Final Section 199A Regulations Offer Clarity, Questions, and Opportunity

Tax Alert
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On January 18, 2018, the Department of the Treasury (Treasury) and Internal Revenue Service (IRS) published final regulations under section 199A (the Final Regulations).[1] Section 199A is a key part of the 2017 tax reform law (the TCJA).[2] The statute provides a deduction equal to 20 percent of a taxpayer's qualified business income (QBI).[3] QBI includes qualified items from any domestic trade or business of the taxpayer operated as a sole proprietorship or through a partnership, S-corporation, trust, or estate (each a relevant passthrough entity, or RPE), unless the business is a "specified service trade or business" (SSTB) or consists of performing services as an employee.[4] The SSTB limitation does not apply to taxpayers with income below the "threshold amount" ($315,000 for married taxpayers filing jointly and half that amount for all others).[5] The 20 percent deduction is limited to the greater of 50 percent of the allocable W-2 wages from the qualifying trade or business or 25 percent of the allocable W-2 wages plus 2.5 percent of the allocable unadjusted basis immediately after acquisition of all qualified property from the trade or business.[6] This limitation, too, does not apply to taxpayers with income below the threshold amount.[7]

The Final Regulations represent significant work on the part of the Treasury and IRS to respond to more than 300 written comments and the testimony of 25 witnesses on the proposed section 199A regulations the Treasury and IRS issued in August 2018 (the Proposed Regulations).[8] In a number of areas, the Final Regulations adopted the approach of the Proposed Regulations, while adding "clarifying language" and "additional examples."[9] In other areas, the Treasury and the IRS made "significant revisions in response to the comments received and testimony provided at the public hearing[.]"[10]

This alert summarizes some of the key changes in the Final Regulations. The Final Regulations are generally effective upon their publication in the Federal Register (typically a week or two after release). However, taxpayers may rely on either the Final Regulations *or* the Proposed Regulations for taxable years ending in calendar year 2018.[11]

What's a trade or business?

QBI must be derived from a qualifying (non-SSTB) trade or business. One pressing issue many commenters identified is how to determine whether a trade or business exists. Should the determination be made at the RPE (*e.g.*, partnership) level, or at the individual-owner level? Can there be a trade or business for purposes of section 199A even where the taxpayer's activity does not rise to the level of being a trade or business for purposes of section 162, the standard set forth in the Proposed Regulations?

The Final Regulations clarify that the trade or business determination is made at the entity level. Thus, if an RPE is engaged in a trade or business, an individual owner of the RPE may be eligible for the section 199A deduction, even if he or she is a completely passive owner.[12]

As to what is a "trade or business," the Final Regulations retained the Proposed Regulations' general rule that trade or business means "a trade or business under section 162 ... other than the trade or business of performing services as an employee."[13] These rules are set forth in a large body of common law, and generally involve a factual determination of the taxpayer's motive and level of activity, which must be considerable, continuous, and regular.[14] The Treasury and IRS spurned requests for a broader definition of trade or business, including ones based on the rules of section 469 or 1411. Those provisions were not appropriate, they reasoned, because whether a taxpayer may receive the section 199A deduction is not based on the level of an individual's

participation in the trade or business, but rather on whether the individual has QBI from a trade or business, which may be conducted by an RPE in which the taxpayer has no active involvement.[15] The Treasury and IRS likewise generally rejected recommendations that additional guidance be provided on the section 162 definition of a trade or business, stating that "whether an activity rises to the level of a section 162 trade or business, however, is inherently a factual question and specific guidance under section 162 is beyond the scope of these regulations."[16]

Notwithstanding this general approach, in response to the many comments that requested clarity on whether a rental real estate enterprise would constitute a trade or business for purposes of section 199A, the IRS proposed a "safe harbor" in a separate document, Notice 2019-07, issued simultaneously with the Final Regulations. The Notice provided the draft text of a proposed revenue procedure under which a rental real estate enterprise would be treated as a trade or business for purposes of section 199A if it met certain requirements during the taxable year at issue. Most notably, 250 or more hours of "rental services" must be performed with respect to the rental real estate enterprise.[17] Rental services include (1) advertising to rent or lease the real estate; (2) negotiating and executing leases; (3) verifying information contained in prospective tenant applications; (4) collection of rent; (5) daily operation, maintenance, and repair of the property; (6) management of the real estate; (7) purchase of materials; and (8) supervision of employees and independent contractors.[18] The rental services may be performed by the RPE/taxpayer directly as well as by its owners, employees, agents, or independent contractors.[19]

The proposed safe harbor will be a relief to some taxpayers in the rental industry. Nevertheless, some taxpayers and RPEs – particularly those enterprises that consist only of a single, low-maintenance property – will struggle to meet the annual 250-hour requirement, while others will easily meet the safe harbor, but likely already will have engaged in a sufficient level of activity to meet the general section 162 test regardless.

To be or not to SSTB

A significant portion of the comments the Treasury and IRS received related to the SSTB rules. Section 199A defined an SSTB (1) through reference to section 1202(e)(3)(A) as a 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 1 or more of its employees or owners; or (2) as any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities (as defined in section 475(e)(2)).[20]

The Proposed Regulations had provided explanations and examples with respect to the categories of SSTBs enumerated above, but in doing so had left many questions.[21] The Treasury and IRS provided significant clarity in the Final Regulations, in some cases taxpayer favorable and in some cases not. Notably, the Final Regulations rejected the suggestions of many commenters to narrowly circumscribe the SSTB definitions (where relevant) to those set forth in regulations under section 448.[22] Several commenters had advocated for this approach on the grounds that the Conference Report to the TCJA had referenced these regulations (which relate to when certain taxpayers may use the cash method of accounting) as providing a "similar list of service trades or businesses" and referred to specifically when describing enumerated SSTB fields.[23] The Preamble states that the intent of section 448 and section 199A are very different, and that it was therefore consistent with the TCJA and its legislative history "to expand the definitions" of an SSTB beyond those provided in the section 448 regulations. The Treasury and IRS made the distinction partially on the grounds that section 199A looks to "the trade or business of performing services *involving* one or more of the listed fields, and not the performance of the services themselves [as is the case with section 448] in determining whether the trade or business is an SSTB."[24] In other words, the Final Regulations conclude that a business "involving" the performance of services in a certain field is broader than the direct performance of services in that field.

For example, the Final Regulations define the performance of services in the field of performing arts to include the services of any

individuals who "participate in the creation of performing arts" such as directors and writers in addition to the list set forth in Treas. Reg. § 1.448-1T(e)(4)(iii) and cited in the legislative history to the TCJA ("the provision of services by actors, actress, singers, musicians, entertainers, and similar artists in their capacity as such").[25] Similarly, the Final Regulations rejected limiting the performance of services in the field of athletics to the limitations provided in Treas. Reg. § 1.448-1T(e)(4)(iii), which generally would require (by analogy) that the service must be performed by an athlete in his or her capacity as such.[26] Hence, professional sports franchises owned through RPEs or directly are SSTBs because they involve services performed in the field of athletics, and owners of these teams will not be able to avail themselves of the section 199A deduction.

How many businesses?

Where a business provides qualifying services along with services in an SSTB field, the Final Regulations follow the bright line rule that was set forth in the Proposed Regulations. That is, if gross receipts attributable to the SSTB services constitute less than five percent of the annual gross receipts of the business (10 percent for businesses that have total annual gross receipts of $25 million or less), then the business is not considered to be an SSTB.[27] However, if the five (or 10) percent threshold is exceeded, then the business will be an SSTB in its entirety, and none of the income derived therefrom will be eligible for the section 199A deduction unless its owners are below the relevant income threshold.

In the "economic analysis" section of the Preamble pursuant to Executive Orders 13563 and 12866, the Treasury and IRS stated that "the de minimis thresholds were set at levels to balance the desire of the Treasury Department and the IRS to allow the deduction for trades or businesses with very small amounts of SSTB activity with the intent of the legislation to disallow the deduction for trades or businesses with SSTB activity."[28] The Treasury and IRS rejected comments that suggested that the deduction could be claimed on the portion of the business that did not involve SSTB services.

For taxpayers who have a qualifying business that also performs SSTB services and cannot avail itself of the de minimis rule, it may be advisable to divide the SSTB and the rest of the business into two different entities, if feasible. While the Preamble states that "multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under [Treas. Reg.] § 1.446-1(d),"[29] it also states that a single trade or business "cannot generally be conducted across multiple entities for tax purposes."[30] Thus, based on this logic, splitting a single business into two different entities should result in two different businesses for purposes of section 199A, ameliorating the "taint" of the SSTB piece of the business.[31]

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Businesses organized as RPEs and their owners (along with their advisors) should study the Final Regulations closely. While the Treasury and IRS intended the Final Regulations to provide certainty for taxpayers filing their 2018 returns, significant ambiguities remain, and many determinations regarding the availability and amount of a taxpayer's section 199A deduction are highly dependent on the underlying facts and circumstances. Miller & Chevalier participated substantially in the development of the Final Regulations, and stands ready to assist taxpayers with the interpretative, planning, and controversy issues that are sure to arise with respect to the Final Regulations.

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[1]RIN 1545-BO71. The Final Regulations were accompanied by proposed regulations relating to the treatment of REIT dividends under section 199A (REG-134652-18).

[2]An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115-97, § 11011 (2017). Congress amended section 199A with respect to issues affecting cooperatives in the Consolidated Appropriations Act of 2018, Pub. L. 115-141, § 101 (2018). All section references are to the Internal Revenue Code of 1986, as amended and currently in effect.

[3]Section 199A(b)(1).

[4]Section 199A(c), (d)(1).

[5]Section 199A(d)(3).

[6]Section 199A(b)(2).

[7]Section 199A(b)(3).

[8]See https://www.regulations.gov/docket?D=IRS-2018-0021 for all comments and a list of witnesses that provided live testimony before representatives of the Treasury and IRS on October 16, 2018. The Proposed Regulations appear in the federal register at 83 Fed. Reg. 40884 (Aug. 16, 2018).

[9]Preamble at 6.

[10]Preamble at 6.

[11]Preamble at 2.

[12]Preamble at 49. *See* Treas. Reg. § 1.199A-1(d)(2)(iv)(A) (referencing "trades or business operated through RPEs" in the determination of QBI.).

[13]Treas. Reg. § 1.199A-1(b)(14).

[14]Preamble at 13 citing *Commissioner v. Groetzinger*, 480 U.S. 23 (1987) and *Higgins v. Commissioner*, 312 U.S. 212 (1941).

[15]Preamble at 14.

[16]Preamble at 13.

[17]Notice 2018-07, § 6.

[18]Notice 2018-07, § 6.

[19]Notice 2018-07, § 6. For taxable years beginning after December 31, 2022, the 250-hour requirement need only be met for any three of the five consecutive taxable years that end with the taxable year at issue for an enterprise held for five years or more.

[20]Section 199A(d)(2)(A).

[21]*See* Prop. Treas. Reg. § 1.199A-5(b)(2).

[22]*See* Treas. Reg. § 1.448-1T(e)(4).

[23]H. Rep. No. 115-466, at 216-17, n.44-46 (Dec. 15, 2017) (Conf. Rep.).

[24]Preamble at 75 (emphasis added).

[25]Treas. Reg. § 1.199A-5(b)(2)(vii); Preamble at 83.

[26]Treas. Reg. § 1.199A-5(b)(2)(vii), (b)(3)(vii); Preamble at 86-87.

[27]Treas. Reg. § 1.199A-5(c)(1).

[28]Preamble at 136.

[29]Preamble at 21.

[30]Preamble at 61.

[31]Taxpayers should consult their advisors and be wary of anti-abuse rules in Treas. Reg. § 1.199A-5 as well as potentially applicable common law doctrines. In particular, taxpayers should consider the anti-abuse rule of Treas. Reg. § 1.199A-5(c)(2), which states that if an otherwise qualifying trade or business provides property or services to an SSTB and there is 50 percent or more common ownership between that trade or business and the SSTB, the portion of the otherwise qualifying trade or business providing property or services to the 50 percent or more commonly-owned SSTB will be treated as a separate SSTB with respect to the related parties.
