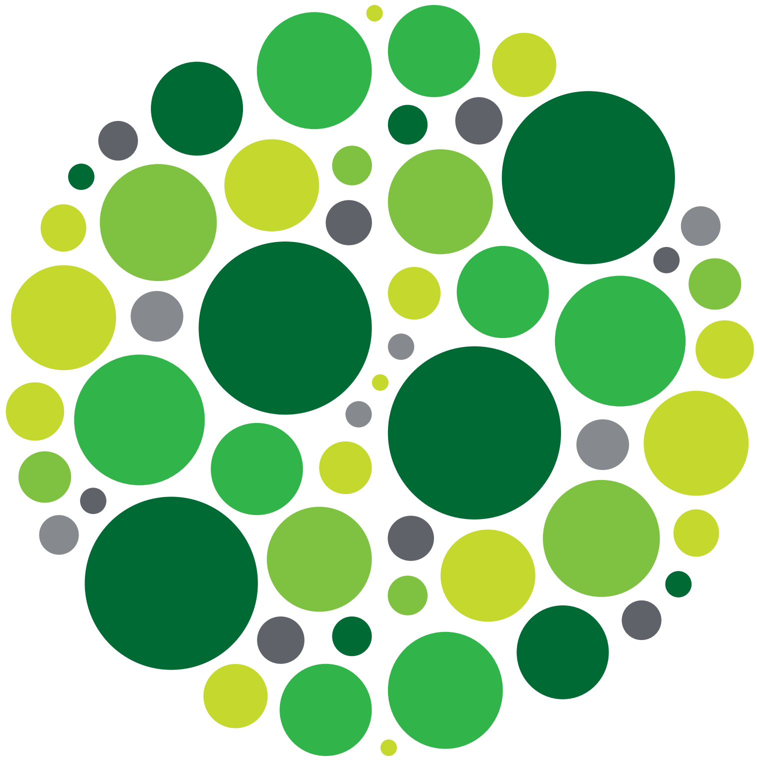
Deloitte.
Private

February 2019



Section 199A
Elusive new pass-through tax deduction demands an early start

Tax season may begin early this year for pass-through businesses. That's because this is the first year individuals, estates, and trusts ("owners") that are owners of these pass-through businesses will be able to claim the pass-through (199A) deduction. The 2017 Tax Act (P.L.115-97) included this deduction to even the playing field with corporations that benefited from its significant cut in the corporate tax rate. The deduction is effective for tax years beginning in 2018 and is available for tax years beginning before December 31, 2025. It allows owners to deduct up to 20 percent of the domestic qualified business income earned by the business on the owner's tax return, subject to other significant limitations. The government issued final regulations for this deduction in February 2019.

But those who have started to address what's required to qualify for the deduction may be realizing that 199A is both a tax benefit and a compliance challenge. Unlike a simple reduction in a tax rate, which is clean and relatively easy to calculate, this deduction is complex. It requires multiple assessments and calculations, new information to be gathered and shared by each pass-through with its owners, and is subject to numerous significant limitations. The provision may also cause some business owners to consider changes in the way some businesses are structured so as to be positioned to better benefit from this provision.

In short, the compliance burden is both complex and mandatory—all pass-through entities must now provide this critical information to their owners on a going-forward basis. Even at a basic level, those who want to claim the deduction must be able to answer three principal questions.

1. Is the trade or business a QTB or an SSTB?

The information needed to calculate the deduction is not based on the legal entity, but rather on a trade or business level. Every company must first determine whether they have trades or businesses and then determine whether each is deemed a qualified trade or business (QTB) or a specified service trade or business (SSTB).

The distinction is important because the new deduction applies only to qualified business income earned by a QTB. Outside of a few specific examples, section 199A defines a QTB by explaining what it's not. Effectively, every trade or business qualifies unless they are SSTBs or services performed as an employee rather than a business.

An SSTB, on the other hand, is any business involved in the fields of health, law, accounting, consulting, performing arts, trading, financial services, and a handful of others. An SSTB is also determined to be any business in which the principal asset is the "reputation or skill" of one or more of its employees or owners. Just because a business is an SSTB doesn't mean the reporting for it isn't necessary, because the income it generates could still result in a benefit at the owners' level if their income is below certain threshold amounts.

The more underlying trades or businesses an organization has, the more challenging it may be to gather the necessary and relevant data for its owners, and it may even require some planning considerations to the extent that the taxpayer has QTB and SSTB activity as part of the same trade or business.

2. What income qualifies?

What makes this particularly burdensome on companies is the need to capture specific information from every trade or business in order to calculate the 199A deduction.

Every pass-through must determine the qualified business income (QBI) from each underlying trade or business. Income that qualifies generally includes qualified items of income or loss with respect to each QTB, so long as they aren't disallowed or suspended under other rules and are effectively connected with the conduct of a domestic QTB. Income that doesn't qualify includes that from capital gains, dividends, net gains from foreign currency, and certain interest and other items listed under the law.

Finally, there's the allocation of expenses. This is another challenge, as the current rules don't define how to go about this but instead allow for any "reasonable" method. Once a method is chosen, there is no going back. The final regulations clearly state that taxpayers must consistently apply the chosen reasonable method for each item in all subsequent years. That means they need to think critically about—and plan around—the approach they want to use for allocating expenses as part of the 2018 tax return process.

Once these calculations are done for every QTB and SSTB, this information is then shared with each owner as part of the tax return process.

3. What income can be deducted?

After this information is shared, each owner of the business must determine the amount they can deduct. At this point, they might be tempted to just take 20 percent of the qualified income to claim as the deduction. Not so fast. Even after all of this work, the amount of the deduction may be further limited by wage and property considerations.

These limitations include a number of "greater of" calculations involving W-2 wages and the unadjusted basis immediately after acquisition (UBIA) of property used by the trade or business. Those calculations require a lot more than simply pulling a number from payroll or depreciation reports. Rather, they involve one of three permissible methods for the W-2 wage limitation and several manual adjustments for UBIA.

As the pass-through deduction is calculated at the owners' level, the pass-through entities won't always know what limitation would be most beneficial to the individual or trust. As a result, both W-2 wages and UBIA may need to be reported to provide the owners with all of the information required to calculate the pass-through deduction at their level. Under the final regulations, if a pass-through fails to report an item of QBI, wages, or UBIA, the unreported item will be presumed to be zero.

In addition, there's the issue of aggregation. Owners will need to assess whether to aggregate activity of qualifying yet related trades or businesses. If two or more trades or businesses meet certain qualifications, their respective section 199A activity can be aggregated to enhance the benefit of the deduction. The rules provide that either the pass-through entity or its individual owners can elect to aggregate separate trades or businesses. If the pass-through entity aggregates certain trades or businesses, the owners of these entities retain the entity aggregation. Like the expense methodology above, the choice to aggregate is locked in once it's made, since once a decision to aggregate is made, one must consistently report the aggregated trades or businesses in all subsequent taxable years. This puts pressure upon the businesses and its individual owners to exercise foresight when deciding to make the election.

Start now

Pass-through businesses should immediately start assessing the business and financial information necessary to answer the questions above. The many complexities involved with the new pass-through deduction, from both an accounting and planning perspective, mean that treating this tax season as any other may, at the least, limit the benefits of the deduction, and, at the worst, push pass-throughs into decision making that may have unintended, negative long-term implications.

This is a new compliance burden unlike any other faced by pass-throughs, and tax teams should get a jump start to respond to these potentially rewarding, but exacting new requirements.

Contact us

Wolfe Tone
Partner | Deloitte Private
Deloitte Tax LLP
wtone@deloitte.com

Fiona Chambers
Partner | Deloitte Private
Deloitte Tax LLP
fchambers@deloitte.com