Important Updates to the Pass-Through Deduction—Will you Qualify?

by Tony Perricelli

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In my earlier article on the 2017 tax reform law, I listed some of the new individual changes and discussed in more detail several changes that will have a tremendous impact on business owners. Now that more than half the year has passed, we have additional clarification in some areas but many questions still remain.

Many of the tax reform changes were straightforward:

- reductions to corporate and individual tax rates – check
- increase in the standard deduction – got it
- enhanced Sec 179 and revised bonus depreciation – fantastic!
- no more personal exemptions and miscellaneous itemized deductions – don't like it, but ok

The biggest questions stemmed from 1) a major new deduction that had no previous history on which to draw insight, and 2) the complex new limits on deductions that were previously allowed without many restrictions. The major new law is the Section 199A pass-through deduction which allows a 20% deduction from taxable income for qualifying sole proprietorships, partnerships, and S Corporations. The new limits to existing deductions include both business interest expenses and net operating losses. The subject of this article is the Section 199A pass-through deduction—I'll cover the interest and net operating loss changes in future installments.

To recap my previous discussion of the Section 199A pass-through deduction, here are the basics. This new deduction is allowed for any business that is organized as a pass-through entity—sole proprietorships, partnerships, and S Corporations—and thus does not pay income tax directly but passes the income through to its owners to be taxed. The deduction is up to 20% of taxable income for the year. There are some restrictions which kick in if your overall taxable income is greater than $157,500 if filing single or $315,000 if married filing joint with your spouse. It was these restrictions that had been the source of much angst and speculation until the IRS gave us proposed regulations in August 2018 that helped answer many (but not all) of our questions.

First, one of the restrictions for taxpayers over the income thresholds mentioned above is that anyone who has income from a "specified service trade or business" (SSTB) is not allowed to take the deduction. The new law references another tax code section (Section 1202) to define the term SSTB. The unlucky businesses include "*…any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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" IRC Section 1202(e)(3)(A).

Section 199A makes three changes to this list:

1. it specifically removes architecture and engineering from the list
2. it adds owners to those for which the reputation or skill test applies, and
3. it adds services in the areas of investment management and dealing in financial securities.

If you are like me and are a bit dazed after muddling through the technical part, then just remember one thing—if you want to qualify for this new 20% pass-through deduction, then you DO NOT want to be considered a SSTB. So how do you know for sure?

Before the proposed regulations came out, we could only speculate about how the SSTB restriction would be interpreted in practice. That situation was not good for business owners or their tax advisors. Now, with the proposed regulations, we have answers to at least a few questions.

1. **Since the SSTB categories are fairly broad, are there certain segments of the listed categories that will not be considered SSTBs?** The proposed regulations address this by giving definitions of what is meant by each of the categories in the SSTB list. For example, in the field of health, only the provision of medical services to a patient is considered a SSTB. The proposed regulations specifically state that, "…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." *Prop Reg Sec 1.199A-5(b)(2)(ii)* There are additional clarifications in other categories such as performing arts, consulting, and athletics which give a little more clarity to the types of businesses that are considered SSTBs. Two consistent themes that arise are:
    a. If your business activity is not in the list of SSTBs, then providing that good or service exclusively or mostly to customers whose business activity is in the list SSTBs generally does not make your business activity a SSTB. For example, the rental, maintenance, and operation of equipment and facilities is not on the list of SSTBs. If you rent, maintain, or operate a facility in which performing arts or athletics are the primary activity, it does not convert your business to a SSTB since your business does not require performance or athletic abilities. Note that if there is at least 50% common ownership between the facility company and the SSTB activity, then this can cause some or all of the facility income to be considered part of the SSBT activity, thus disallowing some or all of the pass-

through deduction. The 50% common ownership rule could also negatively impact SSTB activities that split out their admin functions or real estate to a separate entity—a popular practice for legal liability purposes and in the wake of passage of the original tax reform law to qualify for the 20% deduction.

b. If you provide consulting services as a part of the sale of goods or provision of services that are not on the list of SSTBs and there is no separate fee for those consulting services, then you are generally not considered a SSTB. For example, a building contractor can embed general consulting services into the cost of construction of a building without being considered a SSTB.

2. **What about a business that is a hybrid, selling something that is not on the list of SSTBs (such as manufactured goods) and some other service (such as consulting) which is on the list of SSTBs?** The proposed regulations set up a *de minimis* exception that keeps a small amount of SSTB activity from tainting the entire business and thus disallowing the 20% deduction. For businesses with gross receipts of $25 million or less, the de minimis percentage of allowable SSTB activity is 10% of gross receipts. For those with gross receipts greater than $25 million, the percentage is only 5%. This rate might not help every hybrid business out there but at least it gives owners and advisors a defined amount that allows them to plan accordingly.

3. **How do we interpret the phrase "*the principal asset of such trade or business is the reputation or skill of one or more of its employees?*"** The proposed regulations address this question by giving examples of when to apply it. As a general rule, it looks like the IRS will interpret this phrase in a way that pretty much requires you to be a celebrity, whether local or global, to be caught by it. Here are the businesses which fall under this phrase, direct from the proposed regulations:
    a. A trade or business in which a person receives fees, compensation, or other income for endorsing products or services
    b. 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,
    c. Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format *Prop Reg Sec 1.199A-5(b)(2)(xiv)*
    d. This section goes on to say that compensation for any of the above includes the receipt of a partnership or S corporation ownership interest in lieu of a cash payment, even if said ownership interest is in a business that is not in and of itself considered a SSTB. Thus, the profits from ownership in a manufacturing company, if received as compensation for an endorsement, are considered SSTB.

The most interesting part of this is what the list does NOT include. For instance, one of the examples mentions a well-known chef who both operates restaurants and receives a cash endorsement fee for the use of his name on a line of cookware. The example directly states that the cookware endorsement fee is a SSTB but the restaurant business is not, even though his restaurants ostensibly benefit from his skill and reputation as a chef. Another example mentions bicycle store employees who have gained a tremendous amount of skill and an excellent reputation in the community for their ability to advise customers on purchases. Despite this "reputation and skill of one or more of its employees," the store is not considered a SSTB since it is in the retail business and is not a consulting business.

The second major component of restrictions on claiming the 20% pass-through deduction for taxpayers over the income thresholds ($157,500 single and $315,000 married filing joint in case you already forgot) relates to W-2 wages paid and assets owned by the company. The new law says your pass-through deduction is limited to either:

- 50% of W-2 wages paid, or
- 25% of W-2 wages plus 2.5% of the original basis of assets owned by the business

At the most basic level, application of this second restriction means that the pass-through owner a non-SSTB might not be able to take the new deduction if the business does not have either wages or property.

While a discussion of these two items can get fairly technical because of the myriad details that need to be considered, here are a couple of thoughts that might help provide a framework for your tax planning.

First, the addition of the W-2 plus asset option for calculating the deduction limit is especially helpful to businesses that rent real property and have little or no wage expense. It is not uncommon for the employees who perform the management services for a property to be employed by a contracted management company rather than the entity that actually owns the property. Without the second option, these property ownership entities would likely be denied the new deduction. Even with no direct wages, rental entities can use 2.5% of their rented property's basis and potentially take advantage of some or all of the 20% deduction.

Second, the proposed regulations give insight into the aggregation of income and losses when one taxpayer owns multiple businesses. For instance, consider the case of a single individual who has total taxable income above $157,500 which consists of wages, investments, and net pass-through profit from two businesses that are not SSTBs. The calculation is fairly straightforward if both businesses have income, and wages/property. But what if one company has a profit and one has a loss? What if one company has wages/property and the other one does not?

The proposed regulations allow for fairly flexible aggregation elections which each individual business owner can use to his/her advantage. For a simple example, refer back to the single taxpayer mentioned above. Say one business has a profit with no wages/property and the other has a loss with wages. The proposed regulations allow him to net the profit and loss and combine the wages so that he has all the elements needed to allow at least some amount of pass-through deduction. As you can imagine, these aggregation elections and calculations can get complex and cumbersome as the number of entities involved grows larger, but at least the option is available for these situations.

The recent proposed regulations have provided some valuable insight into the interpretation and application of the new tax reform laws. While some questions still remain, we have enough certainty to at least begin planning for the future.

Please contact me with any questions about these important updates to the pass through deduction, or any other questions about tax reform and how it relates to you and your business.

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