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# IRS Releases Eagerly Awaited Guidance on Deduction for Business Owners

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The Treasury Department and the Internal Revenue Service (the "IRS") have issued proposed regulations and a proposed revenue procedure (Notice 2018-64) providing guidance on the deduction of up to 20% for qualified business income ("QBI") of a U.S. business conducted as a sole proprietorship or in pass-through form. The QBI deduction may reduce an individual's effective federal income tax rate on QBI from 37% to 29.6%.

The QBI rules, which were introduced as part of the Tax Cuts and Jobs Act, provide individuals and certain trusts and estates with a deduction of up to 20% for QBI as well as a 20% deduction for qualified REIT dividends and qualified publicly traded partnership income ("qualified PTP income"). The rules apply to taxable years beginning after December 31, 2017 and before January 1, 2026.

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For taxpayers with taxable income above a $207,500 threshold ($415,000 for joint filers), QBI does not include income from any specified service trade or business (an "SSTB") and is subject to a limitation based on W-2 wages paid by the business and/or cost basis of certain depreciable assets ("UBIA"). These two limitations are gradually phased out for taxpayers with taxable incomes below these levels.

Guidance in the proposed regulations can be relied upon until final regulations are published. The anti-abuse rules contained in the proposed regulations are proposed to apply retroactively to December 22, 2017. Our summary below highlights these key areas of guidance and other notable provisions on the QBI deduction.

The proposed regulations:

- Provide guidance on what types of businesses are considered SSTBs and provide a helpful limitation on the reach of the "reputation or skill" catch-all provision for SSTBs.

- Provide a *de minimis* exception that protects a trade or business with small amounts of SSTB income from being treated as an SSTB.

- Allow for aggregation of multiple businesses when computing QBI and the W-2 wage and UBIA limitations.
- Set forth anti-abuse rules for tax-planning strategies to prevent taxpayers from separating businesses to avoid SSTB status on the ancillary businesses.

## Mechanism for Calculating the QBI Deduction

### The Calculation

A taxpayer's QBI deduction is equal to the "QBI component" plus 20% of any qualified REIT dividends and qualified PTP income. The "QBI component" for an individual with taxable income above the threshold is calculated by adding together the following amount for all qualifying trades or businesses for a taxable year: the lesser of (i) 20% of QBI (the "QBI Limitation") and (ii) 50% of W-2 wages or, if higher, a combined formula of 25% of W-2 wages and 2.5% of the UBIA of the trade or business (the "Wage/UBIA Limitation").

The QBI Limitation and Wage/UBIA Limitation are computed separately for each trade or business. However, if QBI of any trade or business is negative, the loss is applied to reduce QBI of the taxpayer's other businesses pro rata and, to the extent losses remain, carried forward to subsequent taxable years. Wages and UBIA from any loss business are disregarded. These rules have the effect of reducing the QBI Limitation with no corresponding increase in the Wage/UBIA Limitation.

The definition of "trade or business" generally follows the definition used for deducting trade or business expenses, but includes the rental or licensing of tangible or intangible property and excludes the performance of services as an employee. An anti-abuse rule presumes that former employees, including employees who become partners in a partnership, who perform substantially the same services directly or indirectly to the same or related persons as before the change in status are performing services as an employee. This presumption is rebuttable. For example, if an employee is promoted to partner of a partnership, the presumption may be rebutted by showing that employees are regularly considered for promotion to partner status after certain career milestones are met and that the newly admitted partner has met these milestones.

## Defining Specified Service Trade or Business (SSTB)

### General Rule

- No QBI deduction is available for an SSTB. An SSTB includes any trade or business involving the performance of services in specified fields or in a trade or business of which the principal asset is the "reputation or skill" of one or more of its employees or owners. The specified fields are health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading in securities, commodities or partnership interests or dealing in securities, commodities or partnership interests.
  - The proposed regulations narrow the definitions of certain specified services by providing carve-outs for, among other things, directly managing property, loan origination in the ordinary course of business with only negligible sales of the loans and certain hedging transactions for manufacturers and farmers.
  - The proposed regulations provide a narrow interpretation of a trade or business in which the reputation or skill of one or more of its employees or owners is a principal asset. A business falls within this category only if an employee or owner earns income for either (a) endorsing products or services, (b) using the employee or owner's image, likeness, name, signature, voice, trademark or any symbols associated with the individual's identity or (c) appearing at an event or on radio, television or another media format.
    - **Comment**: This narrow interpretation resolves significant uncertainty by clarifying that an owner or employee's skill is not sufficient to classify a trade or business as an SSTB. For example, a restaurant run by a celebrity chef is not an SSTB, even if that chef receives fees as part of a separate trade or business in which the chef endorses a line of cookware. The fees earned for endorsing the cookware, however, are not eligible for the deduction.
- Under a *de minimis* rule, a trade or business can escape SSTB classification if the performance of these services (and any incidental activities) generates less than 5% of the gross receipts of the trade or business (10% for any trade or business with gross receipts of $25 million or less).

### Anti-Abuse Rules

- If a trade or business shares at least 50% of its direct or indirect ownership (including through related parties) with an SSTB, all or part of that trade or business will be

included in the related SSTB (and therefore excluded from the calculation of QBI, W-2 wages and UBIA) under two sets of circumstances:

- First, whenever a trade or business provides property or services to the related SSTB, the portion of the trade or business providing the property or services to the related SSTB will be treated as part of that SSTB. If these property or services provided to the SSTB account for more than 80% of that business's property or services, then the entire trade or business will be combined with the SSTB.

- Second, if a trade or business (i) shares expenses with the related SSTB and (ii) accounts for no more than 5% of the combined trade or business (when combined with the SSTB), it will be combined with the SSTB.

**Comment**: This rule is aimed at strategies for separating non-SSTB components of a business from an SSTB and then aggressively allocating profits to the separated business. The rule has a broader reach as the rules apply even if there is a reasonable profit allocation to the separated business.

Owners of any non-SSTB should be attentive to potential related party ownership with any SSTB to which the non-SSTB provides goods or services or shares expenses in order to avoid triggering the application of the anti-abuse rules.

## Limitation Based on W-2 Wages and UBIA of Qualified Property

### W-2 Wages

- Taxpayers may take into account wages of employees which are paid by a third-party, such as a payroll company, provided that the third-party excludes such wages from their own Wage/UBIA Limitation.

- The proposed regulations provide guidance on the allocation of W-2 wages among multiple trades or businesses and, in the case of an acquisition or disposition of a trade or business, over the ownership period of the trade or business.

- A guaranteed payment made to service partners neither qualifies as QBI to the partner nor as wages paid by the partnership for the Wage/UBIA Limitation.

**Comment**: To increase the Wage/UBIA Limitation, partnerships will want to consider establishing employment relationships in which salary is paid rather than paying guaranteed payments to partners. IRS guidance makes clear that a partner cannot also be an employee—tiered partnership structures have been used to navigate through this

rule. Note that changing from guaranteed payment to salary has employment tax ramifications that need to be considered.

**Comment**: Earnings from self-employment, such as in the case of independent contractors, do not qualify as wages for the Wage/UBIA Limitation. This may have implications for the freelance economy.

## UBIA of Qualified Property

- UBIA of qualified property is determined as of the date the property is placed in service and is not subject to adjustment for any basis adjustments, such as for depreciation, immediate expensing or tax credits. However, qualified property is only included in UBIA during its depreciable period, which is the greater of 10 years from the date property is placed in service and the end of its normal useful life under the tax depreciation rules.
  - UBIA of purchased property will generally be the cost basis.
  - Partnership basis adjustments under Sections 743 and 734 resulting from sales of partnership interests and certain partnership distributions are disregarded. A purchaser of a pass-through business should consider the UBIA implications from structuring the acquisition as an asset purchase versus a partnership interest purchase.
  - UBIA of property contributed in exchange for a partnership interest will generally equal the contributing partner's adjusted basis at contribution rather than the partner's original cost. However, the depreciable period starts from the date the partner placed the property in service rather than the date the partnership placed the property in service.

**Comment**: It is preferable to buy used property, instead of a partner contributing depreciated property to the partnership. For example, if a partner contributed fully depreciated property to a partnership, valued at $100, UBIA would be equal to the zero basis of the property when it was acquired. However, if the partnership purchased used property at $100, UBIA would be equal to the $100 cost basis.

- Certain anti-abuse rules in the proposed regulations prevent the inclusion of property in the Wage/UBIA Limitation if such property is transferred at the end of the taxable year with the sole purpose of increasing the QBI deduction.

## Aggregation of Multiple Businesses

- Owners of multiple entities engaged in a single trade or business may elect to aggregate their businesses under certain circumstances. This may permit a greater pass-through deduction from the Wage/UBIA Limitation being applied on an aggregate basis as compared to the Wage/UBIA Limitation being applied separately.

  - For example, four individuals each own a 25% interest in a partnership engaged in a catering business and a 25% interest in a partnership engaged in a restaurant business. Any owner may elect to combine the catering business and the restaurant business for purposes of computing the Wage/UBIA Limitation for the pass-through deduction.

    **Comment**: Permitting aggregation across businesses and entities generally is favorable to taxpayers and should save businesses the costs of changing holding structures solely to increase pass-through deductions. Aggregation has the potential to enhance the QBI deduction through its ability to unlock excess Wage/UBIA Limitations. However, the rules need to be considered on a case-by-case basis, particularly if any trades or businesses are anticipated to have negative QBI.

- A taxpayer that elects to aggregate must generally do so for future tax years. An owner may aggregate businesses differently from other common owners of the aggregated group.

- The proposed regulations set forth several requirements for aggregation of multiple businesses.

  - Each business itself constitutes a trade or business, no business is an SSTB and the businesses satisfy two of the following three factors: (i) the businesses provide the same products and services or products and services that are customarily provided together; (ii) the businesses share facilities or centralized business elements such as common personnel; or (iii) the businesses operate in coordination or reliance on each other (*e.g.*, supply chain interdependencies).

  - The same person or group of persons owns a majority ownership interest in each of the businesses to be aggregated. Even minority owners may aggregate if they are part of a group of persons that has majority ownership.

- Aggregation requires reporting and disclosure to the IRS of identifying information for each component business. Failure to do so allows the IRS to disaggregate the group.

- Individuals may add a newly started or acquired trade or business to an existing aggregated group if the requirements are satisfied. If a business within an aggregated group no longer satisfies the requirements, it may be disaggregated.

**Comment**: Purchasers of businesses in pass-through form should consider the tax benefits of the acquisition from potential aggregation with existing pass-through businesses.

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Please do not hesitate to contact us with any questions.

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