PUBLICATION

The Qualified Business Income Deduction: Proposed Regulations Shed Light on Several Key Issues

Authors: Thomas J. Mahoney, Jr., William Fones Jr., Stuart M. Schabes, Robert L. Ash, Allen Brooks Blow
August 10, 2018

The 2017 tax reform bill created a new deduction for owners of pass-through entities (partnerships, LLCs taxed as partnerships, S corporations, and sole proprietorships) of up to 20 percent of their "qualified business income" (the "QBI Deduction"). The QBI Deduction has received significant press due to the myriad of unanswered questions with respect to the operation of the deduction. On August 8, 2018, the U.S. Department of Treasury provided guidance on the QBI Deduction by promulgating proposed regulations (the "Proposed Regulations"). While the Proposed Regulations address many issues, this Tax Alert addresses several specific issues that have caused a great deal of uncertainty. We intend to issue additional Tax Alerts providing thoughts on other aspects of the 184 pages of the Proposed Regulations.

Specified Services Trades or Businesses – Definition of "Reputation or Skill" to Be Narrowly Interpreted.

One source of uncertainty with the QBI Deduction has been the exclusion for specified service trades or businesses (the "SSTB Exclusion"). Pursuant to the SSTB Exclusion, a taxpayer engaged in a specified service trade or business (SSTB) who has taxable income above $415,000 (in the case of joint returns) or $207,500 (in the case of other returns), may not treat any of the income from a SSTB as qualified business income for purposes of the QBI Deduction. An SSTB is a trade or business (1) involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or 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 (2) that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. The Proposed Regulations provided guidance on a number of issues pertaining to the SSTB Exclusion.

A particular area of uncertainty with respect to the SSTB Exclusion is the inclusion in the definition of SSTB of the phrase "or 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" (the "Reputation or Skill Clause"). Commentators warned that the Reputation or Skill Clause might act as a "catch-all" causing many types of businesses not specifically identified as SSTBs to be classified as SSTBs. However, the Proposed Regulations take a relatively narrow view of the Reputation or Skill Clause. Under the Proposed Regulations, the Reputation or Skill Clause will only apply to a trade or business consisting of any of the following activities: (A) receiving fees, compensation, or other income for endorsing products or services, (B) licensing or receiving 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, or (C) receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

Aggregation Rules.

In light of the SSTB Exclusion, a number of commentators suggested that taxpayers could split their businesses into multiple businesses, separating the portion of the business which would qualify for the QBI Deduction from the portion of the business which would not qualify for the QBI Deduction due to the SSTB

Exclusion. This strategy has been colloquially referred to as "crack and pack." The Proposed Regulations take the position that such a strategy is inconsistent with the purpose of Section 199A. The Proposed Regulations clarify that a SSTB includes any trade or business that provides 80 percent or more of its property or services to a SSTB if there is 50 percent or more common ownership between the trades or businesses. Additionally, if a trade or business provides less than 80 percent of its property or services to an SSTB and there is 50 percent or more common ownership between the trades or businesses, then that portion of the trade or business which provides property or services to the 50 percent or more commonly-owned SSTB will be treated as a SSTB. For example, assume that a medical practice splits its operations into three separate businesses each under common ownership, one which provides medical services to patients (the "Medical Entity"), one which owns and leases a building to the Medical Entity, and one which provides administrative and back office services to the Medical Entity. Notwithstanding that the leasing business and administrative services business might qualify for the QBI Deduction if provided or performed by unrelated third parties, neither will be eligible for the QBI Deduction under the Proposed Regulations.

On the other hand, the Proposed Regulations permit some commonly owned businesses to be aggregated at the election of each owner. This can be beneficial where, for example, one entity provides management services to related businesses. W-2 wages of the management company can then be used to avoid or minimize a reduction in the 20 percent deduction on the income from the main line businesses. The ability to group the activities of different entities is more restrictive than under the passive loss rules, but still can be helpful in many common situations. If taxpayers elect to aggregate, they will be required to aggregate on a consistent basis in subsequent years, and to comply with certain reporting rules which will serve as a backstop to the consistency requirement.

Conversion of Employees to Independent Contractors.

Employee wages are never eligible for the 20 percent deduction, but in many cases, an independent contractor doing essentially the same work could be eligible for the 20 percent deduction. In light of the IRS's ongoing focus on "worker reclassification" examinations, to prevent abuses, there is an "adverse presumption" that a person converted from employee status to independent contractor status should still be treated as receiving wage income. Also, absent substantive changes in the worker's services rendered, an employer who cooperates in reclassifying the worker may fall outside safe harbors protecting the employer from payroll tax assessments. Nevertheless, new businesses may wish to consider whether engaging workers as independent contractors will be an advantage in recruiting.

The Proposed Regulations are not final and are subject to a statutorily required notice and comment period, during which the public will have the opportunity to comment on the Proposed Regulations. Therefore, the Proposed Regulations may change before they become final.

Please remember that advice and counsel regarding your particular tax related issues, including the potential impact of the developments outlined above, are dependent on your specific facts and circumstances. As noted above, we anticipate providing important updates on other aspects of the Proposed Regulations. For more information about how these issues may affect you, your business, or related matters, contact the co-authors of this alert, Tom Mahoney, William Fones, Stuart Schabes, Larry Ash, and Allen Blow, or any member of the Firm's Tax Group.