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Commentary

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Tax Reform: Final Regulations Clarify Framework for Determining Pass-Through Income Deduction

Treasury finalizes rules for key component of tax reform for pass-through trades and businesses.

Key Points:

- The deduction of up to 20% of pass-through trade or business income effectively may reduce the top marginal federal income tax rate on such income from 37% to as low as 29.6%, excluding the effect of the 3.8% surtax on net investment income and the self-employment tax.
- The deduction is subject to numerous limitations, which may reduce the amount of the deduction or deny a taxpayer the deduction entirely.
- Taxpayers with trade or business activities conducted through multiple pass-through entities should carefully consider how they define the scope of their trades or businesses and whether aggregating eligible trades or businesses maximizes the amount of the deduction.

Overview

On January 18, 2019, the US Department of the Treasury (Treasury) and the US Internal Revenue Service (the IRS) issued final regulations under Section 199A[1] (the Regulations) clarifying the scope and computation of the deduction for non-corporate taxpayers of up to 20% of certain trade or business income (the Pass-Through Deduction). Treasury and the IRS concurrently issued Notice 2019-07, which establishes a safe harbor under which a rental real estate enterprise constitutes a qualifying trade or business for purposes of the Pass-Through Deduction.

Section 199A, enacted as part of the Tax Cuts and Jobs Act,[2] generally allows individuals and certain trusts and estates a deduction of up to 20% of "qualified business income" (QBI). QBI is generally defined as domestic business income earned directly or through pass-through entities, including S-corporations and partnerships (other than publicly traded partnerships). In addition to the Pass-Through Deduction, Section 199A allows for a separate deduction of up to 20% of certain qualified REIT dividends and income from publicly traded partnerships. The total deduction allowed under Section 199A is limited to 20% of the excess of a taxpayer's taxable income from all sources over the taxpayer's net capital gains.

Taxpayers eligible for the Pass-Through Deduction may realize an effective top marginal federal income tax rate as low as 29.6% on qualifying income, excluding the effect of the 3.8% surtax on net investment income and the self-employment tax. However, the Pass-Through Deduction is subject to numerous additional limitations, which may make the deduction unavailable to many taxpayers. In particular, for

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taxpayers whose income exceeds specified thresholds (US$207,500 for individuals and US$415,000 for joint filers),[3] qualified business income is limited to income generated by "qualified trades or businesses" (QTBs), which do not include certain service-oriented businesses. Furthermore, for taxpayers above the income thresholds, the Pass-Through Deduction from each QTB is subject to further limitation based on the taxpayer's share of W-2 wages paid by the QTB and the taxpayer's share of the unadjusted tax basis of "qualified property" used in the QTB.

The Regulations and required calculations are technical and complex, and taxpayers should consult their tax advisors in determining eligibility for the Pass-Through Deduction.

Computing the Pass-Through Deduction

Given the nature of the limitations and the complexity of the Regulations, taxpayers should not assume that any portion of their income qualifies for the Pass-Through Deduction. The effects of the various limitations, including limitations on aggregation, may significantly impair a taxpayer's ability to claim a full deduction. The following discussion summarizes the process for computing the Pass-Through Deduction, including certain key considerations:

Step 1: Identify the taxpayer's QTBs

The first step is to identify all trades or businesses the taxpayer is engaged in directly or indirectly through pass-through entities. The Regulations generally look to court decisions and other interpretive authorities under Section 162 to determine whether a trade or business exists.[4] Beyond this general guidance, the Regulations do not provide any additional rules or list of factors to assist taxpayers in determining whether a group of activities constitutes one or more trades or businesses. However, the preamble to the Regulations and various examples in the Regulations indicate that having separable books and records for an activity is a pre-requisite to treating the activity as a standalone trade or business.

Recognizing the unique considerations associated with real estate, the Regulations and Notice 2019-07 establish safe harbors intended to provide some certainty to taxpayers. The Regulations include a special rule for captive arrangements under which the rental or license of property to a commonly owned (50% or more) trade or business is treated as a trade or business even if the rental or licensing activity would not otherwise constitute a trade or business under Section 162. This exception recognizes that real estate and certain other assets often are held separately from a taxpayer's other trade or business activities, and allows common OpCo/PropCo and intangible licensing structures to remain eligible for the Pass-Through Deduction.

Notice 2019-07 establishes a separate safe harbor under which a rental real estate enterprise — defined as an interest in real property held for the production of rents — will constitute a trade or business for purposes of the Pass-Through Deduction if the taxpayer (or pass-through entity) (i) maintains separate books and records for the rental real estate enterprise, (ii) performs a minimum number of rental services with respect to the enterprise annually (either directly or through an agent or employees) and (iii) maintains contemporaneous records substantiating the rental services performed, including the services performed, the number of hours and dates on which the services were performed, and the person who provided the services.

Real estate rented under a triple-net lease is not eligible for the safe harbor. Taxpayers (or pass-through entities) seeking to take advantage of this safe harbor must hold their interests in the rental property directly (or through disregarded entities) and either treat each rental property as a separate enterprise or treat all similar rental properties as a single property. Commercial and residential rental properties, however, must be treated as separate enterprises. Taxpayers (or pass-through entities) availing

themselves of the safe harbor must apply the safe harbor consistently from year to year, absent a significant change in facts or circumstances.

Step 2: Compute the taxpayer's QBI for each QTB

Once a taxpayer has identified its QTBs, the taxpayer must determine the amount of QBI separately for each QTB. In simple terms, QBI consists of ordinary course domestic income generated by the business, but does not include investment-related income (such as dividends, interest, or items treated as capital gain or loss) or compensation paid to an owner for services (including guaranteed payments). If a taxpayer's overall QBI from all QTBs is negative, the taxpayer's Pass-Through Deduction is zero, and the negative QBI amount is carried over to the next year and treated as negative QBI from a separate QTB. If a taxpayer's overall QBI from all QTBs is positive, any negative QBI produced by a QTB (including negative QBI carried over from the prior year) reduces proportionately the positive QBI from the other QTBs.

Step 3: Calculate the Wage/UBIA Limitations for each QTB

For taxpayers over the applicable income thresholds, the Pass-Through Deduction for each QTB cannot exceed the lesser of:

- 20% of the QTB's QBI calculated pursuant to Step 2 above

- The greater of (i) 50% of the taxpayer's share of W-2 wages paid by the QTB (the Wage Limitation) and (ii) 25% of the taxpayer's share of W-2 wages paid by the QTB, plus 2.5% of the taxpayer's share of the unadjusted tax basis of the QTB's qualified property (the UBIA Limitation)[5]

For purposes of the Wage Limitation, wages generally include all W-2 wages paid by the QTB or treated as paid by the QTB as the common law employer, including deferred compensation. Thus, if a QTB's employees are housed at a professional employer organization or an employee leasing firm, a QTB that is the common law employer may take into account the W-2 wages paid to such employees in determining its Wage Limitation. For purposes of the UBIA Limitation, property must be held on the last day of the tax year to give rise to qualifying tax basis. Dispositions of a QTB's tangible depreciable property should be considered with this requirement in mind. Lastly, taxpayers should note that although overall negative QBI from a prior year carries over to reduce positive QBI in the current year, the wages and unadjusted tax basis associated with the negative QBI do not similarly carry over.

Step 4: Determine whether to aggregate some or all of the QTBs

As described above, each QTB generally is evaluated separately in calculating the Pass-Through Deduction and applying the Wage/UBIA Limitations. As a result, the sum of a taxpayer's Pass-Through Deductions for each QTB may prove suboptimal if, for example, one QTB has low QBI relative to its Wage/UBIA Limitation and another QTB has high QBI relative to its Wage/UBIA Limitation. In these circumstances, a portion of the first QTB's Wage or UBIA Limitation will be underutilized because the limitation cannot be "transferred" to increase the second QTB's limitation. By contrast, if the QTBs are aggregated and treated as a single QTB, the W-2 wage and qualified property base of each QTB are combined for purposes of the determining the Wage/UBIA Limitation on the combined QBI of the QTBs.

Under the Regulations, QTBs may be aggregated only if:

- At least 50% of each QTB is owned, directly or indirectly, by the same person or groups of persons for a majority of the applicable tax year, including the last day of such tax year[6]

- All items attributable to each QTB are reported on tax returns with the same taxable year (not taking into account short taxable years)
- The QTBs satisfy at least two of three factors intended to demonstrate operational integration[7]

The benefits of aggregation are illustrated in the following example.

Example: Taxpayer owns interests in three QTBs:

- QTB 1 has positive QBI and wage expenses
- QTB 2 also has positive QBI, but no wage expenses
- QTB 3 has wage expenses, but negative QBI for the year
- None of the QTBs owns qualified property

If the taxpayer does not aggregate, QBI from QTB 2 does not generate a Pass-Through Deduction because QTB 2's Wage Limitation is zero. By contrast, aggregation allows the wage expenses of QTB 3 to effectively increase the Wage Limitation for QTB 2. As a result, the taxpayer significantly increases its total Pass-Through Deduction.

Taxpayer Does Not Aggregate QTBs

Taxpayer's taxable income (before 199A) 3,000,000
20% of taxable income 600,000

QTB	QBI	Adjusted QBI	Wages	20% of Adjusted QBI	Wage Limitation	Deductible QBI*
1	1,000,000	700,000	500,000	140,000	250,000	140,000
2	1,000,000	700,000		140,000	-	-
3	(600,000)		500,000	-	-	-
Total	1,400,000	1,400,000	1,000,000			140,000

* Deductible QBI is the lesser of 20% of Adjusted QBI and 50% of W-2 wages

Pass-Through Deduction = lesser of total deductible QBI or 20% of taxable income **140,000**

Taxpayer Aggregates QTBs

Taxpayer's taxable income (before 199A) 3,000,000
20% of taxable income 600,000

QTB	QBI	Adjusted QBI	Wages	20% of Adjusted QBI	Wage Limitation	Deductible QBI*
1	1,000,000		500,000			
2	1,000,000					
3	(600,000)		500,000			
Total	1,400,000	1,400,000	1,000,000	280,000	500,000	280,000

* Deductible QBI is the lesser of 20% of Adjusted QBI and 50% of W-2 wages

Pass-Through Deduction = lesser of total deductible QBI or 20% of taxable income **280,000**

The aggregation election for QTBs is irrevocable. Additional QTBs may be subsequently aggregated if the aggregation criteria are satisfied, and a QTB will be disaggregated if it later fails such criteria. The aggregation election may be made by either the pass-through entity conducting the QTB or an owner of the pass-through entity (including an upper-tier pass-through entity). Owners of a pass-through entity generally are not required to aggregate in the same way; however, if a pass-through entity elects to aggregate QTBs, all upstream owners of the entity (including other pass-through entities) are bound by the election. Upstream owners may elect to aggregate additional QTBs that satisfy the aggregation requirements.

Although aggregation generally would be expected to benefit individual taxpayers, an upstream owner of a pass-through entity should consider whether to subject entity-level aggregation elections to the owner's consent. As a result of specific facts and circumstances, a taxpayer's optimal scope of aggregation may differ from other owners of the pass-through entity.

Step 5: Apply the overall cap

The final step is to apply the overall cap on the deduction. A taxpayer's total deduction under Section 199A, taking into account deductions from eligible REIT dividends and income from publicly traded partnerships, cannot exceed 20% of the excess of the taxpayer's taxable income from all sources over the taxpayer's net capital gains.

Specified Service Trade or Business (SSTB)

As described above, taxpayers whose income exceeds the threshold can claim the Pass-Through Deduction only for income from QTBs, which do not include any "specified service trade or business" (SSTB). An SSTB is a trade or business that involves providing services in certain disqualified fields, including health care, investment management, consulting, and any business that has as its principal asset the reputation or skill of one or more employees or owners. Most of the disqualified fields are defined narrowly and capture the performance of personal services by skilled professionals. Importantly, the Regulations limit the catch-all category (reputation or skill of one or more employees or owners) to businesses that earn income through endorsements, personal appearance fees, or licensing the use of a person's identity. By contrast, the Regulations define consulting as "the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems." While this broad definition could include a number of activities not typically regarded as consulting, the Regulations impose some boundaries on the reach of consulting services by excluding sales, the provision of training or educational courses, or consulting services ancillary to, or embedded in, a trade or business that would not otherwise constitute an SSTB (such as advice provided by a building contractor).

If disqualifying services are provided as part of a broader trade or business, the broader trade or business will not be considered an SSTB so long as gross receipts from the disqualifying services do not exceed specified de minimis thresholds — 10% of total gross receipts if the business has gross receipts less than US$25 million or 5% of total gross receipts if the business has gross receipts of US$25 million or more. Taxpayers with trades or businesses that provide disqualifying services might consider whether treating their activities as more than one trade or business can maximize each trade or business' ability to provide such services while staying under the de minimis thresholds. Taxpayers should proceed with caution, however, as the Regulations include rules intended to prevent taxpayers from circumventing SSTB status by segregating disqualifying services into separate trades or businesses. For example, if a QTB provides services to an SSTB, and the QTB and SSTB are commonly owned by 50% or more, the Regulations treat the portion of the services the QTB provides to the SSTB as a separate SSTB.

Reporting Requirements

Pass-through entities must report the following information to each owner on Schedule K-1 for any trade or business the entity is engaged in directly or to the extent such information is provided by a lower-tier pass-through entity:

- Each owner's allocable share of QBI, wages, and unadjusted tax basis in qualified property
- Whether any such trade or business is an SSTB

If such information is not reported by the pass-through entity, the owner's share of each unreported item is presumed to be zero.

In addition, the Regulations require pass-through entities to disclose to their owners the QTBs aggregated by the entity, and individual taxpayers must disclose to the IRS all QTBs aggregated by the taxpayer. Failure to comply with such reporting requirements may result in the disaggregation of QTBs, which may adversely affect the amount of a taxpayer's Pass-Through Deduction.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

E. Rene de Vera
rene.devera@lw.com
+1.312.876.7610
Chicago

Julie M. Marion
julie.marion@lw.com
+1.312.876.7700
Chicago

Michael B. Zucker
michael.zucker@lw.com
+1.312.876.6598
Chicago

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Endnotes

[1] All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the Code). On February 4, 2019, Treasury and the IRS issued corrected final regulations that generally incorporate technical corrections to the Regulations as originally issued. In connection with the original issuance of the Regulations, Treasury and the IRS also issued proposed regulations providing guidance on the treatment of previously suspended losses that constitute qualified business income and the calculation of the deduction for owners of regulated investment companies (*e.g.*, mutual funds) and certain trusts.

[2] Public Law No. 115-97 (Dec. 22, 2017).

[3] The limitations begin to phase-in at incomes of US$157,500 for individuals and US$315,000 for joint filers.

[4] Case law under Section 162 generally requires that the taxpayer (or pass-through entity) maintain continuous and regular involvement in the activity with the principal purpose of producing income or profit. *See, e.g.*, *Commissioner v. Groetzinger,* 480 U.S. 23, 35 (1987).

[5] Qualified property generally consists of tangible depreciable property for which the depreciable period has not expired and that is used by the QTB at the close of the applicable tax year. The unadjusted tax basis of qualified property is the tax basis immediately after the property's acquisition by the QTB, subject to special rules for carry-over basis transactions under Sections 351 and 721.

[6] Ownership is measured by shares (in the case of S-corporations) and capital or profits (in the case of partnerships). Indirect ownership is determined under the attribution rules of Section 267(b) or Section 707(b).

[7] The three factors are: (1) the businesses provide the same products and services or provide products and services that are customarily provided together, (2) the businesses share facilities or significant centralized business elements (*e.g.*, common accounting, legal or human resources functions) and (3) the businesses operate in coordination with, or reliance upon, one or more of the businesses in the aggregated group.