NORTHERN TRUST

GUIDANCE FOR BUSINESS OWNERS: THE QUALIFIED BUSINESS INCOME DEDUCTION OPPORTUNITY

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Tax cuts and jobs — these are the cornerstones of the Tax Cuts and Jobs Act (the "Act"), signed into law in December, with the promise of guidance to come on the key provisions of the Act.

The cut in the corporate tax rate from 35% to 21% has proven to be a material benefit to businesses taxed separately as C-corporations. But the majority of business activity is not conducted in separately taxed corporations. Over 90% of businesses in the U.S. are not C-corporations but instead are passthrough businesses (including sole proprietorships, partnerships, and S-corporations).

To complement the cut in the corporate tax rate, the Act provides for a 20% qualified business income deduction for individuals, trusts and estates. But the operative word is not "business," "income" or "deduction," it is "qualified." How do we qualify for this new deduction? How can we achieve the tax cuts intended to spur economic growth and jobs?

New Internal Revenue Code Section 199A establishes numerous criteria to qualify for the deduction, and proposed regulations under this section have now been released. There is a 45-day comment period on the proposed regulations, then a scheduled public hearing.

The proposed regulations cover six key areas:

1. Operational rules and definitions: How does the deduction operate, and what is a trade or business?
2. Determination of W-2 wages and unadjusted basis immediately after acquisition of property: How are W-2 wage income and unadjusted asset basis determined?
3. Qualified business income and REIT dividends and publicly-traded partnership income: What income is (or is not) qualified business income?
4. Aggregation rules: How are businesses aggregated?
5. Specified service trade or business: What is a specified service trade or business, and how is the trade or business of performing services as an employee treated?
6. Special rules for relevant passthrough entities, trusts and estates: How are trusts, estates and beneficiaries treated?

The proposed regulations are intended to provide computational, definitional and anti-avoidance guidance. They do not answer all of our questions, but they are a good starting point.

SIX KEY AREAS FOR QUALIFYING FOR THE 20% DEDUCTION

1 Operational Rules

The 20% deduction is applied at the partner or shareholder level and does not affect basis in their interests or shares.

2 Determination of W-2 Wages and Basis

The 20% deduction is limited for higher income taxpayers, and the limitation is based on wages paid by the business and/or the basis of property used in the business.

3 Qualified Business Income

The 20% deduction is limited to qualified business income.

4 Aggregation Rules

Aggregation may increase the wage and basis limitation on the 20% deduction.

5 Specified Service Trade or Business

Higher income taxpayers cannot take the 20% deduction for income from a specified service trade or business.

6 Special Rules for Trusts and Estates

Trusts and estates are eligible for the 20% deduction.

THE PATH FORWARD

Changes to the proposed regulations are expected before they are adopted as final. In the meantime, the millions of affected taxpayers, and their advisors, may rely on the proposed regulations. Fortunately, we are not starting from scratch. The proposed regulations borrow heavily from existing regulations and guidance on related business topics. Beginning with the familiar helps flatten the learning curve.

Following is a high-level overview of key concepts in the proposed regulations. It does not address the special circumstances of real estate investment trusts or publicly traded partnerships. There is enough to cover at the core.

KEY CONSIDERATIONS

How Does the Deduction Operate and What Is a Trade or Business?

The logical starting points are the operating rules of the 20% deduction and understanding the meaning of trade or business for purposes of the deduction. That is precisely where the proposed regulations begin. The deduction is for *up to* 20% of qualified business income. It is limited for taxpayers with taxable income above a threshold amount based on the type of trade or business, the W-2 wages paid from the trade or business and/or the unadjusted basis immediately after acquisition of qualified property held for use in the trade or business. The 20% deduction is applied at the partner or shareholder level and does not affect a partner's or shareholder's basis in their interests or shares. It does not reduce net earnings from self-employment or net investment income. It also does not result in individuals being subject to the alternative minimum tax.

"Trade or business" is not defined in Section 199A, but a clear understanding of the meaning of the term is essential to the application of the 20% deduction. The proposed regulations look to the familiar to find meaning — Section 162 trade or business expenses and the law and guidance that have evolved in this context. The term "trade or business" is generally defined as an activity carried out with regularity for economic profit or for a livelihood. However, as is discussed in greater detail below, unlike Section 162, certain related rental or licensing of property is included. Furthermore, the trade or business of performing services as an employee is not a trade or business for purposes of the 20% deduction and the deduction is limited or fully phased out for taxpayers at higher taxable income levels in specified service trades or businesses.

How Are W-2 Wage Income and Unadjusted Asset Basis Determined?

If an individual's taxable income exceeds the threshold amount ($157,500 for single/married filing separately or $315,000 for married filing jointly, adjusted for inflation), the 20% deduction is generally limited to the greater of either (a) 50% of wages paid or (b) the sum of 25% of wages paid plus 2.5% of unadjusted basis immediately after acquisition of qualified property attributable to a trade or business ("UBIA"). The proposed regulations contain rules for the determination of W-2 wages and UBIA of qualified property.

The basic rule for wages follows the common law definition of an employee and asks whether the wages reported on a W-2 are for employment by the trade or business in question. For administrative simplicity, the Internal Revenue Service has proposed a method for determining wages that is based on Form W-2 reporting. But, it also has offered two alternative methods (the "modified Box 1 method" and the "tracking wages" method) which are more complicated but may provide a more accurate report of wages paid.

Finally, businesses may take into account wages reported on Forms W-2 issued by third parties such as professional employer organizations, but only if the wages were paid to employees of the business for employment by the business.

For UBIA, the Internal Revenue Service has not deviated much from existing tax rules. "Immediately after acquisition" refers to the date that the property is placed in service for depreciation purposes, and this makes sense because "qualified property" is property that must be used for the production of qualified business income and is necessarily used in the business. "Basis" means the basis as determined under Section 1012, which generally defines basis as cost. Accordingly, for purchased or produced qualified property, UBIA generally will be its cost under Section 1012 as of the date the property is placed in service. For qualified property contributed to a partnership or an S-corporation, the UBIA generally will be carryover basis in the hands of the contributor, adjusted for any gain recognized. For property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death. However, the proposed regulations do reduce the basis if the taxpayer used the property personally for any portion of the year.

What Income Is (Or Is Not) Qualified Business Income?

Qualified business income is defined as the "net amount of qualified items of income, gain, deduction, and loss attributable to any qualified trade or business of the taxpayer." It is helpful to contextualize this broad definition with specific examples:

Qualified Business Income (Eligible for the 20% Deduction)	Not Qualified Business Income (Not Eligible for the 20% Deduction)
Business income that is effectively connected with the conduct of a trade or business in the United States	Capital gain or loss
Interest income properly allocable to a trade or business, such as interest income received on accounts or notes receivable for services or goods provided	Interest income received on working capital, reserves, and similar accounts
	Dividends
	Certain items of Subpart F income earned through a controlled foreign corporation
	Annuity income not received in connection with a trade or business
	Wages, reasonable compensation and guaranteed payments

There are interesting questions about what constitutes qualified business income. For example, Section 1231 has favorable treatment for gains and losses from the sale of trade or business property. Gains are treated as long-term capital gains and losses are treated as ordinary losses. For purposes of the qualified business income definition, is Section 1231 gain excluded from qualified business income? Unfortunately, the proposed regulations answer in the affirmative. Section 1231 capital gains are not included in qualified business income, but Section 1231 ordinary losses reduce qualified business income. Although this is not optimal for a taxpayer who wants to maximize the 20% deduction, it is logical that the definition of qualified business income follows the Section 1231 treatment of gains from the sale of business property.

Also, Section 751 generally provides that, if a partner sells its partnership interest, any gain will be ordinary income (and not capital gain) to the extent that the partnership itself has unrealized receivables or inventory (often referred to as "hot assets"). The proposed regulations follow this treatment, so the ordinary income portion of gain from the sale of a partnership interest can be considered qualified business income if the other requirements, such as the domestic business requirement, are met.

Qualified business income is required to be determined for each trade or business, before applying the aggregation rules under the proposed regulations.

How Are Businesses Aggregated?

A single business often consists of multiple entities, and there are good legal and economic reasons for structuring a business this way. When it comes to the definition of a "trade or business" for purposes of the 20% deduction, there is a question as to whether trades or businesses should be permitted or required to be aggregated or disaggregated, and if so, whether the aggregation or disaggregation should occur at the entity level or the individual level.

Aggregation is generally taxpayer favorable because the 20% deduction is limited by the W-2 wages paid and/or the unadjusted basis of property used in the trade or business. Aggregation allows taxpayers to combine the wages and basis of property of multiple businesses, which potentially increases the deduction. The preamble to the proposed regulations acknowledges that if aggregation were not permitted, taxpayers could be forced to incur costs to restructure solely for tax purposes. Also, restructuring could be difficult or even impossible for legal or business reasons. Thus, aggregation is permissible, but not required, under the proposed regulations.

An individual may aggregate trades or businesses only if the following conditions are met:

- Each trade or business must itself be a trade or business (generally as defined under Section 162);
- The same person, or group of persons, must directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income;

- None of the aggregated trades or businesses can be a specified service trade or business; and
- The individual must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors include: (1) the businesses provide products and services that are the same (for example, a restaurant and a food truck) or they provide products and services that are customarily provided together (for example, a gas station and a car wash); (2) the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (3) the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies).

Each passthrough entity must report the qualified business income, W-2 wages, and unadjusted basis of qualified property that is attributable to its trades or businesses to its owners. This is particularly relevant in a tiered-entity scenario. There is no ability to aggregate for reporting purposes.

The proposed regulations require that, once an individual aggregates multiple businesses into a single business, he or she must continue to aggregate unless and until circumstances change and aggregation is no longer allowed.

What Is a Specified Service Trade or Business and How Is the Trade or Business of Performing Services as an Employee Treated?

There has been much anxiety around the limits on the 20% deduction for specified service trades or businesses and the status of employees. The list of specified service businesses for which the deduction is limited or entirely phased-out for taxpayers with higher levels of taxable income includes: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, dealing in securities, partnership interests or commodities and any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. It does not include engineers or architects. There are subtle distinctions within these broad service categories and the proposed regulations provide useful guidance:

Service Area	Includes	Does Not Include
Health	Medical services provided by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and similar health care professionals directly to a patient	• Operating health clubs or spas • Processing payments • Pharmaceuticals or medical services research, testing and manufacture or sales
Law	Services provided by individuals such as lawyers, paralegals, legal arbitrators, mediators and similar professionals	Providing printing, delivery or stenography services

Service Area	Includes	Does Not Include
Accounting	Services by accountants, enrolled agents, return preparers, financial auditors and similar professionals	
Actuarial science	Services provided by actuaries and similar professionals	
Performing arts	Services performed by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors and similar professionals	• Maintaining and operating equipment or facilities for use in the performing arts • Services provided by persons who broadcast or otherwise disseminate video or audio of performing arts to the public
Consulting	Professional advice and counsel provided to clients to assist the client in achieving goals and solving problems, including specifically advocacy with the intention of influencing decisions or legislation on behalf of a client by lobbyists and similar professionals	• Sales or economically similar services • Training or educational courses • Embedded or ancillary services related to a non-service business (for example, construction) with no separate payment for consulting
Athletics	Services provided by individuals who participate in athletic competition such as athletes, coaches and team managers	• Services provided that do not require the skills unique to athletic competition • Maintaining and operating athletic facilities or equipment • Broadcasting or dissemination of video or audio of athletic events to the public
Financial services	Financial services provided to clients including managing wealth, advising clients with respect to finances, developing retirement or wealth transition plans, the provision of advisory and similar services regarding valuations, mergers, acquisitions, dispositions, restructurings, raising capital by underwriting or acting as a client's agent in the issuance of securities and similar services. Includes services by: • financial advisors, • investment bankers, • wealth planners, • retirement advisors, and • other similar professionals	

Service Area	Includes	Does Not Include
Investing and investment management	Providing investing, asset management or investment management services for a fee	Directly managing real property
Brokerage services	Services in which a person arranges transactions between a buyer and seller with respect to securities for a commission or a fee, including services by stock brokers and other similar professionals	Services provided by: • real estate agents and brokers • insurance agents and brokers
Trading	Trading in securities, commodities or partnership interests, whether for one's own account or for others	Taxpayers, such as manufacturers or farmers, who engage in hedging transactions as part of their business
Dealing in securities, commodities or partnership interests	Regularly purchasing or selling securities, commodities or partnership interests or offering to enter into, assign or otherwise terminate positions in securities, commodities or partnership interests with customers in the ordinary course of business	Originating loans in the ordinary course of business or the business of making loans, but engaging in no more than negligible sales of loans
Trade or business where principal asset is reputation or skill	• Trade or business in which a person receives fees, compensation or other income for endorsing products or services • Trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark or other symbol associated with an individual's identity • Receiving fees, compensation or other income for appearing at an event or on radio, television or another media format	

The proposed regulations provide helpful *de minimis* rules for specified service trades or businesses. If the gross receipts of the trade or business are $25 million or less for the taxable year and less than 10% of the gross receipts are attributable to the performance of what would otherwise be a specified service trade or business under the regulations, the business will not be treated as a specified trade or business, meaning that the 20% deduction will not be limited or eliminated by reason of the business having a service component. If the gross income is more than $25 million, the cap for the *de minimis* rule is lowered to 5% of gross receipts.

To thwart attempts to disaggregate associated service and non-service businesses to qualify the non-service business for the 20% deduction, the proposed regulations adopt various common ownership rules. For example, a specified service trade or business includes a trade or business that provides 80% or more of its property or services to a specified trade or business if there is 50% or more common ownership of the trades or businesses. The example in the regulations is a law firm partnership that provides legal services to clients, owns its office building and employs its administrative staff. Simply dividing the partnership into three partnerships — one that provides legal services to clients, one that owns the real estate and one that employs the administrative staff — all with the same partners, will not circumvent the limitations on the 20% deduction for income from specified service businesses for the partnerships owning the real estate and employing the staff.

The trade or business of performing services as an employee is not a qualified trade or business. The proposed regulations anticipate efforts by employees to qualify for the deduction by changing their status to that of an independent contractor. The proposed regulations combat this tactic by using a presumption. Solely for purposes of the 20% deduction, if a person was formerly properly treated as an employee, their status changes to that of independent contractor and they continue to perform substantially the same services for their former employer, those services will be presumed to be performed as an employee (and the income will not qualify for the 20% deduction).

How Are Trusts, Estates and Beneficiaries Treated?

Families often own their businesses through trusts. Thus, we were particularly interested to see the guidance under the proposed regulations related to the application of the 20% deduction to trusts, decedent's estates and beneficiaries. At what level will the applicable thresholds limiting the deduction be applied and how will allocations be made?

For what is commonly referred to as a grantor trust, all items of income, deduction or credit are taxed to the grantor or other owner under the long-standing grantor trust rules. The trust will be disregarded and the provisions of Section 199A and the proposed regulations will be applied at the grantor (or other owner) level. This treatment will apply to an electing qualifying subchapter S trust (QSST).

For non-grantor trusts and estates, whether taxable income exceeds the threshold amount, for purposes of determining whether limitations on the 20% deduction apply, is determined at the trust or estate level before taking into account any distribution deduction. The threshold is $157,500 in 2018 and will be adjusted for inflation thereafter. The proposed regulations include anti-avoidance provisions to deter the division of a single trust into multiple separate trusts to circumvent the threshold. Separate trusts formed or funded with a significant purpose of receiving the 20% deduction will not be respected; they will be aggregated for tax purposes. The trust aggregation rule is operative where the trusts have substantially the same grantor(s) and substantially the same primary beneficiary(ies) and if a principal purpose of establishing the trusts or contributing additional cash or property to the trusts is the avoidance of Federal income tax. Spouses are treated as one person for purposes of these rules.

For non-grantor trusts and estates, after the threshold is applied at the trust or estate level, the tax treatment is a bit more complicated. Recall that a non-grantor trust and an estate is a separate taxpayer. In order to avoid duplication of taxes, there is an allocation of income and deductions between a trust or estate and its beneficiaries. Income that is accumulated is taxed to the trust or estate and income that is distributed is, broadly speaking, taxed to the beneficiaries. The trust or estate receives a distribution deduction that corresponds to the income distributed and that is taxed to the beneficiaries. For purposes of the 20% deduction, a trust or estate must calculate its qualified business income, W-2 wage income and any UBIA and allocate those items between itself and its beneficiaries based on how its income was allocated. The proposed regulations include detailed examples of computation of the 20% deduction for a non-grantor trust, the allocation of the deduction between a trust and its beneficiaries and the aggregation of multiple trusts.

NEXT STEPS

The proposed regulations provide welcome, but incomplete, guidance for taxpayers who may be eligible for the 20% deduction. The Internal Revenue Service and the Treasury Department estimate that the gross (not net) change in the annual tax reporting burden associated with the proposed regulations is 25 million hours annually. These provisions do not simplify tax reporting. It will take time and effort to achieve the benefit for a qualifying business and its owners. One irony is that the 20% deduction is scheduled to expire December 31, 2025. The changes in the corporate income tax rates are not, however, scheduled to expire. We will continue to follow developments in this area.

FOR MORE INFORMATION

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