subject mechanical application of the statute.



Final Regulations

- The IRS published final regulations in the federal register via T.D. 9847, 2/12/19.
- The final regulations are effective as of 2/8/19.

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Final Regulations

- Treas. Reg. §§ 1.199A-1 through 1.199A-6 are generally applicable to taxable years ending after 2/8/19.
- However, taxpayers may rely on the rules set forth in Treas. Reg. §§ 1.199A-1 through 1.199A-6, in their entirety, or on the previously issued proposed regulations, in their entirety, for taxable years ending in calendar year 2018.

The Regulatory Framework

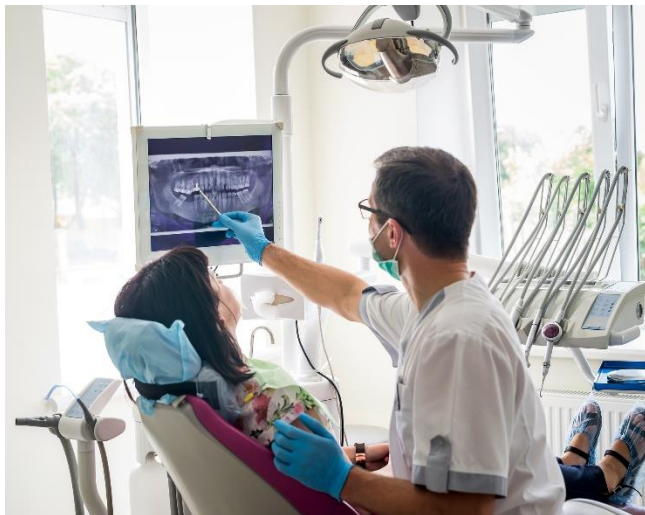
1. § 1.199A-1 includes definitions and operational rules;
2. § 1.199A-2 includes details regarding the determination of W-2 Wages and unadjusted basis immediately after acquisition of qualified property;
3. § 1.199A-3 Guidance regarding various terms including qualified business income, allocation among multiple trades or businesses;
4. § 1.199A-4 Aggregation rules;
5. § 1.199A-5 Specified service trades or businesses and performing services as employee;
6. § 1.199A- 6 Guidance regarding computational and reporting rules for “relevant pass-through entities,” publicly traded partnerships (PTP), and trusts and estates (including an anti-abuse rule).

Important Changes

- SSTB clarifications. The most important clarifications are within the SSTB definitions and rules:
 - The Final Regulations clarify that the trade or business determination is made at the entity level, which means that if a relevant pass-through entity (“RPE”) is engaged in a trade or business, an individual RPE owner can be eligible for the 199A deduction, even if the owner is passive. *See* Treas. Reg. § 1.199A-1(d)(2)(iv)(A) (referencing "trades or business operated through RPEs" in the determination of QBI.)
 - The regulations did not more specifically define what is a “trade or business” but instead deferred to common law. In general, an IRC § 162 “trade or business determination” involves a factual consideration of the taxpayer's motive and level of activity, which must be considerable, continuous, and regular. Preamble to Regulations at 13, citing *Commissioner v. Groetzinger*, 480 U.S. 23 (1987) and *Higgins v. Commissioner*, 312 U.S. 212 (1941).

Important SSTB Changes

- The Treasury and IRS provided significant clarity regarding what is or is not an SSTB via examples in the Final Regulations;
- As a general proposition, the Final Regulations conclude that a business "involving" the performance of services in a certain field is broader than the direct performance of services in that field.



Important SSTB Changes

- If a business provides qualifying services along with services in an SSTB field, the Final Regulations follow the bright line rule that was set forth in the Proposed Regulations:
- (1) Specifically, if gross receipts attributable to SSTB services constitute less than 5% of the annual gross receipts of the business (10% for businesses with total annual gross receipts \$25 million or less), then the business is not considered to an SSTB. Treas. Reg. § 1.199A-5(c)(1).
- (2) If the 5% or 10% thresholds are exceeded, the business will be an SSTB in its entirety, and no income from the SSTB will be eligible for the section 199A deduction unless its owners are below the relevant income threshold.

SSTB Final Regulation – Health Services

- The Final Regulations define “health” related services in Treas. Reg. § 1.199A-5(b)(2)(ii) as follows:

“For purposes of section 199A(d)(2) and paragraph (b)(1)(i) of this section only, the performance of services in the field of health means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such. The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. For example, 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, and manufacture and/or sales of pharmaceuticals or medical devices.”

Initial Thoughts on Healthcare Changes

- The preamble to the final regulations states that the stand-alone sale of pharmaceuticals and medical devices by retail pharmacies are not, without more, health services;
- Device services which relate directly to a health outcome could be more difficult to analyze.

Initial Thoughts on Healthcare Changes

- The IRS does not view therapies manufactured from a patient's body as automatically analogous to pharmaceutical sales;
- The preamble to the final regulations suggests a facts and circumstances approach will be used to classify the sale of these products as SSTB receipts (or not).

Initial Thoughts on Healthcare Changes

- The regulatory preamble offers some (unhelpful) thoughts on medical technicians;
- Whether technicians who operate medical equipment or test samples are performing SSTB health services is a question of fact.

SSTB Final Regulation Health Service Examples

- Health Care Example 1 – Contract Pharmacist. B is a board-certified pharmacist who contracts as an independent contractor with X, a small medical facility in a rural area. X employs one full time pharmacist, but contracts with B when X's needs exceed the capacity of its fulltime staff. When engaged by X, B is responsible for receiving and reviewing orders from physicians providing medical care at the facility; making recommendations on dosing and alternatives to the ordering physician; performing inoculations, checking for drug interactions, and filling pharmaceutical orders for patients receiving care at X.



Health Care Example 1

- B is engaged in the performance of services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section. See Treas. Reg. § 1.199A-5(b)(3) Example 1.
- As such, B is engaged in an SSTB, not a QTB.

SSTB Final Regulation Health Services - Example 1 Discussion

- Health services example 1 suggests that skilled pharmacists who provide technical support to physicians who serve patients directly are performing health care services within the scope of the SSTB rules.
- Example 1 is fairly obvious, particularly since Treas. Reg. § 1.199A-5(b)(2)(ii) refers to the provision of services by pharmacists.

SSTB Final Regulation Health Services - Example 1 Discussion

- What if instead of doing clinical support, the licensed pharmacist is only researching and collating drug interactions for the full time pharmacist to use in support of physicians?

SSTB Final Regulation Health Service Example 2

- Health Care Example 2 – Facilities Operator. X is the operator of a residential facility that provides a variety of services to senior citizens who reside on campus. For residents, X offers standard domestic services including housing management and maintenance, meals, laundry, entertainment, and other similar services. In addition, X contracts with local professional healthcare organizations to offer residents a range of medical and health services provided at the facility, including skilled nursing care, physical and occupational therapy, speech-language pathology services, medical social services, medications, medical supplies and equipment used in the facility, ambulance transportation to the nearest supplier of needed services, and dietary counseling. X receives all of its income from residents for the costs associated with residing at the facility. Any health and medical services are billed directly by the healthcare providers to the senior citizens for those professional healthcare services even though those services are provided at the facility.



SSTB Final Regulation Health Service Example 2

- X does not perform services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section. Treas. Reg. § 1.199A-5(b)(3) Example 2.

SSTB Final Regulation Health Services - Example 2 Discussion

- Example 2 suggests that merely providing a physical location where health services will be performed does not make income derived from monetizing the location a health services business.

SSTB Final Regulation Health Services - Example 2 Discussion

- Example 2 is deceptive in its simplicity – it specifies that 100% of income from the facility comes from residents – i.e. the facility is functionally a traditional landlord. The example’s use of the phrase “to offer residents a range of...health services provided at the facility” is telling;
- The use of the word “offer” implies residents do not have to purchase medical services, and “provided at” does not mean “provided by” the facility.

SSTB Final Regulation Health Service Example 3

- Health Care Example 3 – Facilities Billing and Operations Management. Y operates specialty surgical centers that provide outpatient medical procedures that do not require the patient to remain overnight for recovery or observation following the procedure. Y is a private organization that owns a number of facilities throughout the country. For each facility, Y ensures compliance with state and Federal laws for medical facilities and manages the facility's operations and performs all administrative functions. Y does not employ physicians, nurses, and medical assistants, but enters into agreements with other professional medical organizations or directly with the medical professionals to perform the procedures and provide all medical care. Patients are billed by Y for the facility costs relating to their procedure and by the healthcare professional or their affiliated organization for the actual costs of the procedure conducted by the physician and medical support team.

SSTB Final Regulation Health Service Example 3

- Y does not perform services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section. Treas. Reg. § 1.199A-5(b)(3) Example 3.

SSTB Final Regulation Health Services - Example 3 Discussion

- Example 3 is another facilities hypothetical, but is more ambiguous than example 2. In example 3, the facility ensures it complies with laws related to medical facilities. This point is useful, because it narrows the definition of health services - mere compliance with medical facility classification laws is not health service;
- Like example 2, example 3's facility is collecting fees for the use of its facility, which is still rent-like.

SSTB Final Regulation Health Services - Example 3 Discussion

- There is still ambiguity in example 3. For instance, there is no specification as to what equipment or fixtures are being provided in addition to basic floor-space (or whether the amount matters), or how involved the facilities staff might be within the context of the medical procedure.
- Query: What would result if the facility allows physicians to use a surgical machine that is supported by skilled facility technicians during the procedure? The physical plant is still being “rented” but the patient’s medical outcome depends in part on the facility’s technical support.

SSTB Final Regulation Health Service Example 4

Health Care Example 4 – Medical Testing Analysis. Z is the developer and the only provider of a patented test used to detect a particular medical condition. Z accepts test orders only from health care professionals (Z's clients), does not have contact with patients, and Z's employees do not diagnose, treat, or manage any aspect of patient care. A, who manages Z's testing operations, is the only employee with an advanced medical degree. All other employees are technical support staff and not healthcare professionals. Z's workers are highly educated, but the skills the workers bring to the job are not often useful for Z's testing methods. In order to perform the duties required by Z, employees receive more than a year of specialized training for working with Z's test, which is of no use to other employers. Upon completion of an ordered test, Z analyses the results and provides its clients a report summarizing the findings. Z does not discuss the report's results, or the patient's diagnosis or treatment with any health care provider or the patient. Z is not informed by the healthcare provider as to the healthcare provider's diagnosis or treatment.

SSTB Final Regulation Health Service Example 4

- Z is not providing services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section or where the principal asset of the trade or business is the reputation or skill of one or more of its employees within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section. Treas. Reg. § 1.199A-5(b)(3) Example 4.

SSTB Final Regulation Health Services - Example 4 Discussion

- Example 4 is useful, because it offers guidance to technology companies operating in the health services industry. In this case, the company is performing scientific analysis on samples from health care professionals;
- If scientific technology only provides technical data for a health care professional's interpretation, under this example no health services have occurred.

SSTB Final Regulation Health Services - Example 4 Discussion

- The combination of examples 3 and 4 suggest where a particular service is not specifically listed in the regulatory health services definition, the closer a technical service relates to the actual provision of health care, the more likely it would be a health SSTB;
- Query: what if the company's report both summarized findings and provided if/then conclusions that could be used to support a physician's diagnosis?

Healthcare Businesses and § 199A

- The 4 regulatory examples show that technology companies and real estate companies doing business in the health care industry should be very careful when analyzing SSTB versus QTB status.
- Get a very detailed description of how those businesses will operate before giving 199A advice.

Other Healthcare Business Concerns

- The proposed regulations included a proximity to patients test for defining health services;
- The final regulations dropped the proximity requirement in response to the regulatory comments process;
- This makes the final regulations less arbitrary, but broader.

Other Healthcare Business Concerns – The De Minimis Rule

- The final regulations do allow a taxpayer to operate non-health businesses within an RPE that also does health business;
- The regulations use the example of a veterinary practice that also sells dog food. See Treas. Reg. § 1.199A-5(c)(1) Ex. 2;
- The example is predicated on having separate § 162 businesses under the entity umbrella.

Other Healthcare Business Concerns – The De Minimis Rule

- Contrast the veterinary example with example 1 from the same regulations;
- The first example discusses a lawn care business and landscaping consulting company that fails the de minimis SSTB test (more than 10% of gross receipts are SSTB income);
- It also does not treat the business lines as separate § 162 businesses.

Aggregation Rule Changes

The Final Regulations allow a taxpayer to aggregate multiple trades or businesses, if the taxpayer can show:

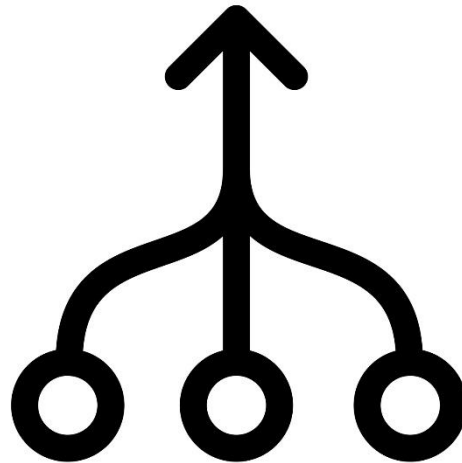
- The same person, or group of persons, directly or by attribution through the related party rules of IRC § § 267(b) and 707(b) owns 50% or more of each trade or business that will be aggregated.

Aggregation Rule Changes - Continued

- None of the trades or businesses that will be aggregated can be SSTBs; and
- The trades or businesses that will be aggregated satisfy at least two of the following three factors:
 - (1) they provide products, property or services that are the same or customarily offered together,
 - (2) they share facilities or significant centralized business elements like personnel, accounting and legal, and
 - (3) they are operated in coordination with, or reliance upon one or more of the businesses in the aggregated group.

Aggregation Rule Changes - Continued

- The Final Regulations clarified that aggregation is allowed at the entity level;
- A relevant pass-through entity may aggregate trades or businesses that it operates directly or through lower-tier RPEs.



RPE Definition Clarification

- In general, an individual is entitled to a pass-through deduction for its share of QBI of a business operated by an RPE;
- The Proposed Regulations provided that the term RPE included only partnerships (other than PTPs) and S-corporations owned (directly or indirectly) by at least one individual, estate, or trust.

RPE Definition Clarification

- The Final Regulations expand the definition of RPEs to include other pass-through entities that file an IRS Form 1065 and are owned, directly or indirectly, by at least one individual, estate, or trust.
- Thus, common trusts maintained by banks and certain religious or apostolic organizations that have a common treasury or community treasury may qualify as RPEs.

The Final Regulations' Calculation Methodology

Step 1: QBI Calculation.

- Calculate QBI for each qualified trade or business (or aggregated trade or business, if the taxpayer chooses to aggregate).
- If a taxpayer has more than one trade or business and QBI from at least one enterprise is negative, the taxpayer must first offset that negative QBI with the QBI from businesses that produced a net positive QBI, and then use the adjusted QBI for that trade or business. Treas. Reg. § 1.199A-1(d)(2)(iii)(A).
- If total QBI is negative, then the negative number is treated as a loss in the next succeeding taxable year for purposes of the 199A deduction. Treas. Reg. § 1.199A-1(d)(2)(iii)(B).
- The taxpayer calculates 20% of the QBI (“gross QBI”) for each trade or business.

The Final Regulations' Calculation Methodology

Step 2: Calculate W-2 Wages and UBIA:

- Calculate the W-2 wages and the unadjusted basis immediately after acquisition (“UBIA”) of qualified property for each trade or business (or aggregated trade or business).
- Under Treas. Reg. § 1.199A-2(c)(1)(i), qualified property is essentially depreciable property which:
 - (i) is held by and available for use in the trade or business as of the end of the taxable year,
 - (ii) is used during the taxable year in the trade or business’ production of QBI, and
 - (iii) has a depreciable period that has not ended before the close of the individual’s or RPE’s taxable year.

The Final Regulations' Calculation Methodology

Step 2 Continued: Calculate W-2 Wages and UBIA:

- Calculate limitations of the QBI portion of the QBI deduction. The gross QBI that can be used for the QBI deduction for each trade or business (or aggregated group of trades or businesses) is limited to the greater of:
 - 50% of W-2 wages with respect to the trade or business, or
 - The sum of 25% of W-2 wages, plus 2.5% of the UBIA of qualified property with respect to the trade or business.
- If TI is above the threshold amount, then the taxpayer is not entitled to any QBI deduction with respect to a SSTB.
- Once the QBI deduction for each of the taxpayer's qualified trades or businesses is determined, they are added together. This sum is the "QBI deductible amount".

The Final Regulations' Calculation Methodology

Step 3: Calculate PTP Income and REIT Dividends:

- Calculate qualified REIT dividends and qualified PTP income.
- Add:
 - (i) 20% of its combined qualified REIT dividends and qualified PTP income, and
 - (ii) the QBI deductible amount.
- This amount is the “total deductible amount”.

The Final Regulations' Calculation Methodology

Step 4: Final Calculation:

- The 199A deduction, in total for all of the taxpayer's trades or businesses, is the lesser of:
 - (1) the total deductible amount and
 - (2) 20% of the excess, if any, of the taxpayer's taxable income for the year over the taxpayer's net capital gain.

Final Regulations Example 1

199A deduction for individuals with taxable income not exceeding threshold amount. A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates \$100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is \$81,000. The business's QBI is \$100,000, the net amount of its qualified items of income, gain, deduction, and loss.

Final Regulations Example 1

- A's section 199A deduction for 2018 is equal to \$16,200, the lesser of 20% of A's QBI from the business ($\$100,000 \times 20\% = \$20,000$) and 20% of A's total taxable income for the taxable year ($\$81,000 \times 20\% = \$16,200$).
Treas. Reg. § 1.199A-1(c)(3) Example 1.

Final Regulations Example 2

199A deduction for individuals with taxable income not exceeding threshold amount:

Assume the same facts as in Example 1 of paragraph (c)(3)(i) of this section, except that A also has \$7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is \$74,000. A's taxable income minus net capital gain is \$67,000 ($\$74,000 - \$7,000$).

Final Regulations Example 2

- A's section 199A deduction is equal to \$13,400, the lesser of 20% of A's QBI from the business ($\$100,000 \times 20\% = \$20,000$) and 20% of A's total taxable income minus net capital gain for the taxable year ($\$67,000 \times 20\% = \$13,400$). Treas. Reg. § 1.199A-1(c)(3) Example 2.

Other Issues Regarding the Final Regulations

- The Operational Regulations of Treas. Reg. § 1.199A-1 provides a series of examples regarding phase-in limitation calculations. These examples are very lengthy and highly technical.



Operational Advice

- The Sunset Problem.
 - Taxpayers will have to weigh the costs of restructuring against the possibility the deduction itself will sunset in 2025. The sunset date makes it difficult to advise a successful business to restructure just to maximize 199A benefits;
 - One planning idea would be to wait until the deduction sunsets, then convert into a C-corporation to take advantage of the new 21% rate structure.



Restructuring Planning

- If a taxpayer has a QTB that also performs SSTB services and cannot use the de minimis rule to be excluded from SSTB treatment, that might be a situation to consider dividing the SSTB and the QTB into two different entities in order to maximize the 199A deduction.



(Re)Classification Planning

- For service businesses, it may make sense to reevaluate what customers are being provided.
- Hypothetical: a consulting firm provides tangible devices in line with its service offerings. Much of the firm's consulting work revolves around supporting the provided devices. Are these service offerings internally divisible, or so closely entwined they could not be separate businesses?

(Re)Classification Planning

- It is very likely that the IRS will scrutinize reclassification transactions where companies try to scope themselves out of service business status.
- It is inadvisable to simply call a transaction the sale of a product instead of a service. As an advisor, consider whether you can in substance (and cost effectively) re-tailor service offerings into product sales.

Reclassification Thoughts

- Reclassification options dovetail with the SSTB classification rules. First consider whether the SSTB de minimis rule applies;
- If a business is very close to meeting the de minimis rule, it may make sense to consider a reclassification plan.

Compensation Planning

- Wage Planning.
 - For W-2 wages, the business owner's wages count for the § 199A limitations – but so do all W-2 wages paid by the business.
 - Wages are one area where S-corporations can be superior to partnerships, because S-corporation owners get W-2 “credit” for reasonable wages.

Compensation Planning

- From an employer's perspective, it might be beneficial to consider whether to hire more employees instead of using contractors in order to increase W-2 wages.
- The inverse is also true – employees might be incentivized to be contractors so that they can use 199A.

Compensation Planning

- Don't be short-sighted on 199A:
- Bringing contractors “in-house” causes non-tax problems.
 - Insurance premiums can increase;
 - ACA concerns can exist if an ALE is created;
 - You can lose any indemnity protection and guarantees provided by the contractor agreement.

De Minimis Rule Planning

- The SSTB de minimis rule does not automatically taint all gross receipts under the final regulation examples;
- Determine whether formalizing separation procedures can occur, such that separate § 162 businesses formally exist within the same company;
- If so, the client may get to exclude some income from the SSTB thresholds.

Anti-Abuse Concerns

- Taxpayers will have to contend with the Final Regulations' anti-abuse rules which, among other things, target cracking transactions that artificially separates QTB income from SSTB income.

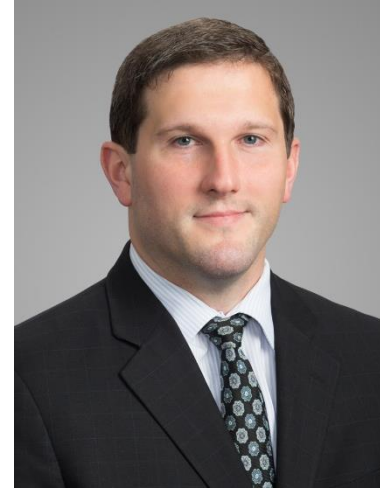
General Anti-Abuse Concerns

- Do not forget that each of the Code's subchapters have anti-avoidance rules in addition to the new 199A rules.
- Separation transactions will also require consideration of "normal" IRC rules. For instance, in Subchapter K, to distribute assets consider:
 - §§ 751(b), 704(c)(1)(B), 707(a)(2)(B), 737

Thank you!



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Final Regulations Example 3

199A deduction for individuals with taxable income not exceeding threshold amount. B and C are married and file a joint individual income tax return. B earns \$50,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates \$100,000 in net income from operations in 2018. X pays C \$150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is \$270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is \$100,000, the net amount of its qualified items of income, gain, deduction, and loss.

Final Regulations Example 3

- The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's section 199A deduction is equal to \$20,000, the lesser of 20% of C's QBI from the business ($\$100,000 \times 20\% = \$20,000$) and 20% of B and C's total taxable income for the taxable year ($\$270,000 \times 20\% = \$54,000$). Treas. Reg. § 1.199A-1(c)(3) Example 3.

Final Regulations Example 4

Section 199A deduction for individuals with taxable income above threshold amount. D, an unmarried individual, operates a business as a sole proprietorship. The business generates \$1,000,000 of QBI in 2018. Solely for purposes of this example, assume that the business paid no wages and holds no qualified property for use in the business. After allowable deductions unrelated to the business, D's total taxable income for 2018 is \$980,000. Because D's taxable income exceeds the applicable threshold amount, D's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations.

Final Regulations Example 4

- D's section 199A deduction is limited to zero because the business paid no wages and held no qualified property. Treas. Reg. § 1.199A-1(d)(4) Example 1.

Final Regulations Example 5

Section 199A deduction for individuals with taxable income above threshold amount.

Assume the same facts as in Example 1 of paragraph (d)(4)(i) of this section, except that D holds qualified property with a UBIA of \$10,000,000 for use in the trade or business. D reports \$4,000,000 of QBI for 2020. After allowable deductions unrelated to the business, D's total taxable income for 2020 is \$3,980,000.

Final Regulations Example 5

Because D's taxable income is above the threshold amount, the QBI component of D's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the business has no W-2 wages, the QBI component of D's section 199A deduction is limited to the lesser of 20% of the business's QBI or 2.5% of its UBIA of qualified property. Twenty percent of the \$4,000,000 of QBI is \$800,000. Two and one-half percent of the \$10,000,000 UBIA of qualified property is \$250,000. The QBI component of D's section 199A deduction is thus limited to \$250,000. D's section 199A deduction is equal to the lesser of:

- (A) 20% of the QBI from the business as limited (\$250,000); or
- (B) 20% of D's taxable income ($\$3,980,000 \times 20\% = \$796,000$).

Therefore, D's section 199A deduction for 2020 is \$250,000. Treas. Reg. § 1.199A-1(d)(4) Example 2.