

Become an Effective 199A Practitioner

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Overview

1. Flow-Through Trade or Business

- Flow Through Entities
- Qualified Trade or Business
- Separate Trades or Businesses

2. Qualified Business Income

3. Taxable Income Limitations

- Threshold Amounts
- Phase In Ranges

4. Wage and UBIA Limitations

5. Specified Service Trade or Business (SSTB)

6. Multiple Trades or Businesses and Aggregation

7. Practical Considerations

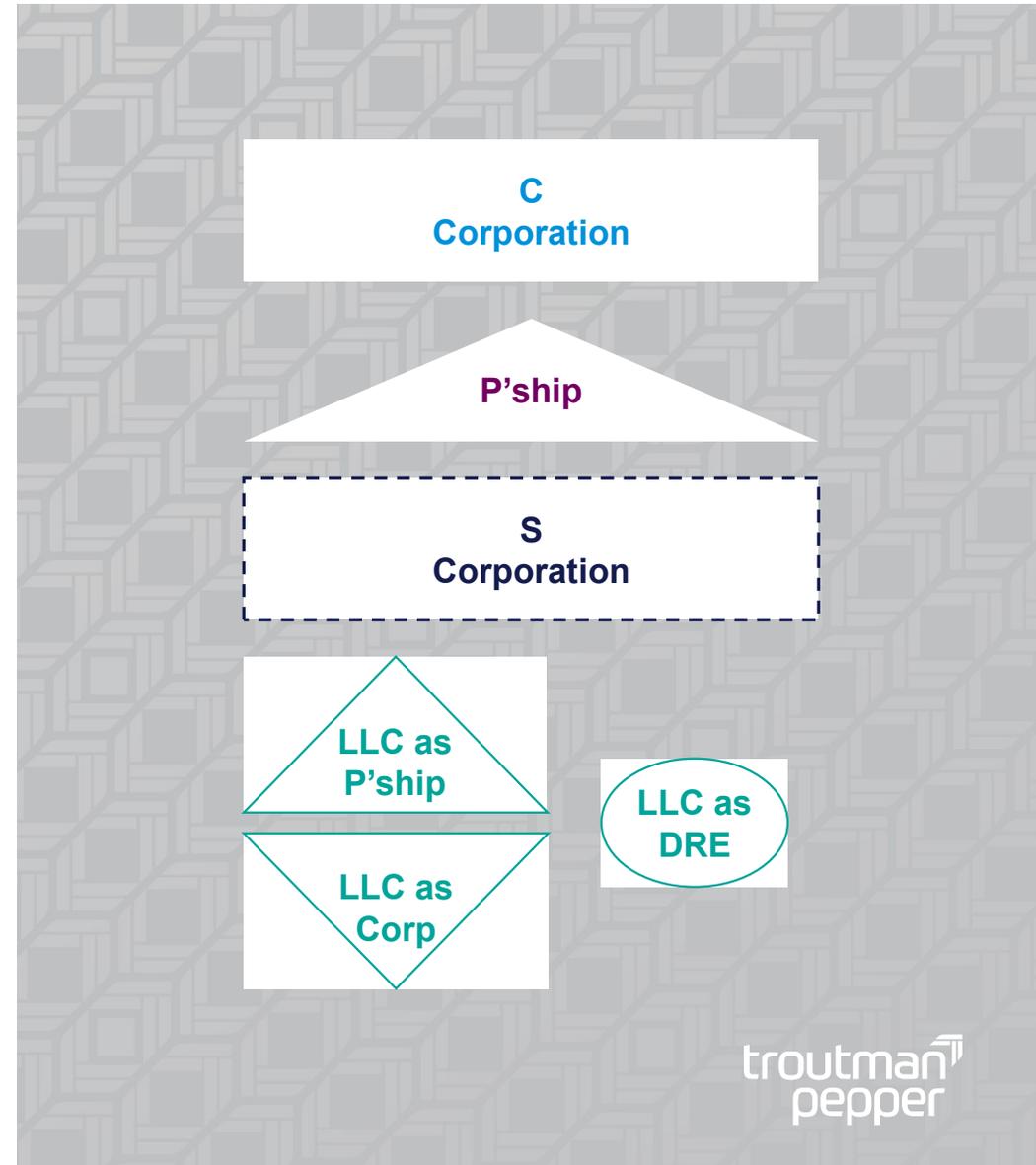
Code Section 199A – Generally

- 20% Deduction:
 - §199A provides a potential 20% deduction with respect to an individual's share of "combined qualified business income" from partnerships, S corporations, or sole proprietorships (a "relevant passthrough entity" (RPE))
 - Effectively reduces the tax rate
 - E.g., a taxpayer subject to a 37% tax rate would receive an effective rate of 29.6%
 - Deduction expires for taxable years beginning after December 31, 2025

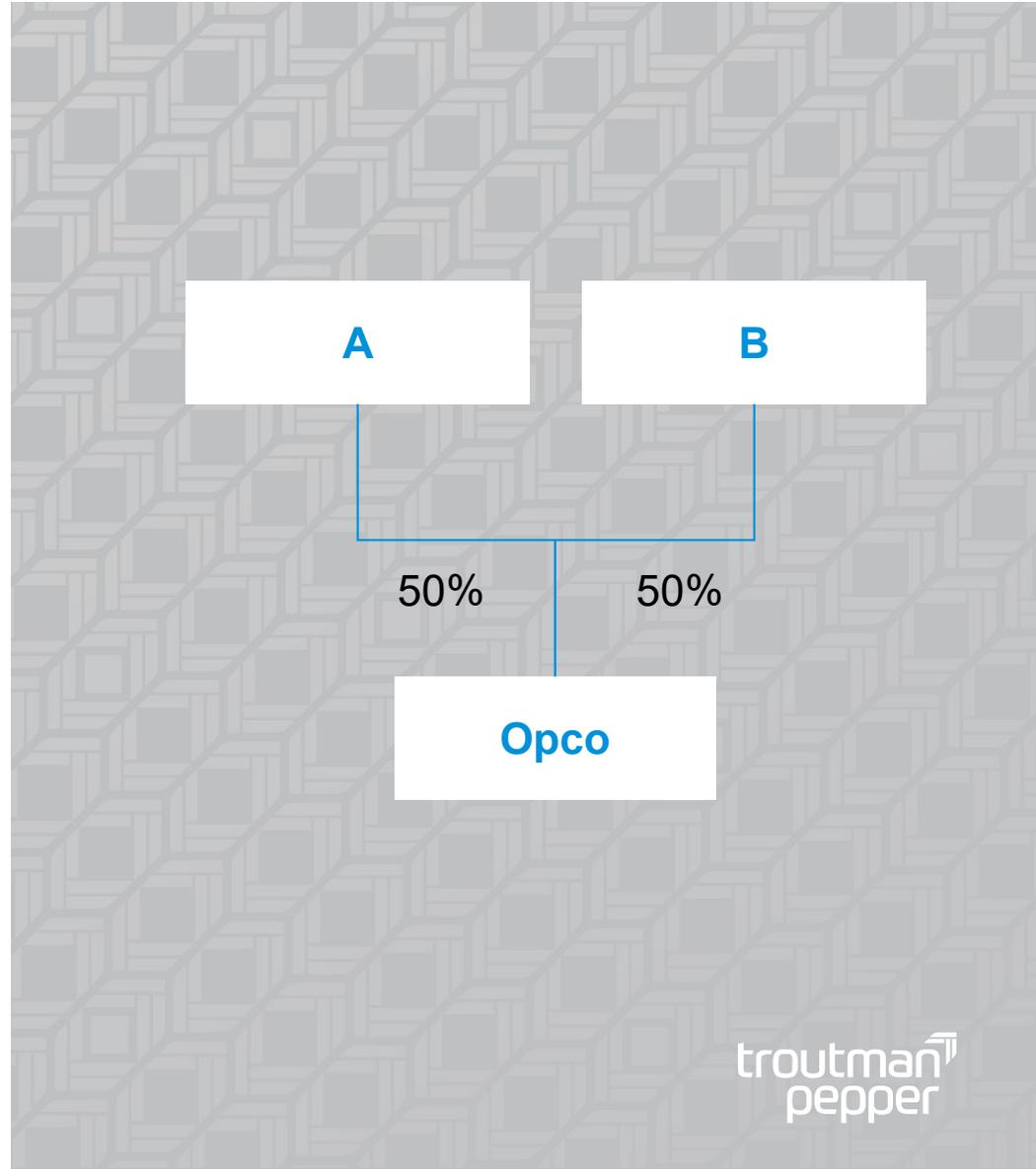
Is There a Flow-Through Trade or Business?

Entity Options

- Corporations
 - 2 layers of tax
 - Easy to form
- Partnerships
 - Single layer of tax
 - Complex rules regarding allocations of income
- S Corporations
 - Single layer of tax
 - Restrictions on ownership
- LLCs
 - Default to flow-through entities (disregarded or partnership)
 - Election available to treat as a corporation
 - Very flexible



- Earns \$5M in Taxable Income
- Distributes all After Tax Income
 - \$1,050,000
 - \$3,950,000
 - \$1,975,000
 - \$470,050
 - \$1,504,950
- Opco Tax 21% of \$5M
- Distribute After Tax
- 'A' Taxable Income
- 'A' Tax @23.8%
- 'A' After Tax Cash
- Don't forget state taxes



Using a Pass Through, With Distributions

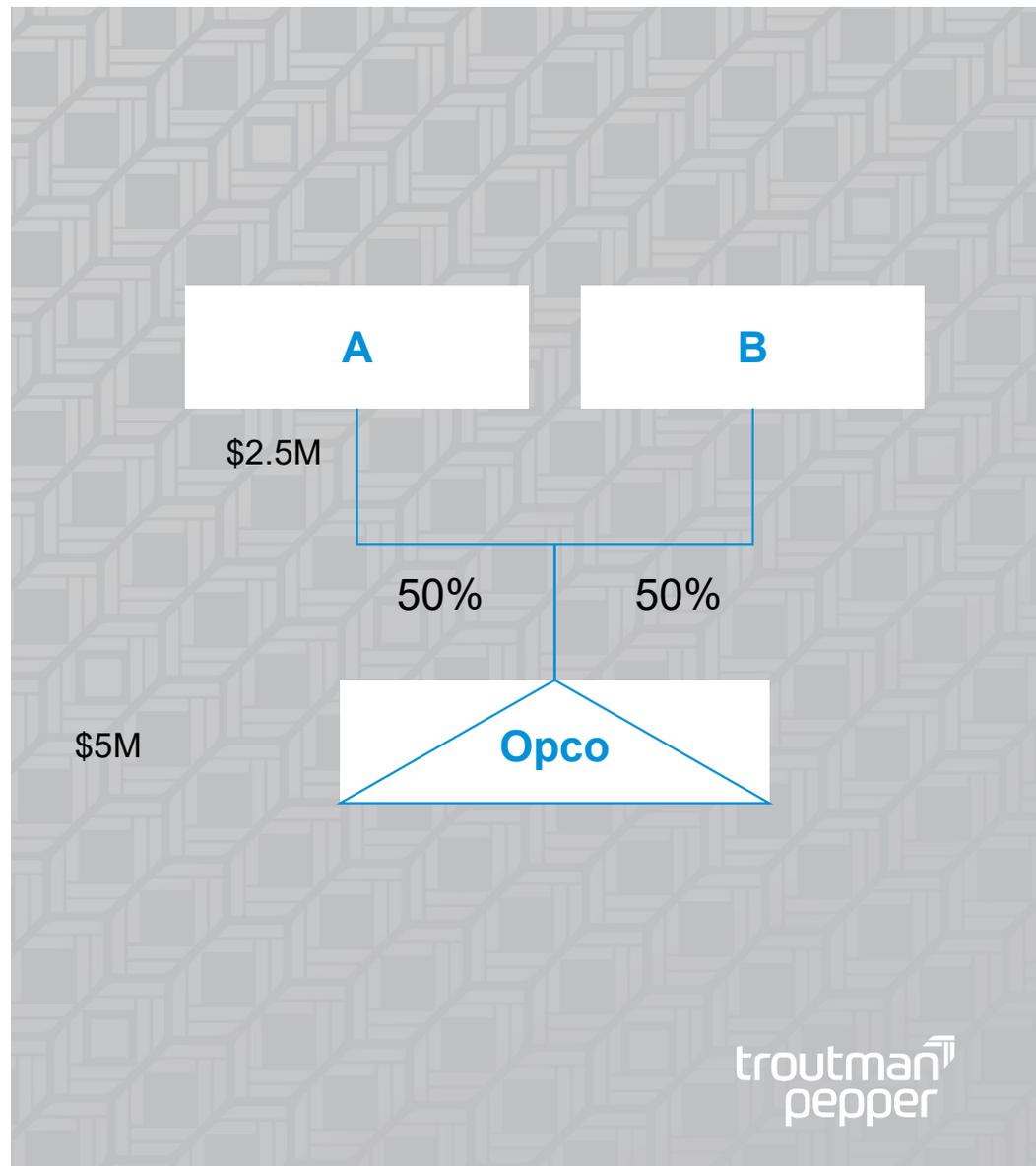
Case 1. Assume no 20% deduction

Opco Tax	-0-
Member Income	\$2.5M
Tax 37%	\$925,000
After Tax Cash	\$1,575,000

Case 2. Assume each member can claim the 20% deduction for qualified business income

Opco Tax	-0-
Member Income	\$2.5M
QBI Deduction	\$.5M
Tax, Income	\$2.0M
Tax 37%	\$740,000
ETR	29.6%
After Tax Cash	\$1,760,000

- Opco earns \$5M, which is allocated pro rata to A & B



After-Tax Cash Comparisons

C Corporation:
\$1,504,950

Pass Through
(No Deduction):
\$1,575,000

Pass Through
(With Deduction):
\$1,760,000

Don't forget to
add state taxes

Relevant Pass Through Entities

- Section 199A deduction only applies to an individual's share of qualified business income from:

Partnerships

S-Corporations

**Sole
Proprietorships**

**Each known
as a relevant
passthrough
entity ("RPE")**

- **Not available to C corporations.**

Qualified Trade or Business

- **Qualified Trade or Business:**
 - The term “qualified trade or business means a trade or business other than a specified service trade or business (“SSTB”) or the trade or business of performing services as an employee.” Section 199A(d)(1)
- **Trade or Business (“ToB”)**
 - The regulations refer to a ToB under Section 162, other than a trade or business of performing services as an employee. Treas. Reg. 1.199A-1(b)(14)
 - Section 162(a) does not provide a specific definition as to what constitutes a trade or business
 - There is no bright line test for what is a ToB
 - Case law has provided that to establish a ToB (Groetzinger v. Commissioner, 480 U.S. 23 (1987)):
 - Taxpayer must engage in the activity with continuity and regularity
 - Taxpayer’s primary purpose must be for income or profit

Separate Trades or Businesses?

Generally, activities operated in separate taxable entities are considered separate trades or businesses.

Additionally, a single entity may also have multiple trades or businesses.

The IRS declined to adopt any specific bright-line guidance on how to determine if an RPE has more than one ToB.

The preamble to the final Section 199A regulations provide that multiple trades or business will generally not exist within an entity unless different methods of accounting could be used for each trade or business under 1.446-1(d).

Separate Trades or Businesses Under Section 446

- The Treasury Regulations under Section 446 provide that:
 - In order for a taxpayer to have separate and distinct trades or businesses, the taxpayer must use a different method of accounting for each trade or business
 - No trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business
 - However, trades or businesses will not be considered separate and distinct if maintaining different methods of accounting creates a shifting of profits and losses between the trades or businesses

Example from the Final Regulations

- Animal Care LLC provides veterinarian services performed by licensed staff and also develops and sells its own line of organic dog food at its veterinarian clinic and online
- The veterinarian services are considered to be the performance of services in the field of health under paragraphs (b)(1)(i) and (b)(2)(ii) of 1.199A-5
- Factors determining there are separate trades or businesses:
 - Animal Care LLC separately invoices for its veterinarian services and the sale of its organic dog food
 - Animal Care LLC maintains separate books and records for its veterinarian clinic and its development and sale of its dog food
 - Animal Care LLC also has separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products
 - Animal Care LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for purposes of Secs. 162 and 199A
- Animal Care LLC has gross receipts of \$3,000,000. \$1,000,000 of the gross receipts is attributable to the veterinary services, an SSTB

Example Analysis

- The example provides insight into what factors, if present, are helpful in determining if there is more than one trade or business. The conclusion in the example provides the following:
 - Although the gross receipts from the services in the field of health exceed 10 percent of Animal Care LLC's total gross receipts, the dog food development and sales business is not considered an SSTB due to the fact that the veterinary practice and the dog food development and sales are separate trades or businesses under Sec. 162
 - In reaching this conclusion, the example provides insightful guidance that activities that have the following factors will likely be treated as separate trades or businesses:
 - Separately invoiced customers
 - Separate books and records; and
 - Separate employees that only work in their respective activity

What Is Qualified Business Income (QBI)?

Qualified Business Income

- Qualified Business Income (QBI):
 - Qualified items of income, gain, deduction and loss that are (a) effectively connected with a U.S. trade or business within the meaning of §864 (i.e., non-U.S. income does not qualify for the deduction) and (b) included or allowed in determining taxable income for the year
- QBI Includes:
 - With respect to a partnership, gain or loss under §751(a) or §751(b) (not just in the context of a PTP)
 - Gain resulting from adjustments under §481 so long as the adjustment arises in tax years ending after December 31, 2017 and is attributable to a QTB

Income Not Treated as Qualified Business Income

- QBI does NOT Include:
 - Capital gain or loss (long or short term), including §1231 gains or losses
 - Interest income other than interest income properly allocable to a trade or business, which does not include interest income received on working capital, reserves, and similar accounts
 - Wage income
 - Reasonable compensation from an S corporation (“Reasonable compensation” only applies to S corporations.)

Income Not Treated as Qualified Business Income (Cont'd)

- QBI does NOT Include:
 - Guaranteed payments for partner services under § 707 (a) and (c)
 - Includes payments for the use of capital and payments to upper-tier partnership
 - Dividends and dividend equivalents, including payments in lieu of dividends under § 954(c)(1)(G)
 - Gains/loss from certain commodities transactions, or foreign exchange gains, certain gains from notional principal contracts, non-business annuity income, and any item of deduction or loss properly allocable to any of the previous amounts

What Income Qualifies for the Deduction?

- Qualified REIT Dividends and Qualified PTP Income are eligible for 20% Deduction
 - Qualified REIT Dividend:
 - Any dividend from a REIT received during the taxable year which is neither:
 - A capital gain dividend, as defined in §857(b)(3), nor
 - Qualified dividend income, as defined in §1(h)(11)
 - If the REIT stock is held for fewer than 45 days, the dividend will not be treated as a qualified REIT dividend
 - Uncertainty regarding REIT dividends received through RICs

What Income Qualifies for the Deduction? (Cont'd)

- Qualified REIT Dividends and Qualified PTP Income are eligible for 20% Deduction
 - Qualified PTP Income:
 - The net amount of such taxpayer's allocable share of income, gain, deduction and loss from a PTP plus
 - Any gain or loss attributable to assets of the PTP giving rise to ordinary income under §751(a) or (b) that is considered attributable to the trades or businesses conducted by the PTP
 - §707(a) and (c) payments generally not eligible

Do the Taxable Income Based Limitations Apply?

Threshold Amounts and Phase-in Range

- Threshold Amounts (2018)
 - Individuals and Trusts/Estates: \$157,500
 - \$50,000 phase-in range (up to \$207,500)
 - Married, Filing Jointly: \$315,000
 - \$100,000 phase-in range (up to \$415,000)
 - These amounts are adjusted annually for inflation
- Is the taxpayer's taxable income at or below the threshold?
 - SSTB, W-2 wage and UBIA of qualified property limitations do not apply
- Within the phase-in range?
 - W-2 wage and UBIA of qualified property limitations phased-in
 - An SSTB is a qualified trade or business but only a portion of its QBI can be used in determining the deduction
- Above the phase-in range?
 - SSTBs are not qualified trades or businesses (not eligible for deduction)
 - W-2 wage and UBIA of qualified property limitations apply in full

Is QBI Limited by the W-2 Wage or UBLA of Qualified Property Limitations?

The W-2 Wage and UBIA of Qualified Property Limitations

- For taxpayers with taxable income above the threshold and phase-in range, the amount of QBI from each qualified trade or business that is used in determining the section 199A deduction is limited to the lesser of:
 - 20% of the QBI from the trade or business OR
 - The greater of:
 - 50% of the W-2 wages paid with respect to the trade or business OR
 - 25% of the W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of all qualified property held for use in the trade or business as of the last day of the taxable year
- These limitations are phased in for taxpayers with taxable income within the phase-in range

Determining W-2 Wages

- W-2 wages means the amount paid with respect to a trade/business as W-2 wages to employees for services rendered
- W-2 wages include the total amount of W-2 wages as defined in section 3401(a) plus:
 - Total amount of elective deferrals within the meaning of § 402(g)(3)
 - Compensation deferred under § 457
 - Designated Roth contributions as defined in § 402A
- Rev. Proc. 2019-11 provides guidance on methods for determining W-2 wages for purposes of the § 199A wage limitations
- W-2 wages only includes amounts properly reported on a return filed with the Social Security Administration on or within 60 days of the due date (including extensions) for the return

Determining W-2 Wages (Cont'd)

- Only W-2 wages properly allocable to QBI are included
 - Wages must also be allocated among various trades/businesses if the taxpayer or RPE conducts more than one trade/business
- W-2 wages paid by a different person (such as a payroll agent, common paymaster, or professional employer organization (PEO)) may be taken into account, provided that the W-2 wages are paid to common law employees of the individual or RPE
- W-2 wages do not include:
 - Guaranteed payments for services
 - Section 707(a) payments for services
 - Payments to independent contractors
 - Reasonable compensation not paid as W-2 wages

Determining UBIA of Qualified Property

- Qualified Property is:
 - Tangible property of a character subject to an allowance for depreciation under § 167(a)
 - Held by and available for use in the trade or business at the close of the year
 - Used at any point during the year in the production of QBI, and
 - The depreciable period has not ended before the end of the tax year
- The depreciable period is the later of:
 - 10 years after the placed-in service date
 - The last full day of the last full year in the applicable recovery period under § 168(c)
- Improvements to qualified property are treated as separate qualified property placed in service on the date the improvement is placed in service

Determining UBIA of Qualified Property (Cont'd)

- Unadjusted Basis Immediately after Acquisition (UBIA)
 - Basis on the placed in service date of the property as determined under § 1012 or other applicable section of the Code
 - Determined without regard to any adjustments described in § 1016
- Nonrecognition Transactions Described in § 168(i)(7)
 - If qualified property is acquired in a nonrecognition transaction such as a § 351 or § 721 contribution, the UBIA for the property in the hands of the transferee will generally be the same as the transferor's UBIA
- § 1031 or § 1033 Transactions
 - The UBIA of the replacement property will generally be the same as the UBIA of the relinquished property, adjusted for money or other property transferred in the transaction

Is the Taxpayer in a SSTB?

Specified Service Trades or Businesses, Defined

- Involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services or where the principal asset of such trade or business is the “reputation or skill” of one or more of its employees or owners (as defined in §1202(e)(3)(A) with changes), or
- Which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities
- The fields of engineering and architecture were deleted from the list of SSTBs in the final legislation

SSTBs, Defined in the Regulations

- Final Regulations provide detailed definitions and examples on each SSTB listed in the final legislation
- Consulting Services
 - Limited to advice and counsel and does not include sales or other services
 - Consulting services imbedded in a trade or business that is not otherwise an SSTB will not cause the trade or business to be treated as an SSTB if the consulting services are not separately paid for
- Financial Services
 - Does not include taking deposits or making loans

SSTBs, Defined in the Regulations (Cont'd)

- Brokerage Services
 - Does not include brokerage services provided by real estate agents or insurance agents
- Services in Dealing
 - Loan origination is not treated as buying a security
- Skill or Reputation of a Person
 - A trade or business where the principal asset is the reputation or skill of one or more employees or owners is one in which a person receives fees, compensation or income (including partnership equity) in exchange for:
 - Endorsing products or services
 - The use of their image, name, signature, voice, trademark, etc., or
 - Appearing at an event or on the radio, television or other media format

De Minimis Rule

- Not an SSTB if:
 - Gross receipts of \$25 million or less
 - Less than 10 % of the gross receipts are attributable to the performance of services of the defined SSTBs
 - The performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field
 - Gross receipts of greater than \$25 million
 - Less than 5% of the gross receipts are attributable to the performance of services of the defined SSTBs

Services or Property Provided to an SSTB

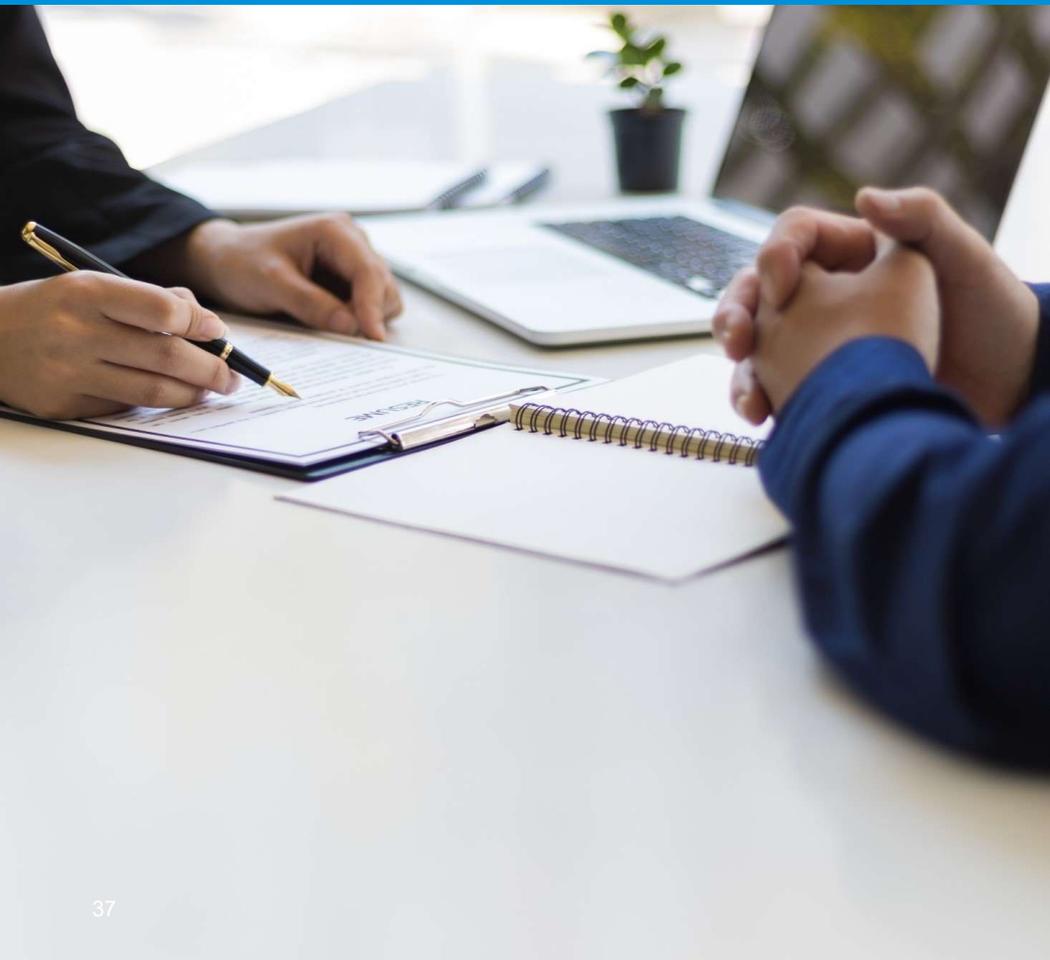
- The portion of an otherwise qualifying trade or business that provides property or services to an SSTB will be treated as a separate SSTB if:
 - The otherwise qualifying trade or business provides services or property to an SSTB and
 - There is 50 % or more common ownership between the SSTB and the otherwise qualifying trade or business
- “50 % or more common ownership” includes direct or indirect ownership by related parties under sections 267(b) and 707(b)

Example

- Lisa Lawyer is a married partner in a law firm. Lisa earns K-1 income of \$200,000. Lisa's husband, Larry, is an associate at the law firm. He is an employee and earns wages of \$50,000. Their combined taxable income is \$210,000. Are they entitled to a Section 199A deduction?
 - Does the result change if their combined taxable income is (a) \$375,000 or (b) \$500,000?
 - What if Lisa is not a lawyer? Assume Lisa owns and operates a bicycle repair shop

When Can or Should a Taxpayer Aggregate T/B?

Section 199A – Aggregation



- Each trade or business is separate for purposes of determining the QBI component
 - However, an individual or RPE may aggregate trades or businesses for purposes of the W-2 wage and UBIA limitations
- Individuals and RPEs may aggregate multiple trades or businesses if:
 - Each trade or business to be aggregated is commonly controlled (50% or more ownership)
 - Items for each trade or business are reported on returns within the same tax year
 - None of the trades or businesses are an SSTB; and
 - Two of the following factors are satisfied by the trades or businesses to be aggregated:
 - Provide products, property, or services that are the same or customarily offered together
 - Share facilities or significant centralized business elements (e.g. personnel, accounting, legal, manufacturing, purchasing, HR or IT); and
 - Operated in coordination with, or reliance upon, one or more of the businesses of the aggregated group (e.g. supply chain interdependencies)



Section 199A – Aggregation (Cont'd)

- Individuals and RPEs may aggregate trades or businesses operated directly or through RPEs to the extent an aggregation is not inconsistent with the aggregation of a lower-tier RPE
- Individuals and RPEs may not remove trades or businesses aggregated by a lower-tier RPE, but may aggregate additional trades or businesses with the lower-tier RPE's aggregation if the aggregation rules are otherwise satisfied
- Even if an RPE itself does not aggregate, multiple owners need not aggregate in the same manner
- If an RPE aggregates, it must compute and report QBI, W-2 Wages, and UBIA of qualified property for the aggregated trades or businesses



Section 199A – Aggregation (Cont'd)

- An individual or RPE that chooses to aggregate must consistently report the aggregated trades or businesses in all subsequent taxable years
 - A failure to aggregate is not considered to be an aggregation for purposes of this rule
 - An individual or RPE that fails to aggregate may not aggregate on an amended return (other than for the 2018 taxable year)
 - An individual or RPE may add a newly-created or newly-acquired (including through non-recognition transactions) trades or businesses to an existing aggregated trades or businesses

Questions?

Thank You



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- Morgan's practice focuses on federal and international income tax, specifically on the private equity arena and pass-throughs.
- Morgan advises clients on federal and international income tax and private equity matters. Her practice includes advising on mergers, acquisitions, reorganizations, dispositions, capital markets, and restructurings. She is also involved in the formation of private equity and hedge funds.
- Morgan is an adjunct tax professor at Temple University Beasley School of Law, Vice-Chair of the Partnership Committee of the Tax Section of the American Bar Association, and treasurer of the Philadelphia Tax Conference.



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