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Qualified Business Income Deduction -Initial Guidance

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Last winter we told you about a new provision in the December 22, 2017 tax reform law called the Qualified Business Income or pass-through deduction. Many questions on how the law applies were left unanswered. We've been waiting on guidance and that came on August 8th. Treasury released proposed regulations for Section 199A. Proposed regulations are not final, but they tell you what the Treasury Department is thinking.

In an attempt to lower taxes on owners of LLC's, partnerships, S corporations and sole proprietorships who cannot take advantage of the new lower 21% corporate tax rate, a deduction under new code section 199A was put into place.

Section 199A allows pass-through business owners to deduct 20% of the net profit of the business on their individual income tax returns. There were numerous exceptions. If an owner's income is too high, additional limitations based upon wages and basis of property come into play. Certain service businesses that typically fall out of favor with Congress cannot take advantage of the provision. Accounting, medicine, law, consulting, etc. were left out.

The statute was unclear in a number of instances. For example, the list of prohibited services (technically called specified services) contained a catch all for any trade or business in which the principal asset is the skill or reputation of one or more employees or owners. This was one of the new law's vaguest provisions. The wording is broad, so how wide of a net was Congress casting? Also, keep in mind, despite some service businesses falling out of favor tax-wise, this deduction is allowed to any owner of a pass-through specified service business if his or her income is low enough, \$ 315,000 on a joint return and \$ 157,500 on a single return.

On a more basic level, what does Qualified Business Income mean? Without delving too far into the tax language, rental properties are not trades or businesses. Trades and businesses fall under Section 162 of the Code. Rental properties are activities held for the production of income under Section 212. Exactly what is Qualified Business Income?

Following are the highlights.

The regulations take a Section 162 trade or business perspective. There is one exception to that, recognizing that businesses commonly structure their affairs to have the operating business in one entity and the real estate in another, they allow the rental to be considered part of the same trade or business. Common ownership, etc. must be present. Generally, rentals will be excluded unless related to another business or the activity rises to the level of a trade or business.

The specified service rule was narrowly interpreted. The “skill or reputation” language does not apply broadly and was limited to situations involving endorsing products or services, licensing the use of an individual’s image, likeness, voice, etc. and receiving appearance fees to reality performers on TV, radio, social media, etc.

Some of the planning techniques that were evolving since December 22, 2017 included segregating a business into components are curtailed. For example, a medical group or accounting firm that was a specified service might spin off its IT and administrative staff and charge the practice a fee. That new entity is not providing medical or accounting services in this example so its profit might qualify for the 20% deduction. The preamble to the regulations specifically refers to this and states the separation strategy is outside of the intent of the statute. Regulations prohibit this if there is common ownership and little income from outsiders.

The rules clarify that wages paid by different companies can be used by the trade or business for purposes of the wage limitation. When income exceeds the \$ 315,000/\$ 157,500 mentioned above, even non specified service businesses have limits. The pass-through deduction is limited to 50% of wages or 25% of wages and 2.5% of property basis. It was unclear if wages paid through a common entity for all of a taxpayer’s trades or businesses could be considered. Rules are provided for allocating those wages to each trade or business.

Another planning technique that was being touted was for current employees to quit their jobs and to be hired as independent contractors. The 20% deduction does not apply to an employee’s wages, but could to the profit from a sole proprietorship. The new rules make reference to the existing rules for determining an employee, vs. an independent contractor relationship and also state that if the person is still performing substantially the same services the person is presumed to still be earning income in an employee capacity despite how the employer reports it, i.e. Form 1099.

For more sophisticated planning, there are rules to limit a business owner, who is running into issues with the income limit, to transfer ownership to multiple trusts so that each trust can use its own \$ 157,500 income level. Remember, any taxpayer with income below that avoids any limitations, whether that’s the wage and basis limitation or the prohibition for specified services. If the trusts were availed of to avoid taxes, the IRS can deny the tax savings.

There are 184 pages of proposed regulations addressing a number of areas too numerous to mention. Keep in mind they are only proposed rules, but they are a clear indication of how the Treasury is thinking regarding this very complex tax provision.