

Treasury Releases Long-Anticipated Guidance on Taxation of Passthrough Entities

On Aug. 8, 2018, the Department of Treasury issued proposed regulations under Section 199A of the Internal Revenue Code (“Code”) regarding the 20-percent deduction for passthrough businesses.

Section 199A was created by the *Tax Cuts and Jobs Act* (P.L. 115-97) and was amended retroactively on March 23, 2018, by the *Consolidated Appropriations Act, 2018*, (P.L. 115-141). This highly anticipated guidance will have a significant impact on the taxation of individuals, partnerships, S corporations, trusts and estates engaged in domestic trades or businesses.

In addition to the proposed regulations, Treasury simultaneously issued [Notice 2018-64](#), which provides three methods for calculating W-2 wages for the purposes of the limitations on the Section 199A deduction.

Background

Section 199A of the Code provides a deduction of up to 20 percent of income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust or estate. The Section 199A deduction is not available for wage income or for business income earned through a C corporation.

For taxpayers whose taxable income exceeds a threshold amount, the Section 199A deduction may be limited based on:

1. the type of trade or business engaged in by the taxpayer;
2. the amount of W-2 wages paid with respect to the trade or business; and/or
3. the unadjusted basis immediately after acquisition (UBIA) of qualified property held for use in the trade or business.

The wage limitation does not apply to taxpayers with annual taxable income less than \$315,000 (married filing jointly) or \$157,500 (individuals). The limitation is phased-in for taxpayers with taxable incomes above this threshold.

The Section 199A deduction cannot exceed the greater of:

1. 50 percent of the taxpayer’s share of W-2 wages paid with respect to the trade or business; or
2. the sum of 25 percent of the taxpayer’s share of W-2 wages with respect to a qualified trade or business, plus 2.5 percent of the UBIA for all qualified property.

The deductible amount of qualified business income for each of the taxpayer’s qualified trades or businesses is determined separately and added together. The sum of these amounts is then subject to a second limitation equal to the lesser of the taxpayer’s combined qualified business income or 20 percent of income otherwise taxed at the top marginal rate (excludes net capital gains and qualified cooperative dividends).

The purpose of this overall limitation is to ensure that the 199A deduction is not taken against income that is taxed at preferential rates.

The Section 199A proposed guidance also includes special rules for real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

Section 199A applies to taxable years beginning after 2017 and before 2026.

The Proposed Rules

The proposed rules are fairly comprehensive and provide computational, definitional and anti-avoidance guidance regarding the application of Section 199A. The proposed regulations are organized into six substantive sections, each of which provides rules relevant to the calculation of the Section 199A deduction, including:

1. **Operational Issues:** This subsection provides not only general information on how to compute the 199A deduction but also critical information on how certain terms are defined, including the *definition of an eligible trade or business*. In addition, the subsection provides the steps taxpayers must take to calculate Qualified Business Income (QBI) in a manner that avoids perverse incentives for shifting wages and capital assets across businesses.
2. **Determination of W-2 Wages and the Unadjusted Basis Immediately After Acquisition (“UBIA”) of Qualified Property:** This section defines W-2 wages and UBIA of qualified property. The guidance includes rules regarding wages paid in less traditional arrangements, including those that outsource their human resources and other payroll functions to professional employer organizations (PEOs).
3. **Rules regarding Qualified Business Income, Qualified REIT Dividends, Qualified PTP Income:** This section provides additional guidance on the determination of QBI, qualified REIT dividends and qualified PTP income. It provides anti-abuse rules that will discourage the creation of tiered partnerships purely for the purposes of increasing the Section 199A deduction.
4. **Aggregation Rules:** This section provides rules for aggregating income for taxpayers with passthrough income from multiple sources. The guidance includes anti-abuse rules to prevent passthroughs from separating business activities in order to maximize the deduction by spinning off administrative and other non-professional service functions (the so-called “Crack and Pack” strategy).
5. **Rules regarding Specified Service, Trade or Business (SSTB) and Performing Services as an employee:** This section provides rules on which trades or businesses would be characterized as an SSTB. It also outlines a de minimis exception to the SSTB exclusion, if the trade or business earns only a small fraction of its gross income from specified service activities (de minimis exception). Additionally, the rules provide that former employees providing services as independent contractors to their former employer will be presumed to be acting as employees.
6. **Rules regarding Relevant Passthrough Entities (RPE), Publicly Traded Partnerships (PTPs), Trusts and Estates:** This section provides rules for RPEs, PTPs, trusts and estates. In particular, RPEs are required to calculate and report their owners' QBI, SSTB status, W-2 wages, UBIA of qualified property, REIT dividends and PTP income. Similarly, PTPs must calculate and report their owners' QBI, SSTB status, REIT dividends and other PTP income.

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The rules also contain regulations under section 643 of the Code, which define the manner in which trusts are subject to the threshold amount. The rules prohibit taxpayers from setting up trusts in attempts to avoid the threshold amounts.

Next Steps

While this guidance is comprehensive, more is expected, including rules that will address the application of Section 199A to cooperative businesses. Treasury has asked for written comments on the published guidance within 45 days of the date the proposed regulations are published in the federal register. We anticipate that the comments will be due in mid-October. A public hearing has also been scheduled for Oct. 16, 2018, at 10 a.m.

Given that these rules will significantly impact the taxation of passthrough entities, we believe that it is important for businesses to engage in the rulemaking process. By doing so, policymakers will have a better understanding of the impact these rules will have on businesses and the challenges businesses will face during the implementation process.

The Brownstein Federal Tax Policy team can assist you in considering the impact that these rules will have on your business, including drafting and submitting written comments to the proposed guidance. Our team has significant knowledge on the taxation of passthroughs as well as experience with the rulemaking process. To the extent questions are unanswered or the rules are not clear, our team can facilitate a dialogue with policymakers to help resolve your issues.

For more information, contact:

Russ Sullivan
Shareholder
rsullivan@bhfs.com
202.383.4423

Greg Berger
Shareholder
gberger@bhfs.com
303.223.1158

Radha Mohan
Policy Advisor
rmohan@bhfs.com
202.383.4425

Rosemary Becchi
Strategic Advisor and Counsel
rbecchi@bhfs.com
202.383.4421

Harold Hancock
Shareholder
hhancock@bhfs.com
202.383.4422

Charlie Iovino
Senior Policy Advisor
ciovino@bhfs.com
202.383.4424

Erik Jensen
Shareholder
ejensen@bhfs.com
303.223.1205

Andrew Elliott
Shareholder
aelliott@bhfs.com
303.223.1154

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