APPLIED KNOWLEDGE

Regulations clarify application of Section 199A deduction for service businesses

The deduction for up to 20% of qualified business income (QBI) of pass-through entities was created by the Tax Cuts and Jobs Act of 2017.[1] The deduction is designed to reduce the income taxes of pass-through business owners who do not benefit from the income tax rate reduction for C corporations, also included in that legislation. The deduction is applied at the individual level, so the availability of it depends in part on the individual business owner's **taxable income**.

Passthrough business owner's taxable income level	**Specified service business[2]**	**Nonservice business[3]**
Owner with 2022 taxable income **below threshold** ($340,100 married filing jointly, $170,050 single)[4]	Deduction is 20% of QBI[5]	Deduction is 20% of QBI[5]
Owner with 2020 taxable income **in phaseout range** ($340,100 - $440,100 married filing jointly, $170,050 - $220,050 single)	Entire deduction is subject to phaseout over the phaseout range	Part or all of deduction is phased out, depending on results of the wage/basis calculation amount[6]
Owner with taxable income **exceeding phaseout range** ($440,100 married filing jointly, $220,050 single)	No deduction	Deduction of the lesser of 20% of QBI[5] or a portion of the wage/basis calculation amount[6]

Treasury regulations[7] clarify a number of questions raised by Section 199A, including the definition of "service business," the calculation process, and the ability (or lack thereof) to aggregate, disaggregate, or split business interests to manage or maximize the deduction. Highlights of the regulations follow, but business owners are encouraged to consult with local counsel for detailed tax and legal advice.[8]

Service businesses

The most stringent limitations on the deduction are imposed on specified service trade or businesses (SSTBs, also referred to as "service businesses"). An SSTB is a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services (see below), brokerage services, investing and investment management, trading, dealing in securities interests, partnership interests or commodities, and certain trades or businesses in which the principal asset is the reputation or skill of one or more of its employees.[9] Engineering and architecture are excluded from this definition.[10]

As shown in the chart above, no deduction is available for service business owners whose income is above the phaseout levels. Furthermore, the regulations include rules designed to prevent service business owners from splitting their business into several entities to take advantage of the deduction.[11] And, they prohibit the aggregation of service businesses with other businesses.[12]

The regulations attempt to clarify some issues around the SSTB definition:

- "Financial services" means the provision of financial services to clients, including "managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings, and raising financial capital." It includes "services provided by financial advisors, investment bankers, wealth planners, retirement advisors and other similar professionals."[13]
- "Brokerage services" includes "services provided by stockbrokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers."[14] (However, it appears likely that many insurance agents' services would otherwise meet the SSTB definition in the category of financial services.)
- For a trade or business in which only a small amount of services is specified service activity, a special de minimis rule may exclude it from being treated as a service business. If less than 10% of gross receipts are attributable to the performance of services, and gross receipts are $25 million or less, the trade or business will not be considered an SSTB.[15] Similarly, if less than 5% of gross receipts are attributable to the performance of services, and gross receipts are over $25 million, the trade or business will also not be considered an SSTB.[16]
- "Consulting" businesses are defined as those providing advice and counsel to clients to assist the client in achieving goals and solving problems (including advocacy and influencing government or governmental officials). Ancillary consulting services that are not separately purchased or billed do not constitute a trade or business in the field of consulting.[17]
- Businesses where the principal asset is the reputation or skill of one or more employees are defined very narrowly to encompass only businesses not otherwise covered by the other categories, and where income is received based directly on the skill or reputation of employees or owners. Examples include receiving income for endorsing products, licensing or receiving income for the use of the individual's name, likeness signature, voice or trademark, and receiving appearance fees or income, such as reality television performers, media hosts, etc.[18]

Aggregation and splitting issues

Owners of multiple trades or businesses can sometimes choose to aggregate the businesses for purposes of calculating the deduction.[19] For example, an owner of a chain of restaurants or stores might wish to aggregate them even though they are operated as separate entities.

For this purpose, service businesses may not be aggregated with other types of businesses.[20]

After the enactment of Section 199A, many commentators speculated about "splitting" businesses into service and nonservice entities to take advantage of the more favorable deduction rules for nonservice businesses.[21] The regulations anticipated, and are designed to prohibit, this practice by providing a special rule for service businesses: any trade or business that has 50% or more common ownership with an SSTB will, itself, be considered an SSTB to the extent of the property or services provided to the commonly owned SSTB.[22]

Other definitions relevant to the deduction

Qualified business income (QBI). The net amount of qualified items of income, gain, deduction and loss that are connected with the conduct of the qualified trade or business.[23] Investment items of capital gain or loss, dividends, and annuity income received by the business are excluded from this amount.[24] It also does not include reasonable compensation paid to the owner, or guaranteed payments to a partner, for services rendered.[25]

W-2 wages. Includes all wages paid by the business as taxable compensation, including the compensation to the owner, as well as elective deferrals (such as salary contributed to a 401(k) plan). Wages do not include owner distributions. An owner's share of W-2 wages is his or her share based on the partnership allocations, or on the pro rata share of the owner in an S corporation.[26]

Qualified property. For purposes of the basis calculation, generally the tangible property used in the trade or business that is depreciable, but has not reached the end of its depreciation recovery period.[27] (Basis, for this purpose, is referred to in the regulations as "UBIA," which stands for "unadjusted basis immediately after acquisition.")

Conclusions

The regulations provide a great deal of clarity on what types of trades or businesses constitute a service business. They make it clear that strategies to "split" a service business into service and nonservice components will not allow the owners to maximize the deduction.

Many additional details, such as the treatment of nonrecognition events (e.g., 1035 exchanges of qualified property) and the netting process of businesses with a zero (or negative) deduction and those generating higher deduction amounts, are beyond the scope of this article.

In many cases, the deduction will result in a lower income tax bill to owners. This can free up funds for other business needs, such as key person protection and benefits, or for personal planning needs.

[1] See IRC Sec. 199A. Pass-through entities potentially subject to the deduction include S corporations, partnerships, sole proprietorships, and LLCs that are taxed as one of these pass-through entity types. See Reg. §1.199A-1(b)(10). Certain trusts and estates that own shares of a pass-through entity can potentially be eligible for the deduction, but regulations include limitations designed to limit abuses. See Regs. §§1.199A-6(d), 1.643(f)-1.

[2] See the separate discussion of Service Businesses. Examples include accountants, attorneys, doctors and dentists.

[3] Examples include manufacturing, construction and retail businesses.

[4] For taxpayers below the threshold amounts, the wage and basis calculation and service business limitations are disregarded. See IRC Secs. 199A(b)(3)(A), 199A(d)(3)(A); Reg. §1.199A-1(c).

[5] The deduction under 199A (prior to reduction or phaseout) is limited to the lesser of 20% of the owner's allocable share of qualified business income (QBI) or 20% of the excess of the owner's taxable income over net capital gain. See IRC Sec. 199A(a).

[6] The wage/basis calculation amount determines the *greater of* the following two amounts: (a) 50% of the owner's allocable share of the W-2 wages of the business, or (b) 25% of the owner's allocable share of the W-2 wages of the business PLUS 2.5% of the owner's unadjusted basis (UBIA) of tangible business property that is eligible for depreciation and still within its depreciable period. IRC Sec. 199A(b)(2)(B)

[7] TD 9847, 84 Fed. Reg. 2952, February 8, 2019.

[8] The final regulations are effective for taxable years ending after February 8, 2019.

[9] See IRC Sec. 199A(d)(2); Reg. §1.199A-5(b). The regulations provide a comprehensive listing of these SSTBs, examples of each one, and additional rules for applying the Section 199A deduction to individuals working in SSTB trades or businesses.

[10] See IRC Sec. 199A(d)(2)(A).

[11] See Reg. §1.199A-5(c)(2).

[12] Reg. §1.199A-4(b)(iv).

[13] See Reg. §1.199A-5(b)(2)(ix).

[14] See Reg. §1.199A-5(b)(2)(x).

[15] See Reg. §1.199A-5(c)(1). This rule is applied *before* the aggregation rules of Reg. §1.199A-4.

[16] See Reg. §1.199A-5(c)(2).

[17] Reg. §1.199A-5(b)(2)(vii).

[18] See Reg. §1.199A-5(b)(2)(xiv).

[19] See Regs. §§1.199A-1(d)(2)(ii), 1,199A-4.

[20] See Reg. §1.199A-4(b)(iv).

[21] This strategy has been referred to by some commentators as "crack and pack."

[22] Reg. §1.199A-5(c)(2)(i).

[23] See Reg. §1.199A-3(b)(1). Qualified business income does not include qualified REIT dividends or qualified publicly traded partnership income, but those items are treated separately and may trigger the deduction separately. See IRC Secs. 199A(b)(1)(B), 199A(g); Reg. §1.199A-3(c). Qualified business income also does not include qualified cooperative dividends, but those are subject to separate treatment under IRC Sec. 199A(g).

[24] See Reg. §1.199A-3(b)(2(ii)

[25] See Reg. §1.199A-3(b)(2(ii)(H) and (I).

[26] See IRC Sec. 199A(b)(4); Reg. §1.199A-2(b).

[27] See IRC Sec. 199A(b)(6); Reg. §199A-2(c). The regulations refer to this unadjusted basis amount as "UBIA," which means "unadjusted basis immediately after acquisition."

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