FAQS ON THE NEW 20% DEDUCTION FOR QUALIFIED PASS-THROUGH ENTITY INCOME

(Based on proposed regulations released by the Treasury Department and IRS on August 8, 2018)

Below are answers to some frequently asked questions about the new federal tax deduction for qualified business income. Of course, these issues are complex and a thorough review of the regulations and its implications will likely keep accountants and lawyers busy for quite some time. Because the rules apply differently depending on the type of business and the mix of the taxpayer's businesses, most businesses owners will want to consider discussing these issues with their accountants and other trusted advisors.

Question: Who is eligible to claim the new deduction?
Answer: New Internal Revenue Code § 199A allows individual taxpayers a new federal income tax deduction based on the individual's qualified business income (QBI) from pass-through entities such as partnerships, S Corporations, and sole proprietorships.

Question: How much is the deduction?
Answer: Subject to certain other limitations, each individual pass-through business owner may be able to claim the § 199A deduction for the lesser of:

(i) 20% of the combined qualified business income (QBI) from the individual's trades or businesses, plus 20% of the individual's combined qualified REIT dividends and qualified Publicly Traded Partnership (PTP) income; or

(ii) 20% of the amount by which the individual's taxable income exceeds the individual's net capital gain.

Question: When is the deduction available?
Answer: The deduction is generally available beginning with the 2018 tax year. It is scheduled to sunset after 2025.

Question: What counts as QBI?
Answer: Generally, QBI for a taxable year is the net amount of qualified items of income, gain, deduction, and loss with respect to a trade or businesses of the individual. QBI specifically does not include (i) reasonable compensation paid to an S Corp. owner for services rendered with respect to the trade or business, or (ii) guaranteed payments paid by a partnership to a partner for services rendered with respect to the trade or business. QBI also may not include income from a Specified Service Trade or Business (SSTB) (see below).

Question: Where do I claim the deduction?
Answer: Each eligible business owner may claim the deduction on his or her individual federal income tax return (i.e., generally the IRS Form 1040, with attachments).

Question: Are there any other limitations on the deduction?

Answer: Yes. For individuals with taxable income (from all sources) above the threshold amounts of $157,500 for individuals and $315,000 for joint returns (in 2018), there are additional limitations based on (1) the W-2 wages paid by the pass-through entity and (2) whether the business is an SSTB.

Question: What is the W-2 wages limitation on the deduction?
Answer: Generally, for individuals with taxable income above the threshold amounts, the QBI from any trade or business is capped at an amount equal to 50% of the individual's allocable share of "W-2 wages" paid by such trade or business. An alternative limitation (that may be advantageous to certain capital-intensive industries) caps the QBI at 25% of W-2 wages plus 2.5% percent of the unadjusted basis immediately after acquisition (UBIA) of qualified tangible depreciable property used in the production of QBI.

Question: How are W-2 wages defined?
Answer: W-2 wages include the total amount of wages that are subject to federal income tax withholding rules, plus the total amount of employee contributions to 401(k), 403(b), and 457 retirement plans.

Question: What if my business uses a PEO or another type of third party payroll company to pay and report wages and provide W-2s?
Answer: An individual or pass-through entity "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 [pass-through entity] for employment by the individual or [pass-through entity]." So, if you are a common law employer with respect to the employees performing services for you, it does not matter that the PEO is listed on the W-2 as the employer, you can still take those the wages into account in calculating your § 199A deduction.

Question: For purposes of the new deduction under § 199A, is there a difference in the treatment of W-2 wages that are reported by certified PEOs and non-certified PEOs?
Answer: As noted above, a client that is an individual or pass-through entity may take into account W-2 wages paid by a PEO if the "wages were paid to common law employees or officers of the individual or pass-through entity for employment by the individual or pass-through entity." In a traditional PEO co-employment relationship, the client remains a common law employer of the work site employees. That is true whether the PEO is certified or not. Of course, in such cases the PEO is precluded from taking such wages into account for purposes of determining the PEO's own eligibility for the § 199A deduction.

Question: What is the SSTB Limitation?
Answer: For individuals with income in excess of the overall taxable income thresholds described above, income from SSTBs is excluded from QBI and none of the W-2 wages (or UBIA of qualified property) with respect to the SSTBs may be taken into account for purposes of the W-2 limitation. An SSTB is (1) any trade or business 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, and (2) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Code § 475(c)(2)), partnership interests, or commodities (as defined in Code § 475(e)(2)).

Question: What if I have more than one business?
Answer: Many of the rules for calculating the new deduction must be performed independently for each business of the individual taxpayer. However, aggregation of multiple trades or businesses is permitted (but not required) if certain conditions are met. Aggregation is allowed if (i) the same person, or group of persons, directly or indirectly, owns a majority interest in each of the businesses to be aggregated; (ii) all of the items attributable to the businesses are generally reported on returns with the same taxable year; (iii) none of the aggregated businesses is an SSTB; and (iv) the businesses satisfy certain factors that demonstrate that the businesses are part of a larger, integrated trade or business. There are also certain situations where aggregation may be required. Although aggregation may be advantageous in some instances, once multiple trades or businesses are aggregated into a single aggregated trade or business, individuals must consistently report the aggregated group in subsequent tax years.

Question: What does it mean to be in a trade or business "involving the performance of services in the fields of health, law, [etc.]"?
Answer: The proposed rules discuss the scope of the definition of each of these types of SSTBs, with numerous specific examples provided for different types of businesses.

Question: How do I determine if "the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners?"
Answer: The vague catch-all "reputation or skill" clause has been narrowly interpreted to apply only to fact patterns in which the individual or pass-through entity is engaged in the trade or business of: (i) receiving income for endorsing products or services; (ii) licensing or receiving 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 (iii) receiving appearance fees or income.

Question: What if a small part of my business relates to a specified service activity?
Answer: There is a de minimis rule under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity (defined as less than 10% for businesses with gross receipts of $25 million or less, and less than 5% for larger businesses).

Question: What if one of my current employees wants to start their own business and declare herself as an independent contractor instead of employees in order to try to qualify for the new section 199A deduction?
Answer: Individuals in the business of performing services as an employee are not entitled to the § 199A deduction with respect to income from such business. If an employer improperly treats an employee as an independent contractor or other non-employee, the improperly classified employee will be treated as being in the trade or business of performing services as an employee and the employee will not be eligible for the § 199A deduction. Similarly, if an individual was treated as an employee for Federal

employment tax purposes by the person to whom he or she provided services but is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services to the person (or a related person), the IRS will presume that individual to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted only upon a showing by the individual that he or she is performing services in a capacity other than as an employee.

Question: May a business be split into multiple businesses for purposes of the rules?
Answer: A taxpayer is not allowed to separate out parts of what otherwise would be an integrated SSTB, such as administrative functions, in an attempt to qualify those separated parts for the § 199A deduction.

August 10, 2018