Applying the New 20% Passthroughs Deduction under Section 199A in the Real World (PowerPoint)

James B. Sowell
Stephen J. Giordano
Mark C. Van Deusen

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Repository Citation
Sowell, James B.; Giordano, Stephen J.; and Van Deusen, Mark C., "Applying the New 20% Passthroughs Deduction under Section 199A in the Real World (PowerPoint)" (2018). William & Mary Annual Tax Conference. 784.
https://scholarship.law.wm.edu/tax/784

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Applying the New 20% Passthroughs Deduction under Section 199A in the Real World

William and Mary Tax Conference

Stephen Giordano, Principal  
KPMG LLP  
Washington National Tax  
November 8, 2018

Jim Sowell, Principal  
KPMG LLP  
Washington National Tax
Notice

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The 20% Deduction
20% Deduction for Qualified Business Income

For taxable years beginning after December 31, 2017, and on or before December 31, 2025, section 199A allows individuals, estates, and trusts a 20% deduction for qualified business income. (References in this slide presentation from this point forward will be only to individuals, but include estates and trusts).

— Obviously, the effective reduction of a taxpayer’s rate will depend on the rate that would have been charged on the income against which the deduction would be applied.

  - For instance, a taxpayer who would have paid tax at a rate of 37% would receive an effective rate reduction of 7.4% as a result of a 20% deduction (20% x 37%), bringing the effective rate on such income down to 29.6%.

— For a partner in a fiscal-year partnership with a taxable year ending before December 31, 2018, all items are treated as incurred in the individual’s taxable year during which the partnership’s taxable year ends (e.g., partner takes all items of January 31, 2018 year-end partnership into account as 2018 items for purposes of section 199A even though 11 months of the fiscal year occurred before January 1, 2018). Prop. Reg. §§1.199A-1(f)(2), -2(d)(2)(ii), -3(d)(2)(ii), -4(e)(2), -5(e)(2)(ii), and -6(e)(2)(ii).
Recipients of Qualified Business Income

Individuals may receive qualified business income through a passthrough entity.

— The proposed regulations define a “relevant passthrough entity” (“RPE”) as “a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly by at least one individual, estate, or trust. A trust or estate is an RPE to the extent that it passes through qualified business income, W-2 wages, unadjusted basis of qualified property, qualified REIT dividends, or qualified PTP income.” Prop. Reg. §1.199A-1(b)(9)
Qualified Business Income
“Qualified business income" means the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.

— The proposed regulations provide that section 751(a) and (b) gain is attributable to the trades or businesses conducted by the partnership and will be taken into account in computing qualified business income. Prop. Reg. §1.199A-3(b)(1)(i).

— Guaranteed payments for the use of capital cannot be qualified business income, although the deduction is taken into account for purposes of computing qualified business income. Prop. Reg. §1.199A-3(b)(1)(ii).

— Section 481 adjustments are taken into account in computing qualified business income to the extent the section 199A requirements are otherwise satisfied, but only if the adjustment arises in taxable years after December 31, 2017. Prop. Reg. §1.199A-3(b)(1)(iii).

— Disallowed losses (e.g., sections 465, 469, and 704(d)) are taken into account in computing qualified business income when allowed, unless the losses were disallowed in a taxable year ending before January 1, 2018. Prop. Reg. §1.199A-3(b)(1)(iv).

— Net operating losses are not taken into account in computing qualified business income except to the extent that the net operating loss was disallowed under section 461(l) (relating to excess business losses). Prop. Reg. §1.199A-3(b)(1)(v).
Qualified business income excludes specified items of income in the nature of investment income.

— Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.
  - Section 1231 gain treated as capital gains or losses fall within this category. Prop. Reg. §1.199A-3(b)(2)(ii)(A).

— Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G).

— Any interest income other than interest income which is properly allocable to a trade or business.
  - Interest attributable to working capital is not allocable to a trade or business. Prop. Reg. §1.199A-3(b)(2)(ii)(C).

— Any item of gain or loss described in section 954(c)(1)(C) or (D) (applied by substituting "qualified trade or business" for "controlled foreign corporation").

— Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).

— Any amount received from an annuity which is not received in connection with the trade or business.
Qualified business income also excludes specified items that are compensatory in nature.


— Any guaranteed payment described in section 707(c) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. Prop. Reg. §1.199A-3(b)(2)(ii)(I).

— Any payment described in section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. Prop. Reg. §1.199A-3(b)(2)(ii)(J).

— Note that while these amounts are not treated as qualified business income, the partnership’s deduction for such payments will reduce qualified business income if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.
Qualified Business Income – Trade or Business

Qualified business income must be earned with respect to a “trade or business.” Prop. Reg. §1.199A-1(b)(4).

— The proposed regulations define “trade or business” by reference to section 162, except that a trade or business of being an employee is excluded. Prop. Reg. §1.199A-1(b)(13).

- Reclassification of employees to independent contractors – An individual that was properly treated as an employee for Federal employment tax purposes by the service recipient services and who subsequently is treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), will be presumed to be in the trade or business of performing services as an employee with regard to such services. Prop. Reg. §1.199A-5(d)(3).

— The presumption may be rebutted upon a showing by the individual that, under Federal tax law, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee.

- Related party rent or royalties - The proposed regulations provide that rental or licensing of tangible or intangible property that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented to a trade or business which is commonly controlled under Prop. Reg. §1.199A-4(b)(1)(i). Prop. Reg. §1.199A-1(a)(13).
Qualified Business Income - Domestic Income

Qualified business income is limited to “domestic qualified items of income, gain, deduction, and loss with respect to a taxpayer’s qualified business.”

— The proposed regulations make clear that the standard for identifying domestic income is the same as applies in determining effectively connected income under section 864(c). Prop. Reg. §1.199A-3(b)(2)(i)(A).

- The fact that income is effectively connected with a U.S. trade or business under section 864(c), however, does not necessarily mean that the income is qualified business income.

— For example, section 871(d) allows a nonresident alien individual to elect to treat income from real property in the United States that would not otherwise be treated as effectively connected with the conduct of a trade or business within the United States as effectively connected. However, for purposes of section 199A, if items are not attributable to a trade or business under 162, such items do not constitute qualified business income.
Qualified business income also excludes income related to a specified service trade or business, which is discussed later at slides 36 – 48.
Wage and Unadjusted Basis Limitations on the Deduction
Section 199A contains certain limitations on the ability of an individual to claim the 20% deduction with respect to qualified business income.

— The allowable deduction with respect to qualified business income of an individual cannot exceed the greater of
  - 50% of an applicable taxpayer’s allocable share of the W-2 wages with respect to a qualified business; or
  - 25% of an applicable taxpayer’s allocable share of the W-2 wages paid with respect to a qualified business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property.

— The proposed regulations refer to this calculation as the “QBI component calculation.” Prop. Reg. §1.199A-1(d)(2)(iv).
Limitation on 20% Deduction

Example: Domestic grocery business operated as a sole proprietorship earns qualified business income for the taxable year equal to $2M. The business employs 15 people and wages paid for the taxable year are equal to $500,000. The business owns no qualified property with unadjusted basis.

— $2M (qualified business income) x 20% = $400,000 (the potential deduction amount).
— $500,000 x 50% = $250,000 (limitation amount).
— In this situation, the permitted deduction amount would equal $250,000.

Note that, as a sole proprietorship, the owner does not pay himself or herself any wages.

— If the owner contributed the business to an S corporation, he or she could earn wages which would increase the wage limitation amount for the business.
— While the wages would increase the wage limitation amount, they would reduce the qualified business income earned by the owner.
  - In order to increase the limitation amount to $400,000, the owner would have to pay to himself or herself $300,000 (i.e., $150,000/50%).
  - By paying $300,000 deductible wages that would not qualify for the 20% deduction, qualified business income would be reduced to $1,700,000, which would qualify for a deduction amount of $340,000.
— But once the business is contributed to an S corporation, can wages earned by the owner be limited to a targeted amount, given the “reasonable compensation” requirement?
For purposes of applying the limitations to a partner, a partner’s share of

- W-2 wages will be determined in the same manner as the partner’s allocable share of wage expenses.

- Unadjusted basis will be determined consistent with the partner’s share of depreciation expense attributable to such qualified property.

  - Each partner’s share of unadjusted basis of qualified property is an amount which bears the same proportion to the total unadjusted basis of qualified property as the partner’s share of tax depreciation bears to the partnership’s total tax depreciation with respect to the property for the year (i.e., section 704(c) impacts allocation of depreciation). Prop. Reg. §1.199A-2(a)(3).

  - In the case of qualified property held by a partnership which does not produce tax depreciation during the year (e.g., property that has been held for less than 10 years but whose recovery period has ended), each partner’s share of the unadjusted basis of qualified property 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 cash equal to the fair market value of the qualified property. *Id.*
W-2 wages means, with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. I.R.C. §199(b)(4)(A).

— Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a) plus the total amount of elective deferrals (within the meaning of section 402(g)(3)), the compensation deferred under section 457, and the amount of designated Roth contributions (as defined in section 402A). Prop. Reg. §1.199A-2(b)(2).
  - Notice 2018-64 sets forth a proposed revenue procedure outlining three methods for calculating W-2 wages.

— The statute is specific in providing credit only for W-2 wages, so payments to independent contractors and section 707(c) guaranteed payments to partners for services will not be taken into account in applying the wage limitations under section 199A(b)(2)(B).
  - The proposed regulations make no provision for treatment of guaranteed payment for services as W-2 wages.
  - The wage limitation creates pressure when issuing profits interests to employees, as these parties will cease to be employees receiving wages and instead will receive guaranteed payments under section 707(c) unless tiered-partnership structuring is undertaken to preserve employee status. Rev. Rul. 69-184, 1969-1 C.B. 256; Reg. §1.707-1(c).
20% Deduction and Wages

The requirement that an eligible taxpayer must have a share of W-2 wages with respect to a business puts a premium on the identity of the party paying the wages.

— Businesses use many wage payment arrangements (e.g., payroll company, common paymaster, secondments, employee leasing, etc.) that can create uncertainty regarding who is treated as the payor of wages for purposes of section 199A.

— Prop. Reg. §1.199A-2(b)(2)(ii) provides that “an individual or RPE may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE.”

- In effect, under this regulation, the W-2 wages generally should be treated as paid by the business that is the common law employer of the workers.

- These proposed regulations further provide that “persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.” Id.
Allocation of Wages

Wages must be allocated among trades or businesses and, within a trade or business, must be identified to the extent properly allocable to qualified business income.

— W-2 wages must be allocated to the trade or business that generated those wages.
  - In the case of W-2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under Prop. Reg. §1.199A-3(b)(5), which requires allocations using a reasonable method based on all facts and circumstances. Prop. Reg. §1.199A-2(b)(3).

— Once W-2 wages for each trade or business have been determined, each individual or RPE must identify the amount of W-2 wages properly allocable to qualified business income for each trade or business (e.g., effectively connected with a U.S. trade or business, etc.). Prop. Reg. §1.199A-2(b)(3).
  - W-2 wages are properly allocable to qualified business income if the associated wage expense is taken into account in computing qualified business income under Prop. Reg. §1.199A-3.
  - In the case of an RPE, the wage expense must be allocated and reported to the partners or shareholders of the RPE as required by the Code, including subchapters K and S.
  - The RPE must also identify and report the associated W-2 wages to its partners or shareholders.
The alternative limitation allowing consideration of the unadjusted basis of qualified property provides some benefit to capital intensive businesses that do not pay significant W-2 wages to directly-employed individuals (e.g., real estate investors).

— “Qualified property” means, with respect to any trade or business of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167(a)—
  - which is held by, and available for use in, the trade or business at the close of the taxable year,
  - which is used at any point during the taxable year in the trade or business’s production of qualified business income, and
  - the depreciable period for which has not ended before the close of the individual’s or RPE’s taxable year. Prop. Reg. §1.199A-2(c)(1)(i).

— In the case of any addition to, or improvement of, qualified property that has already been placed in service, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service. Prop. Reg. §1.199A-2(c)(1)(ii).

— Section 734(b) and 743(b) basis adjustments are not qualified property. Prop. Reg. §1.199A-2(c)(1)(iii).
Unadjusted Basis - Depreciable Period

The “depreciable period” of the property determines how long the unadjusted basis of the property will provide limitation amount.

— “Depreciable period” means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of—

- The date that is 10 years after such date, or

- The last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of any application of section 168(g) (relating to ADS depreciation). Prop. Reg. §1.199A-2(c)(2)(i) (emphasis added).

— Additional first year depreciation under sections 168(k) or (m) does not affect the applicable recovery period for purposes of this provision. Prop. Reg. §1.199A-2(c)(2)(ii).
The “depreciable period” of the property determines how long the unadjusted basis of the property will provide limitation amount. (cont’d)

— Qualified property acquired in a like-kind exchange or involuntary conversion is treated like replacement MACRS property under Reg. §1.168-6(b)(1), with the exchanged basis portion being treated as placed in service on the date when the relinquished property was placed in service, and the excess basis portion being treated as acquired when the replacement property is first placed in service. Prop. Reg. §1.199A-2(c)(2)(iii).

- If an election is made under Reg. §1.168-6(i)(1), the entire property will be treated acquired when the replacement property is first placed in service.
The “depreciable period” of the property determines how long the unadjusted basis of the property will provide limitation amount. (cont’d)

— If qualified property is acquired in a section 721 contribution or section 731 distribution, the date on which the qualified property was first placed in service for these purposes will be determined as follows:

- For the portion of the transferee’s unadjusted basis in the qualified property that does not exceed the transferor’s unadjusted basis in such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service; and

- For the portion of the transferee’s unadjusted basis in the qualified property that exceeds the transferor’s unadjusted basis in such property, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer. Prop. Reg. §1.199A-2(c)(2)(iv).
The unadjusted basis of property is the basis on the placed in service date of property. Prop. Reg. §1.199A-2(c)(3) (emphasis added).

— Unadjusted basis is determined without regard to any adjustments described in section 1016(a)(2) or (3), to any adjustments for tax credits claimed (for example, under section 50(c)), or to any adjustments for any portion of the basis for which an election was made to treat as an expense (e.g., under sections 179, 179B, or 179C). Id.

— Unlike the rules for depreciable period, the “placed in service” date for purposes of measuring unadjusted basis in a nonrecognition transaction does not relate back to the placed in service date of the transferor but instead relates to the actual placed in service date of the transferee.

- Property acquired in a nonrecognition transaction will be placed in service by the recipient taxpayer following receipt of the property, so a nonrecognition transaction, such as a section 721 contribution, section 731 distribution, or section 1031 exchange, will reset the unadjusted basis of property to the current adjusted basis of the qualified property (accounting for depreciation taken to date) as of the new placed in service date. Cf. Prop. Reg. §1.199A-2(c)(4), Ex. 3.
Application of Limitations to Separate Businesses
Application of Limitations to Separate Businesses

The allowable deduction for qualified business income is determined separately with respect to each qualified trade or business (although qualified business losses from other trades or businesses must be netted against such income before determining the deduction).

— The limitations relating to wages paid, and unadjusted basis of qualified property held, by each qualified trade or business are compared to the qualified business income from each qualified trade or business.

- A taxpayer does not simply aggregate all of the taxpayer’s qualified business income and limitation amounts in determining the allowable deduction.
Qualified Business Losses and Limitation Amounts

If an individual has a qualified business loss with respect to a separate trade or business, the qualified business loss will be allocated among other trades or businesses with positive qualified business income in proportion to such positive income, and the qualified business income of such profitable trades or businesses will be determined as the net amount (i.e., reduced by allocated qualified business losses) for purposes of applying the limitation amounts. Prop. Reg. §1.199A-1(d)(2)(iii)(A).

— Example: Taxpayer is engaged in businesses A, B, and C. Business A earns $1M and pays $400,000 in wages for a $200,000 limitation amount. Business B earns $1M and has $0 limitation amount (i.e., no wages or unadjusted basis). Business C incurs a $1M loss.

— Ignoring the qualified business loss from business C, Taxpayer would qualify for a $200,000 deduction with respect to Business A ($1M x 20% = $200,000, matched by $200,000 limitation amount) and $0 with respect to Business B ($1M x 20% = $200,000, but no limitation amount).

— Under the proposed regulation, the qualified business loss from Business C offsets the income from Businesses A and B equally, so Taxpayer would qualify for a $100,000 deduction with respect to Business A (($1M - $500,000) x 20%).
Example: Partnership owns two properties – a rental office building and residential condominium development. Neither business pays wages. The two properties are operated using different personnel in management and operations, and it is determined that the activities are two separate businesses for purposes of section 162.

— The unadjusted basis of qualifying business property related to the office building is $500M, and 2.5% of that amount is $12.5M. The office building generates $50M of income, for a 20% deduction amount of $10M.

— The condominium business has no depreciable property, so there is no unadjusted basis in qualifying property for that business. The condominium business also generates $50M of business income, but it has no limitation amount and hence no deduction may be claimed.

— The fact that the office building business has $2.5M of unused limitation amount does not permit any deduction amount for business income generated by the condominium business.
Determination and Aggregation of Trades or Businesses
Identification of Trades or Businesses

As an initial matter, an individual or RPE must determine the scope of each trade or business conducted by such party.

— A trade or business is defined by reference to section 162, but otherwise the proposed regulations provide no guidance as to the parameters of a trade or business. Prop. Reg. §1.199A-1(b)(13).

— Each trade or business is a separate trade or business for purposes of applying the limitations, except to the extent that such trades or businesses may be aggregated. Prop. Reg. §1.199A-4(a).

— The preamble makes the following statements:

- “The proposed regulations incorporate the rules under section 162 for determining whether a trade or business exists for purposes of section 199A. A taxpayer can have more than one trade or business for purposes of section 162. See §1.446-1(d)(1). However, in most cases, a trade or business cannot be conducted through more than one entity.”
Aggregation of Trades or Businesses

To the extent that the aggregation rules are satisfied, an *individual* may aggregate trades or businesses conducted directly and through RPEs. Prop. Reg. §1.199A-4(b)(2).

— Multiple members of an RPE need not aggregate in the same manner. Id.

— Once an individual chooses to aggregate separate trades or businesses, those businesses must remain aggregated for all subsequent taxable years unless the businesses would no longer qualify for aggregation. Prop. Reg. §1.199A-4(c)(1).

— A new trade or business can be added to an existing aggregated trade or business. Id.
Trades or businesses may be aggregated only if an individual can demonstrate that–

— The same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business to be aggregated;
  - For partnerships, ownership is determined by reference to interests in capital or profits in the partnership.
  - Attribution applies between an individual and that person’s spouse (unless legally separated), children, grandchildren, and parents. Prop. Reg. §1.199A-4(b)(3).
  - In determining indirect ownership, do you look through C corporations (i.e., important in the fund/blocker corporation scenario)?

— The ownership described in the prior bullet exists for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income;

— All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;

— None of the trades or businesses to be aggregated is a specified service trade or business; and

— The trades or businesses to be aggregated satisfy at least two of three factors. Prop. Reg. §1.199A-4(b)(1).
Aggregation of Trades or Businesses

In addition to the first four factors described in the prior slide, at least two of the three following factors must be satisfied in order to aggregate separate trades or businesses (based on all of the facts and circumstances):

— The trades or businesses provide products and services that are the same or customarily offered together.

— The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

— 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 chain interdependencies). Prop. Reg. §1.199A-4(b)(1)(v).
How do we fare with the office/condo example?
— Because these properties are held in the same partnership, there is the initial issue as to whether you can (or will be required to) characterize them as part of the same trade or business under generally applicable section 162 standards.
How do we fare with the office/condo example? (cont’d)

— If the properties are operated in separate partnerships (or if the properties are separate trades or businesses under section 162), it is necessary to look to the factors for aggregation.

  - Assuming that the first four factors are met (e.g., 50% common ownership, etc.), one must analyze the “2 of 3” factors.

  — In the real estate fund context, it seems likely that the trades or businesses could share facilities or share significant centralized business elements, such as personnel, accounting, legal, purchasing, human resources, or information technology resources.

  — If the office building and condo are part of the same development project (e.g., same building or contiguous and jointly operated), the arguments seem good that the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

  — If the properties are simply owned by the same fund, but are in separate locations with little other commonality, one seems left to argue that the trades or businesses provide products and services that are the same (e.g., real estate) or customarily offered together.

    - Obviously, this argument could be difficult to sustain.
For each taxable year, individuals must attach a statement to their returns identifying each aggregated trade or business.

— The statement must contain –

- A description of each trade or business;
- The name and EIN of each entity in which a trade or business is operated;
- Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year; and
- Such other information as the Commissioner may require in forms, instructions, or other published guidance. Prop. Reg. §1.199A-4(c)(2)(i).

— If an individual fails to attach the statement, the Commissioner may disaggregate the individual’s trades or businesses. Prop. Reg. §1.199A-4(c)(2)(ii).
Specified Service Trades or Businesses
Qualified business income does not include income earned with respect to a specified service trade or business.

— A specified service trade or business is defined (by reference to section 1202(e)(3)(A), but excluding engineering and architecture) as any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or investing and investment management, trading, or dealing in securities, partnership interests, or commodities.” (italics is from section 1202(e)(3)(A) and remainder is added for purposes of section 199A)
The proposed regulations elaborate on the items described as specified service trade or businesses.

— Health – 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 who provide medical services directly to a patient (service recipient). Prop. Reg. §1.199A-5(b)(2)(ii).

- 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 (e.g., 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).

— Accounting – The provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such. Prop. Reg. §1.199A-5(b)(2)(iv).
The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

— Law – the performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such. Prop. Reg. §1.199A-5(b)(2)(iii).

  - The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

— Actuarial services – The provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such. Prop. Reg. §1.199A-5(b)(2)(v).
The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

— Performing arts – The 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 as such. Prop. Reg. §1.199A-5(b)(2)(vi).

- The performance of services in the field of performing arts does not include
  — the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts, or
  — the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.
The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

— Athletics - the 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. Prop. Reg. §1.199A-5(b)(2)(viii).

- The performance of services in the field of athletics does not include
  — the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events, or
  — the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.
Investing and Investment Management

The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

— Investing and investment management – a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. Prop. Reg. §1.199A-5(b)(2)(xi).

- The performance of services of investing and investment management does not include directly managing real property. Id.

— The proposed regulations do not describe what is meant by “directly managing real property,” but this would appear to address the leasing and operational aspects of real property rather than decisions with respect to investing in real property.
Other Listed Activities of Focus for Real Estate

The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

  - Consulting includes lobbying
  - Consulting does not include
    — the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses, or
    — 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 specified service trade or business (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.
Other Listed Activities of Focus for Real Estate

The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

— Financial services – provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as a client’s agent in the issuance of securities and similar services. Prop. Reg. §1.199A-5(b)(2)(ix).

- This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals performing services in their capacity as such. Id.
Other Listed Activities of Focus for Real Estate

The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

— Trading - A trade or business of trading in securities (as defined in section 475(c)(2)), commodities (as defined in section 475(e)(2)), or partnership interests. Prop. Reg. §1.199A-5(b)(2)(xii).

  - Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof.

  - A taxpayer, such as a manufacturer or a farmer, who engages in hedging transactions as part of their trade or business of manufacturing or farming is not considered to be engaged in the trade or business of trading commodities.
The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

— Dealing in securities – Regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. Prop. Reg. §1.199A-5(b)(2)(xiii)(A).

- For purposes of this provision, a taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities for purposes of this provision.

— Dealing in commodities - regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business. Prop. Reg. §1.199A-5(b)(2)(xiii)(B).

— Dealing in partnership interests - means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business. Prop. Reg. §1.199A-5(b)(2)(xiii)(C).
Other Listed Activities of Focus for Real Estate

The proposed regulations elaborate on the items described as specified service trade or businesses. (cont’d)

— Brokerage services – services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. Prop. Reg. §1.199A-5(b)(2)(x).

  - Brokerage services includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

— A trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners – any trade or business that consists of any of the following (or any combination thereof):

  - A trade or business in which a person receives fees, compensation, or other income for endorsing products or services,

  - A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual’s image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual’s identity,

  - Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format. Prop. Reg. §1.199A-5(b)(2)(xiv).
A trade or business may be comprised of activities that are broader than the activities defined as listed activities.

— A “specified service trade or business” is “[a]ny trade or business involving the performance of services in one or more of the [listed fields].” Prop. Reg. §1.199A-5(b)(1) (emphasis added).

— If a trade or business is a specified service trade or business, no qualified business income, W-2 wages, or unadjusted basis of qualified property from the specified service trade or business may be taken into account by an individual, even if the item is derived from an activity that is not itself a specified service activity. Prop. Reg. §1.199A-5(a)(2) (emphasis added).
Trade or Business Broader Than Listed Activities

There is a de minimis rule that excludes trades or businesses if listed activities fall below a threshold amount of the overall trade or business.

— For a trade or business with gross receipts of $25 million or less for the taxable year, a trade or business is not a specified service trade or business if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a listed field. Prop. Reg. §1.199A-5(c)(1)(i).

  - For purposes of this rule, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field.

— For a trade or business with gross receipts of more than $25 million for the taxable year, less than 5% of gross receipts of the trade or business must be attributable to the performance of services in a listed field. Prop. Reg. §1.199A-5(c)(1)(ii).
Can You Structure to Limit the Scope of a Trade or Business?

Remember the preamble states that a trade or business generally cannot be conducted through more than one entity.

— Is there a benefit to dividing activities that are not listed activities into separate regarded entities to cause such activities to be treated as separate trades or businesses?
Aggregation for Specified Service Trades or Businesses

There are rules providing for mandatory aggregation of trades or businesses for purposes of causing businesses not involving listed activities to be combined with a specified service trade or business.

— A specified service trade or business includes any trade or business that provides 80 percent or more of its property or services to a specified service trade or business if there is 50 percent or more common ownership of the trades or businesses. Prop. Reg. §1.199A-5(c)(2)(i) (emphasis added).

— If a trade or business provides less than 80 percent of its property or services to a specified service trade or business and there is 50 percent or more common ownership of the trades or businesses, that portion of the trade or business of providing property or services to the 50 percent or more commonly-owned specified service trade or business is treated as a part of the specified service trade or business. Prop. Reg. §1.199A-5(c)(2)(ii) (emphasis added).

— For purposes of these rules, 50% or more common ownership includes direct or indirect ownership by related parties within the meaning of sections 267(b) or 707(b). Prop. Reg. §1.199A-5(c)(2)(iii).
Aggregation for Specified Service Trades or Businesses

There are rules providing for mandatory aggregation of trades or businesses for purposes causing businesses not involving listed activities to be combined with a specified service trade or business (cont’d).

— A trade or business (that would not otherwise be treated as a specified service trade or business) will be treated as incidental to and, therefore, part of a specified service trade or business if:

- the trade or business has 50 percent or more common ownership with a specified service trade or business, including related parties (within the meaning of sections 267(b) or 707(b));

- the trade or business has shared expenses with the specified service trade or business, including shared wage or overhead expenses; and

- the gross receipts of the trade or business represents no more than 5 percent of the total combined gross receipts of the trade or business and the specified service trade or business. Prop. Reg. §1.199A-5(c)(3).
Can You Structure to Limit the Scope of a Trade or Business?

Example: A real estate sponsor wishes to break apart two service functions that are part of its overall trade or business – valuation and property management.

— As a first step, it seems likely that the functions need to be separated into different legal entities that are regarded for federal income tax purposes in order to establish separate trades or businesses.
Can You Structure to Limit the Scope of a Trade or Business?

Example: A real estate sponsor wishes to break apart two service functions that are part of its overall trade or business – valuation and property management (cont’d).

— It then is necessary to determine whether the separate trades or businesses would be aggregated.

- Valuation services are a necessary part of the investment management function, and thus presumably must be provided to the entity that is providing the investment management services.

  — Accordingly, unless the valuation entity lacks 50% common ownership or provides more than 20% of its services to outsiders, Prop. Reg. §1.199A-5(c)(2)(i) would seem to aggregate the valuation business with the investment management business.

- Property management services can be provided directly to the fund that owns the property and not to the entity conducting the investment management services.

  — Contract arrangement is important – management company should not hire the property manager and receive reimbursement – fund should contract directly.

  — It is important to ensure that the gross receipts of the property management business represent more than 5 percent of the total combined gross receipts of the property management business and the investment management business, or the businesses could be combined under the “incidental” rule due to shared expenses.
 Specified Service Trade or Business - Qualified Income

It appears that income from a lower-tier partnership that is not a specified service trade or business will not be tainted by virtue of flowing through an upper-tier partnership that is conducting a specified service trade or business since the businesses conducted by the separate entities are separate trades or businesses (assuming they are not aggregated).

— Qualified business income is computed separately for each trade or business. Prop. Reg. §1.199A-1(b)(4).

— An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business engaged in directly by the RPE—

  - Each owner’s allocable share of qualified business income, W-2 wages, and unadjusted basis of qualified property attributable to each such trade or business, and

  - Whether any of the trades or businesses described in paragraph (b)(3)(i)(A) of this section is a specified service trade or business.

  - An RPE must also report on an attachment to the Schedule K-1, any qualified business income, W-2 wages, unadjusted basis of qualified property, or specified service trade or business determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest.
De Minimis Exclusion from Wage/Unadjusted Basis Limitation Amount and Specified Service Trade or Business Analysis
De Minimis Exclusions from Limitations

Section 199A excepts individuals who make below a threshold amount of taxable income from both the wage/unadjusted basis limitations and the exclusion for specified service trade or business income.

— The wage/unadjusted basis limit does not apply to individuals whose taxable income does not exceed $157,500 ($315,000 for married filing jointly), and the benefit is phased out over the next $50,000 ($100,000 for married filing jointly).

— The exclusion for specified service businesses does not apply to individuals whose taxable income does not exceed $157,500 ($315,000 for married filing jointly), and the benefit is phased out over the next $50,000 ($100,000 for married filing jointly).

— Thresholds are adjusted for inflation.
Qualified Business Losses
Qualified Business Losses

If an individual has a net loss from qualified trade or business activities for a taxable year, that loss carries over to the following year for purposes of determining the qualified business income that qualifies for the 20% deduction. Prop. Reg. §1.199A-1(d)(2)(iii)(B).

This rule does not limit the utilization of the loss in the year incurred, but instead impacts the amount of income in future years that can qualify for the 20% deduction.

- Essentially, a taxpayer may only take the 20% deduction to the extent of the taxpayer’s positive net qualified business income for all taxable years beginning after December 31, 2017.

- Example: In 2018, taxpayer has $100 of qualified business loss. In 2019, taxpayer has $100 of qualified business income. Taxpayer is not eligible for the 20% deduction in 2019, as the cumulative qualified business income for 2018 and 2019 is $0.
REITs, PTPs, and Cooperatives
REIT and PTPs - the 20% Deduction

REIT dividends qualify for the 20% deduction by virtue of treatment as qualified REIT dividends (and not as qualified business income), except to the extent that such dividends are eligible for taxation at capital gain rates with respect to capital gain or qualified dividend income.

— Note that qualified REIT dividends qualify for the 20% deduction without regard to the various limitations or restrictions applicable to qualified business income (i.e., domestic vs non-U.S. income, wage/unadjusted basis limitation, specified service trade or business, or requirement for cumulative qualifying business income).

- Accordingly, to the extent that a partner is allocated REIT dividend income, 100% of such income seemingly could qualify for the 20% deduction (except for the portion that qualifies for a lower rate).

- A REIT dividend is not a qualified REIT dividend if the stock with respect to which it is received is held for fewer than 45 days, taking into account the principles of section 246(c)(3) and (4). Prop. Reg. §1.199A-3(c)(2)(B).

- Proposed regulations do not address qualified REIT dividends paid by a RIC/mutual fund.

— Qualified publicly-traded partnership income is treated the same as qualified REIT dividends for these purposes, so such income should qualify for the 20% deduction without regard to the wage and unadjusted basis limitations.

— If the combined amount of REIT dividends and qualified PTP income is less than zero (due to PTP losses), the portion of the individual’s section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. Prop. Reg. §1.199A-1(d)(3).

- The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends/qualified PTP income in the succeeding taxable year of the individual for purposes of section 199A.
Application of 20% Deduction in Determining Tax Liability
The 20% deduction cannot exceed the taxable income (reduced by net capital gain) of a taxpayer for the taxable year. I.R.C. §199A(a) (flush language at end).

— Accordingly, a taxpayer with “combined qualified business income” (which includes both qualified business income and qualified REIT dividends, PTP income, etc.) but significant investment losses may be limited in his or her ability to claim the deduction. I.R.C. §199A(b)(1).
20% Deduction Not Otherwise Limited

The 20% deduction is not allowed in calculating adjusted gross income, but instead is allowed as a deduction reducing taxable income. I.R.C. §62(a) (last sentence).

— As a result, the deduction does not affect limitations that are based on adjusted gross income.

The deduction is available both to taxpayers who itemize deductions and those who do not. I.R.C. §63(b)(3) & (d)(3).

For purposes of determining alternative minimum taxable income under section 55, the deduction allowed under section 199A(a) for a taxable year is equal in amount to the deduction allowed under section 199A(a) in determining taxable income for that taxable year (that is, without regard to any adjustments under sections 56 through 59). Prop. Reg. §1.199A-1(e)(4).
The 20% deduction is not allowed in calculating the tax imposed on net earnings from self-employment under section 1402 or net investment income under section 1411. Prop. Reg. §1.199A-1(e)(2).
20% Deduction and Penalties
A taxpayer who claims the 20% deduction under section 199A will be subject to the substantial understatement penalty by reference to a lower threshold of misreporting. Prop. Reg. §1.199A-1(e)(5).

— Specifically, in determining whether a taxpayer has a substantial understatement of income tax under section 6662(d)(1), a substantial understatement will exist if the understatement for the taxable year exceeds the greater of (1) five percent, rather than 10%, of the tax required to be shown on the return for the taxable year, or (2) $5,000. I.R.C. §6662(d)(1)(C).
Effective Date
Effective Date

The proposed regulations generally are proposed to apply to taxable years ending after the date of publication as final regulations in the Federal Register.

— However, taxpayers may rely on the proposed regulations, in their entirety, until the date of publication as final regulations in the Federal Register.

Contact info

Stephen J. Giordano
stephengiordano@kpmg.com
202.330.5345

James B. Sowell
jsowell@kpmg.com
202.533.5710
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