Tax Reform:
Section 199A Update

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Agenda

1. Section 199A Overview Refresh
2. Trade or Business Determination
3. Utilizing W-2 Wages
4. SSTB Planning
5. Aggregation and Reporting

Section 199A Overview Refresh

Section 199A – Overview:

- Provides a deduction of up to 20% from passthrough income
    - Individuals and some trusts and estates are allowed to take a deduction of up to 20% of income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate
    - Excludes passthrough income from a specified service trade or business (SSTB) – unless under taxable income thresholds
- Subject to a limit on the aggregate Section 199A deduction = 20% of taxable income in excess of net capital gains

C corporations are not entitled to the Section 199A deduction

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Section 199A – Overview:

- For taxpayers whose income exceeds certain thresholds, the deduction is limited to the lesser of:
  - 20% of Qualified Business Income **(QBI)**, or
  - Greater of:
    - 50% of the total W-2 wages paid by the business **(W-2 wage limitation)**, or
    - Sum of 2.5% of unadjusted basis immediately after acquisition (UBIA) of qualified property plus 25% of W-2 wages **(UBIA of qualified property limitation)**

For 2019, the phase in for W-2 wage limitation and UBIA of qualified property limitations begins when taxable income exceeds $321,400 for married filing joint returns, $160,725 for married filing separate returns, and $160,700 for other taxpayers

Section 199A – Overview:

- Individuals and some trusts and estates are also allowed a deduction of up to 20% of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, including qualified REIT dividends and qualified PTP income earned through passthrough entities.

This component is not subject to W-2 wages or UBIA of qualified property limitations.

Special Rules

- The Section 199A deduction does not
  - Affect a partner's outside basis in its partnerships interest or a shareholder's basis in stock or the accumulated adjustments account of S corporation.
  - Reduce AGI.
  - Reduce net earnings from self-employment under section 1402 or net investment income under section 1411.
    - Each should be calculated as if there is no section 199A deduction.
  - Result in individuals being subject to AMT.
    - The deduction is the same for both regular tax and AMT purposes.

Special Rules (cont'd)

Previously disallowed losses and net operating losses

- Generally, previously disallowed losses or deductions allowed in the taxable year are taken into account for computing QBI (incl. sec. 465, 469, 704(d) and 1366(d))
    - Losses shall be used in order from the oldest to the most recent on FIFO basis
    - Disallowed, suspended, limited, or carried over losses or deductions from taxable years ending before January 1, 2018 are not taken into account for computing QBI
- Generally, net operating loss deduction under sec. 172 is not considered with respect to a trade or business and therefore, not taken into account for computing QBI
    - Excess business loss under sec. 461(l) is taken into account for computing QBI in the subsequent taxable year in which it is deducted

Trade or Business Determination

Trade or Business - Overview

- Final regulations define trade or business as a trade or business under section 162 other than the trade or business of performing services as an employee
    - Definition contains a special rule for renting property to a related person
- Section 162(a) permits a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business

- **Numerous questions arose after the issuance of proposed regulations:**
    - Can rental real estate rise to the level of a section 162 trade or business?
        - If not, are there alternatives for rental real estate to qualify for the section 199A deduction?

Trade or Business – Overview (cntd.)

Three Main Considerations For Rental Real Estate to Qualify for the Section 199A Deduction

1) Is the rental real estate considered a trade or business under ***section 162***?
2) If not, does the ***special rule*** in the Section 199A trade or business definition apply?
3) If neither 1 or 2 apply, does the rental real estate meet the ***safe harbor*** requirements under Rev. Proc. 2019-38?
    - Failing the safe harbor doesn't prevent a taxpayer or the IRS from otherwise proving the activity is a trade or business
    - May increase the time spent and level of detail to track and log information

Exploring Alternatives
Trade or Business Special Rule for Rental Property

Special Rule:

- Regulations extend the definition of trade or business to rental or licensing of tangible or intangible property (rental activity) that ***does not rise*** to the level of a section 162 trade or business but is nevertheless treated as a trade or business solely for purposes of section 199A, ***if the property is rented or licensed to a trade or business that is commonly controlled.***

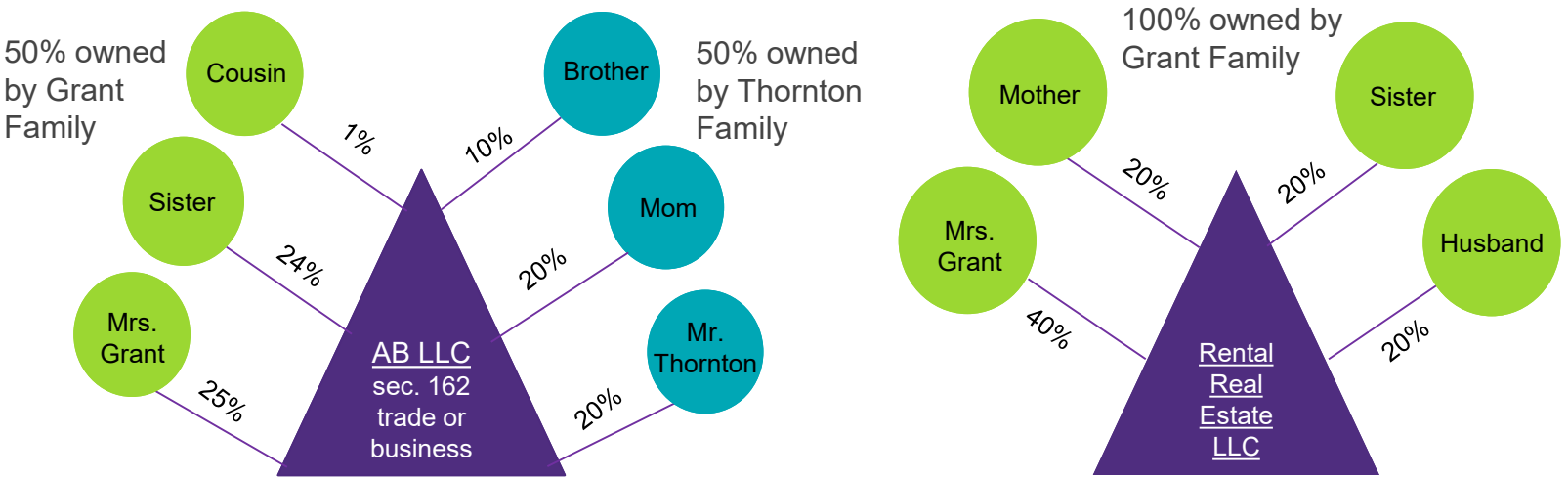
- **Commonly controlled test** – Same person or group of persons, owns 50 percent or more of each trade or business directly or by attribution under sections 267(b) and 707(b)
    - Family attribution includes brothers, sisters, spouse, ancestors, and lineal decedents

Trade or Business Special Rule
C-Corporation Example

Property rented to a C-Corporation is ***not eligible*** for the trade or business special rule

Trade or Business Special Rule

Common Ownership Example



Does Rental Real Estate LLC meet the common ownership requirement under the special rule qualifying the property as a trade or business for section 199A?

Exploring Alternatives
Trade or Business Rental Real Estate Safe Harbor

If the special rule does not apply can my rental real estate still qualify?

- In January 2019, the IRS released Notice 2019-07 which provides taxpayers the ability to treat rental real estate as a trade or business if several requirements are met
- On September 24th, 2019 the IRS issued Rev. Proc. 2019-38 finalizing the safe harbor requirements
    - If all the requirements are met, the rental real estate enterprise is treated as a single trade or business solely for purposes of Section 199A
    - Applies to taxable years ending after December 31, 2017
    - However, taxpayers and RPEs may rely on the safe harbor in Notice 2019-07 for the 2018 taxable year

Real estate rented or leased under a triple net lease is still not eligible for the safe harbor.

Exploring Alternatives
Trade or Business Rental Real Estate Safe Harbor

What is needed to qualify for the safe harbor?

- Four requirements must be met:
  - Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise
  - For rental real estate enterprises that have been in existence **less than four years**, 250 or more hours of rental services are performed (as described in Rev. Proc.) per year. For enterprises in existence **at least four years**, in any three of the five consecutive taxable years, 250 or more hours of rental services are performed
  - Contemporaneous records have been maintained, including time reports, logs, or similar documents *(Note: this requirement does not apply to taxable years beginning prior to January 1, 2020)*
  - The taxpayer or RPE attaches a statement to a timely filed original return for each taxable year they rely on the safe harbor. *(Rev. Proc. 2019-38 provides a list of required information that needs to be included on the statement)*

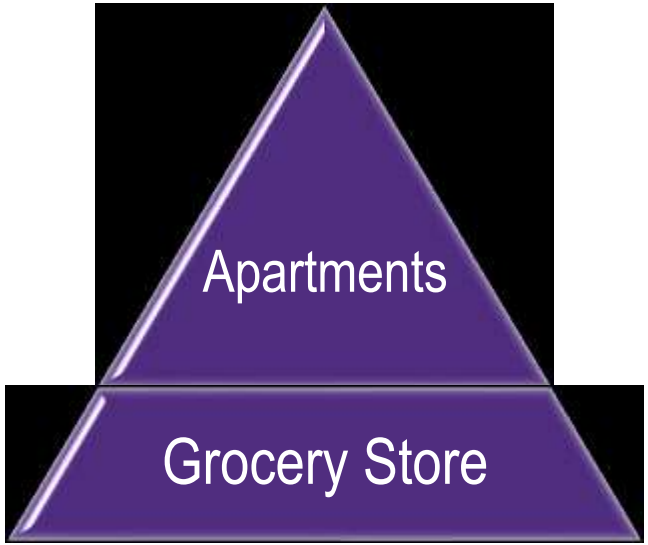
Exploring Alternatives
Trade or Business Rental Real Estate Safe Harbor

Rev. Proc. 2019-38 provides additional guidance

- Mixed-Use Property:
    - Generally, interests in multiple property can be treated as a single rental real estate **only** if they are part of the same rental real estate category – residential or commercial
    - In situations where a single property has **both** commercial and residential, an interest
        1) May be treated as a single enterprise and not combined with any other residential, commercial, or mixed-use property or
        2) May be bifurcated into separate residential and commercial interests

Rental Real Estate Safe Harbor
Mixed-Use Example

Building LLC



Building LLC is a single building that has a grocery store (commercial) located on the first floor and apartments (residential) on the second floor

Considerations:

- Would treating Building LLC as a single or separate RRE enterprises be more beneficial for the taxpayer?
- Any burdens in taking the separate RRE enterprise approach?
- Does either approach create issues in aggregating the RRE enterprise(s) with others?

Utilizing W-2 Wages

Utilizing W-2 Wages

- **Significance of allocations of W-2 Wages**
- If income exceeds certain thresholds the section 199A deduction is limited to the lesser of:
  - 20% of Qualified Business Income **(QBI)**, or
  - Greater of:
    - 50% of the total W-2 wages paid by the business, or
    - Sum of 2.5% of unadjusted basis immediately after acquisition (UBIA) of qualified property plus 25% of W-2 wages

- **A partner or S corporation shareholder of a trade or business with minimal wages may face sharp limits on the section 199A deduction attributable to that trade or business**

Utilizing W-2 Wages

Under section 199A, the W-2 wage limitation applies separately for each trade or business

- If W-2 wages are allocable to more than one trade or business, the portion of W-2 wages allocable to each trade or business is determined in same proportion as deductions associated with those wages.
- A partner or shareholder's share of W-2 wages paid by an RPE is determined in the same manner as its allocable share of wage expense.
    - As we will discuss in a moment, this determination can be more difficult where the RPE does not have a "wage" expense on its books

Utilizing W-2 Wages

Which business entity takes credit for a business's W-2 wages?

It is not uncommon for the payor listed on an employee's Form W-2 to be different from the entity for which the employee performs services.

- Professional employer organizations (PEO's)
- Common paymaster structures

- The proposed and final regulations provide that an individual or RPE may take into account any W-2 wages paid and reported by another person, provided that the W-2 wages were paid to its common law employees or officers of the person for employment by the individual or RPE.

The determination of which entity/trade or business takes into account an employee's W-2 wages depends on who is the common law employer of that employee

Utilizing W-2 Wages

Significance of the "common law" employer

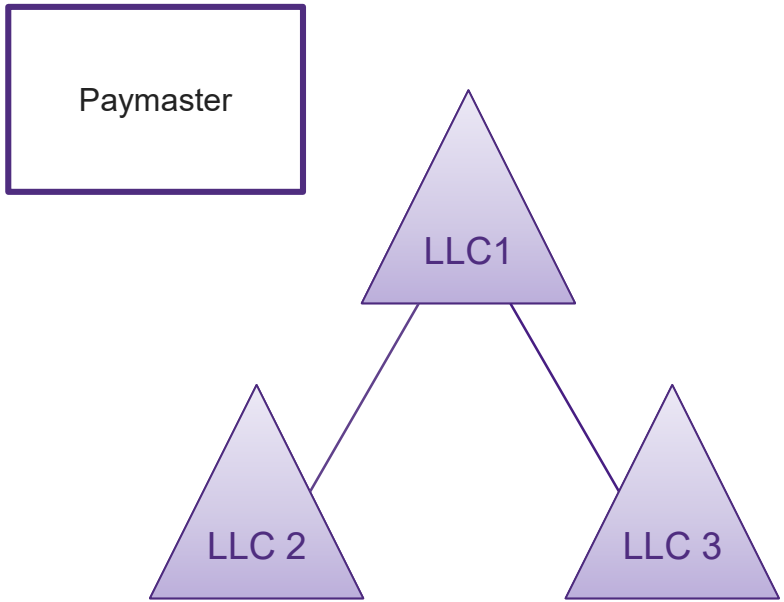
- The common law test for employee status is a facts and circumstances based determination
- The determination is made taking into account many factors, with an emphasis on who has "control" over the employee
- The section 199A regulations did not create a new test for determining employment…
    - However, prior to the enactment of Section 199A, this area was frequently overlooked by many taxpayers

The manner in which a workforce is deployed across a business structure can have a significant impact on how the business's W-2 wages are allocated for purposes of the section 199A deduction

Utilizing W-2 Wages

Example 1:

- LLC 1, LLC 2, and LLC 3 (the "**LLCs**") are related operating entities
- Paymaster issues paychecks/W-2s to individuals who perform services for the LLCs
- The cash that Paymaster uses to pay the employees comes from the LLCs



Potential issues:

- If the LLCs are the employers, their owners may include the employees' wages for section 199A purposes, notwithstanding that Paymaster actually issues the W-2s
- If Paymaster were found to be the employer, the LLCs' owners would not be able to use those wages, even though they benefit form those services

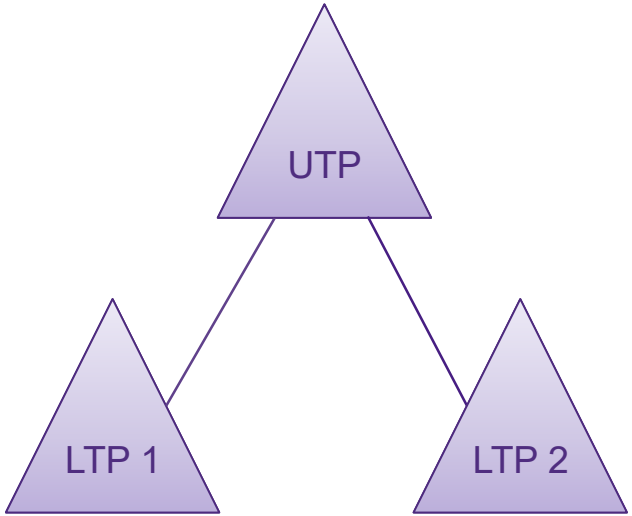
Utilizing W-2 Wages

Example 2:

- UTP issues paychecks/W-2s to individuals who perform services for all 3 entities
- UTP personnel provide management and administrative services for all three entities
- LTP 1 and LTP 2 pay UTP a management fee

Potential issues:

- If aggregation is possible, it may diminish the significance of where the W-2 wages are located (for some owners at least)
- If aggregation in **not** possible, are the administrative personnel solely the employees of UTP?
- If aggregation is **not** possible, can LTP 1 and 2 view the management fee as containing a “wages” component?
    - Or is UTP in the trade or business or providing management services?



SSTB Planning

Specified service trade or business planning
What is an SSTB?

‘Cliff’ rule makes SSTB designations very painful

If as little as 5% of gross receipts (10% if gross receipts are $25 million or less) is derived from the following trades or businesses, the entire trade or business is considered an SSTB and ineligible for the deduction:

SSTB list:

- Health
- Law
- Consulting
- Accounting
- Actuarial science
- Performing arts and athletics
- Financial and brokerage services, investing and investment management, and trading
- Any business where the principal asset is the reputation or skill of one or more employees or owners

Specified service trade or business planning
Opportunities to separate activities

Is there a silver lining?

Final regulations remove two anti-abuse rules from the proposed regs:

- ~~80% of property and services provided to a related SSTB, whole thing is an SSTB~~
- ~~Trade or business has less than 10% gross receipts of related SSTB, whole thing is SSTB~~

Just one anti-abuse rule left:

- Do not get deduction for providing goods and services to an SSTB with shared majority ownership

Bottom line:

If you have a truly separate qualifying trade or business from your SSTB, then you are eligible for the deduction on any third-party revenue. Only amounts for selling back to the SSTB will be disqualified

Specified service trade or business planning
What kinds of activities can be separated?

Many of the SSTB activities are defined narrowly

There are likely opportunities to carve out ancillary activities if there is third party revenue

EXAMPLES:

SSTB	Exclusions
Health	Drug or medical device sales
Law	Printing, delivery, stenography
Performing arts and Athletics	Broadcasting, concessions, arena or venue operation
Financial services	Bank lending and depository activities

Specified service trade or business planning
How do you separate activities?

Maintaining separate trades or businesses

It all comes back to the Sec. 162 determination. Whether one or more trades or businesses is a facts and circumstances. There is very little guidance in the regulations themselves, though the preamble includes slightly more information on how the IRS views the issue.

Important considerations

- Are separate legal entities feasible?
- What about separate books and records?
- Can these truly operate as separate businesses?
- How would this affect contracts and other business arrangements?
- Would the separate activity generate third-party revenue?

Aggregation and Reporting

Aggregation: Overview

- Trades or businesses (operated directly or through an RPE) are ***permitted*** to be aggregated by an ***individual*** or ***RPE*** if all of the requirements are met.
- **Requirements:**
    1. Must be a trade or business (“ToB”)
    2. ***50 percent or more common ownership***
    3. Common ownership exists for majority of year (incl. last day of taxable year)
    4. All ToB’s have same taxable year
    5. None of the ToB’s are SSTB’s
    6. Two of three “shared” factors are fulfilled
- **Purpose**: Intended to permit taxpayers over the income threshold to combine W-2 wages and UBIA of qualified property limitations in situations in which a unified business is conducted across multiple entities

Aggregation at the RPE Level: Opportunities and Considerations

Opportunities

- Provides flexibility to plan and optimize the Sec. 199A deduction
- Reduces the volume of information passed on to owners
- May benefit tiered structures
- Allows additional aggregation at the owner level

Considerations

- Will it be beneficial to all of my owners to aggregate at the RPE level?
    - Once the RPE aggregates, owners cannot disaggregate ToB's
- Who will have the responsibility of determining whether to aggregate?
    - RPE representative or partner/shareholder vote?
- Does the RPE have sufficient information to demonstrate the ability to aggregate?

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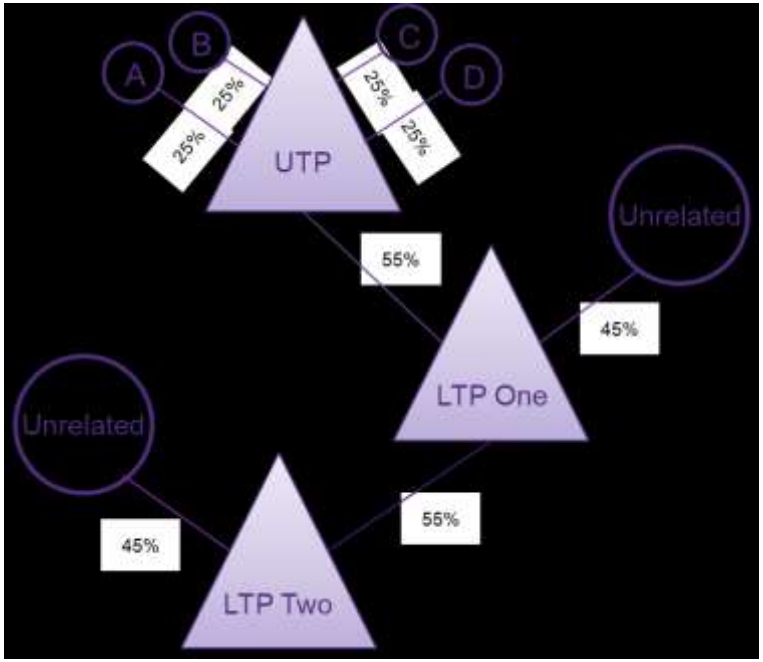
Aggregation at the RPE Level Tiered Structure Example



Consider:

- What information will UTP need to know to aggregate with LTP One or Two?
- Will UTP be able to obtain the necessary information?
- Could UTP owners benefit from not aggregating at the RPE level?

Aggregation at the Individual Level: Opportunities and Considerations

Opportunities

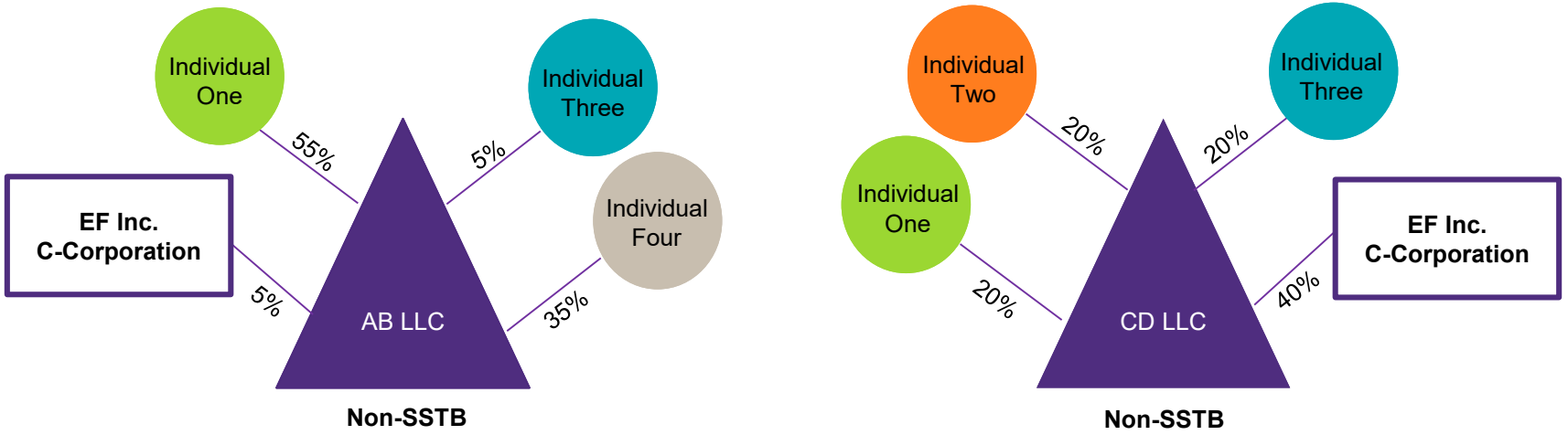
- Provides the taxpayer multiple ways to maximize the Sec. 199A deduction
- For purposes of Sec. 199A, the common ownership test was broadened
    - Siblings and C Corporations can now be included

Considerations

- Is it beneficial to aggregate eligible ToB's?
    - Owners should model their deduction out on both an aggregated and disaggregated basis
- How will the individual obtain sufficient information to demonstrate the ability to aggregate?
- How will minority owners know that the common ownership test was met?

Aggregation at the Individual Level: Common Ownership Example

In this example, assume Individual One and Two are siblings and all other aggregation requirements are met. Who is permitted to aggregate ToB AB LLC and ToB CD LLC?



Individual One and Individual Three would be permitted to aggregate ToB AB LLC and ToB CD LLC

Aggregation Reporting

RPE and Individual Required Annual Disclosure:

- Each taxable year a statement ***must*** be attached identifying each trade or business aggregated
- Statement must contain:
  - Description of each trade or business
  - Name and EIN of each entity for each trade or business
  - Information of any trade or business formed, acquired, ceased, or disposed of during the taxable year
  - Information identifying any aggregated trade or business of an RPE in which the individual/RPE holds an ownership interest
  - Other information as the Commissioner may require in forms, instructions and other published guidance
    - ***Schedule B – Aggregation of Business Operations***

Aggregation Reporting

Found in Publication 535 – Business Expenses

Schedule B—Aggregation of Business Operations *Keep for Your Records*

Aggregation:

1. Provide a description of the trade or business and an explanation of the factors met that allow the aggregation in accordance with Regulations section 1.199A-4. In addition, if you hold a direct or indirect interest in a relevant pass-through entity (RPE) that aggregates multiple trades or businesses you must attach a copy of the RPE's aggregations.

2. Has this trade or business aggregation changed from the prior year? This includes changes in the aggregation due to a trade or business being formed, acquired, disposed, or ceasing operations. If yes, explain.

3.

(a) Name of trade or business	(b) Taxpayer identification number	(c) Qualified business income/ (loss)	(d) W-2 wages	(e) Unadjusted basis immediately after acquisition

4. Totals. Total columns (c), (d),and (e). Enter the total amounts on Schedule C or Parts II and IV of Worksheet 12-A, as appropriate. See instructions .....

Note. If you have more than one aggregated group, attach additional Schedules B. Name the additional aggregations 2, 3, 4, and so forth.

Section 199A Reporting

Entity Level

- Schedule K-1
  - Line 20, codes Z-AD (1065)
  - Line 17, codes V-Z (1120-S)
  - Line 14, code I (1041)
- Report separately for each trade or business on attached statement
- Report Sec. 1231 gain/loss, Sec. 179 deduction separately
- Draft forms for 2019 indicate single code on K-1s for 1065 and 1120-S

Individual Level

- Form 1040, line 9
- For 2018, no separate forms
- Draft forms for 2019
  - Form 8995 (simplified)
  - Form 8995-A

Any final questions?

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