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Newly Proposed IRS Regulations Put a Monkey Wrench in Plans by Service Businesses Seeking IRC § 199A Deduction

By Larry Brant and Steven Nofziger on 8.8.18 | Posted in Legislation, Tax Laws, Tax Planning, Tax Procedure

The Service issued [proposed regulations](#) corresponding to IRC § 199A today. As discussed in a [prior blog post](#), IRC § 199A potentially allows individuals, trusts and estates to deduct up to 20% of qualified business income (“QBI”) received from a pass-through trade or business, such as an S corporation, partnership (including an LLC taxed as a partnership) or sole proprietorship.

BACKGROUND

Deduction

The deduction effectively reduces the new top 37% marginal income tax rate for business owners to approximately 29.6% (i.e., 80% of 37%) in order to put owners of pass-through entities on a more level playing field with owners of C corporations who now have the benefit of the greatly reduced 21% top corporate marginal tax rate under the Tax Cuts and Jobs Act (“TCJA”). The concept sounds simple, but the application is complex. The new Code provision contains complex definitions and limitations, requires esoteric calculations, and is accompanied by many traps and pitfalls.

In general, IRC § 199A provides that a non-corporate taxpayer may, subject to certain adjustments and limitations, deduct 20% of the taxpayer’s qualified business income (“QBI”) with respect to each qualified trade or business, plus; 20% of the aggregate amount of qualified cooperative dividends, qualified real estate investment trust dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

The deduction is applied to the taxpayer’s taxable income, not adjusted gross income, and it cannot exceed the amount of the taxpayer’s taxable income for the tax year. In the case of partnerships and S corporations, the deduction applies at the partner or shareholder level, and each partner or shareholder takes into account his or her allocable share of items of income, deduction and loss from the partnership or S corporation.

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The amount of QBI subject to the deduction from each qualified trade or business is subject to certain limitations, including a limitation contained in IRC § 199A(b)(2). This limitation (“QBI Limitation”) is the greater of:

(1) 50% of the W-2 wages paid with respect to the qualified trade or business (“W-2 Wage Limit”), or

(2) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business, plus 2.5% of the unadjusted basis, immediately after acquisition, of all “qualified property”^[1] of the qualified trade or business (the “Wage and Capital Limit”).

If a taxpayer’s taxable income for the year does not exceed the applicable “income threshold amount,” the QBI Limitation is inapplicable. The “income threshold amount” is \$315,000 for married individuals filing jointly and \$157,500 for other individuals. Both amounts are subject to inflation adjustments in future years.

For married individuals filing jointly, the QBI Limitation is phased in on a sliding scale over the next \$100,000 of taxable income above the “income threshold amount.” For other taxpayers, the phase in occurs over the next \$50,000 above the “income threshold amount.” Thus, the limitation fully applies when taxable income is over \$415,000 for married individuals filing jointly, and \$207,500 for other individuals.

Specified Service Businesses

IRC § 199A provides that a “qualified trade or business” means any trade or business other than a “specified service business” or the trade or business of performing services as an employee.

For these purposes, a “specified service business” means any trade or business in the fields of:

- Health;
- Law;
- Accounting;
- Actuarial Science;
- Consulting;
- Athletics;
- Financial Services;
- Brokerage Services;

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- Businesses involving investing, investment management, trading or dealing in securities, partnership interests or commodities; and
- Businesses in which the principal asset of the business is the reputation or skill of one or more of its employees or owners.

Not all service businesses made the list. While the list of service businesses is broad, Congress specifically excluded architecture and engineering services from the list.

For owners of a “specified service business,” if their taxable income exceeds the “income threshold amount,” the IRC § 199A deduction is totally lost without application of the QBI Limitation. By way of example, a partner in an accounting firm who has less than \$315,000 of taxable income (married filing jointly) will be entitled to an IRC § 199A deduction, subject to the QBI Limitation, while another partner in the same accounting firm who is married filing jointly and has over \$415,000 of taxable income will be excluded entirely from the deduction (without the application of the QBI Limitation).

COMMENTATOR RHETORIC

After the TCJA was adopted this past December, the tax media was replete with discussions about how “specified service businesses” could plan around a total loss of the IRC § 199A deduction due to the “income threshold amount.” The plan, commonly referred to as a “crack and pack” plan, involves spinning off the administrative and non-professional service functions to a new pass-through entity owned by the same persons who own the service business. The new entity would charge the old entity for its work, thereby reducing the old entity’s owners’ income to a negligible amount. Like magic, in the minds of several commentators, the IRC § 199A deduction would be preserved to a significant degree.

Proposed Regulations

Not so fast! Many commentators and tax practitioners, including us, believed that the Service would include anti-abuse safeguards in any regulations issued under IRC § 199A in order to prevent this type of plan around strategy. **We were correct.**

The IRS issued proposed regulations today that contain anti-abuse provisions, including provisions that throw a monkey wrench in the so-called “crack and pack” plan. The proposed regulations (184 pages in total) provide in part some interesting anti-abuse provisions:

- If a “specified service business” owns fifty (50) percent or more of another entity, such entity will be ignored as separate and apart from the “specified service business.” In other words, the entity’s tax attributes for purposes of IRC § 199A will be treated as the tax attributes of the “specified service business.”

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- For businesses with “specified service business” income and income from other sources, they will not be considered a “specified service business” for purposes of IRC § 199A if: (i) for businesses with gross receipts of \$25 million or less, less than ten (10) percent of gross receipts is generated from the specified service; and (ii) for businesses with gross receipts over \$25 million, less than five (5) percent of gross receipts is generated from the specified service.

Stay tuned! We will report further on the new proposed regulations in a future blog post.

[i] For these purposes, “qualified property” means tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of QBI, and the depreciable period for which has not ended before the close of the tax year. The “depreciable period” is the later of 10 years from the original placed-in-service date or the last day of the last full year of the applicable recovery period under IRC § 168.

Tags: "spin-off" transactions, deductions, Internal Revenue Code, Internal Revenue Service, IRC § 199A, IRS, limitations, pass-through entity, qualified business income, Reasonable Compensation, specified service businesses, Tax Cuts and Jobs Act, taxable income, threshold amount