IRS Proposed Section 199A Regulations would Limit use of "Crack and Pack" Planning

By David Hochman, Shareholder

Section 199A was added to the Internal Revenue Code by The Tax Cuts and Jobs Act ("TCJA"), enacted in December 2017. It provides taxpayers, other than corporations, with an income tax deduction of up to 20% of Qualified Business Income [1] from flow-through entities such as S corporations, LLCs, partnerships and sole proprietorships, but limits the ability of professionals engaged in a Specified Trade or Business or "SSTB" to take advantage of this new deduction. Proposed regulations issued by the on IRS August 8, 2018, provide guidance on the application of these rules.

A Specified Trade or Business or SSTB is a trade or business providing services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial and brokerage services, investing and investment management, trading or dealing in securities, partnership interests and commodities, and a trade or business in which the principal asset is the skill or reputation of one or more employees or owners. The regulations broadly define the performance of services in the field of health to include not only the performance of services by physicians and dentists, but also the performance of services by nurses, veterinarians, physical therapists, psychologists and similar health care professionals who provide services directly to a patient. A taxpayer who is an owner of a flow-through entity that is an SSTB is treated as being engaged in an SSTB, without regard to his actual participation in the trade or business.

The Section 199A deduction for Qualified Business Income from an SSTB is fully available to non-corporate taxpayers whose taxable income does not exceed $157,500 (or $315,000 for married taxpayers filing jointly). The deduction is phased out for taxpayers with taxable income between $157,500 and $207,500 ($315,000 and $415,000 for married taxpayers filing a joint return). For example, a single taxpayer engaged in an SSTB whose taxable income is $182,500 would be eligible for 50% of the otherwise permitted Section 199A deduction. Taxpayers whose taxable income exceeds $207,500 ($415,000 for married taxpayers filing jointly) are not eligible for any deduction under Section 199A for income from their SSTB. If an SSTB is conducted via a flow-through entity, such as an LLC, the eligibility for the Section 199A deduction is determined at the taxpayer level, not the entity level. Accordingly, it is possible that the ability of owners of a flow-through entity that is an SSTB to take a Section 199A deduction will vary because of differences in their taxable income.

Crack and Pack

One strategy intended to salvage the Section 199A deduction for high-income taxpayers engaged in an SSTB has been dubbed "crack and pack." This planning would split off portions of an SSTB into a separate entity providing services that are not a Specified Service Trade or Business.

> Example: Dr. A is engaged in the practice of medicine as a sole proprietor. He is married and files a joint income tax return with his spouse. Dr. and Mrs. A's taxable income exceeds $415,000, which would make them ineligible to claim a Section 199A deduction based on that income. Dr. A creates a new S corporation ("Admin Corp") that contracts with his medical practice to provide the practice with various administrative services and personnel (other than physicians and other licensed health care providers).

Prior to the issuance of the proposed regulations, many commentators suggested that the taxable income received by Dr. A from Admin Corp would be eligible for the Section 199A deduction because it would not be received from an SSTB. However, that would not be the case under the proposed regulations. A trade or business that has 50% or

[1] Qualified Business Income, or "QBI," is net income from a qualified trade or business. A qualified trade or business includes all businesses. However, no portion of the income from the business of performing services as an employee constitutes QBI. The Section 199A deduction for QBI is limited to the greater of: 50% of the W-2 wages with respect to the qualified trade or business; or the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of depreciable tangible property. The deduction may not exceed the taxpayer's taxable income in excess of net capital gains.

more common ownership with an SSTB and provides 80% or more of its services or property to that SSTB (the "50/80 rule") is considered to be part of that SSTB, even though it is operated as a separate entity. Even if the separate entity provides less than 80% of its property or services to an SSTB, if the separate entity has 50% or more common ownership with one or more SSTBs, the income of the separate business is considered to be SSTB income. In the preceding example, under the proposed regulations, the income of Admin Corp taxable to Dr. A is treated as income from an SSTB and would not provide a deduction under Section 199A because Dr. and Mrs. A's taxable income exceeds $415,000.

While the crack and pack strategy would not be totally eliminated by the proposed regulations, its implementation is still possible, although more complicated.

1. In the preceding example, if Admin Corp is owned by the owners of three unrelated medical practices so that common ownership between each medical practice and Admin Corp is less than 50%, the income of Admin Corp taxable to its shareholders would be Qualified Business Income eligible for the Section 199A deduction.

2. Physicians who own the office building in which their practice is located may be able to obtain a Section 199A deduction for part of the rental income. In many cases, the office building is already owned by a flow-through entity (e.g., an LLC) owned by the same physicians who own the medical practice, and leased by the LLC to the medical practice. If the medical practice uses all of the office building, it will not meet the requirements of the 50/80 rule because of the common ownership and because more than 80% of the building is used by the medical practice. However, if the medical practice leases less than 80% of the office building (and the remainder is leased by an unrelated party), the income of the LLC for the portion of the building leased to the medical practice would be treated as income from an SSTB under the 50/80 rule. However, the balance of the net rental income would be QBI and qualify for the Section 199A deduction. There is no bar against the LLC that owns the medical office building owning another rental property. If the "80%" part of the 50/80 rule presents a problem because of the percentage of the medical building occupied by the medical practice, adding a second rental property to the LLC, which is occupied by parties who are unrelated to the medical practice and its owners, could provide a way to reduce the percentage of the LLC's property used by the medical practice to less than 80%. Physicians who own less than 50% of a separate entity that owns the office building in which their practice is located should be able to take the Section 199A deduction for the income from the building.

Converting an Employee to an Independent Contractor

Another strategy that has been suggested to generate Qualified Business Income is to change the relationship between an employer and employee by making someone who was an employee an independent contractor. The proposed regulations exclude income from the trade or business of being an employee as Qualified Business Income on which a Section 199A deduction could be claimed. However, fees for work performed as an independent contractor can qualify for the Section 199A deduction. The proposed regulations make this more difficult by creating a presumption that a person treated as an employee, for tax purposes, and who is subsequently treated as an independent contractor but provides services for the same person or entity will still be considered an employee of his former employer. The presumption may be rebutted only by demonstrating that under Federal tax law and regulations, the individual is performing services other than as an employee. For example, a lawyer who is an associate of a law firm terminates his employment with the firm and thereafter enters into an agreement with the law firm to perform the same legal services as an independent contractor. Under these assumed facts, the lawyer is presumed remain an employee of his old law firm and his income as an "independent contractor" is not eligible for the Section 199A deduction because it is derived from the trade or business of being an employee.

The *De Minimis* Exception

Prior to the issuance of the proposed regulations, there was a concern that a business that had only a small amount of income from services provided by an SSTB would, nevertheless, be treated as an SSTB. For example, an engineering firm also provides consulting services. While engineering is excluded from services that are an SSTB, consulting is not. The proposed regulations address this issue by providing a *de minimis* exception. A trade or business that provides services that are an SSTB (the "SSTB services") and that also provides non-SSTB services will not be treated as an SSTB if the gross receipts attributable to the SSTB services are less than 10% of its gross receipts. That threshold is reduced from 10% to 5% if the business has gross receipts in excess of $25,000,000. In

the foregoing example, if the gross receipts of the engineering firm are $10,000,000 and the income from the consulting services provided are less than $1,000,000, the engineering firm would not be an SSTB as a result of the consulting services.

The *de minimis* exception may provide an opportunity for professionals engaged in an SSTB to obtain a Section 199A deduction for non-SSTB income, without creating a separate entity, if the gross receipts from the non-SSTB are 5% or more of the total gross receipts of the entire trade or business. For example, a dermatology practice, operated as a single member LLC, has gross receipts of $9,000,000, of which $550,000 is from the sale of non-prescription skin care products. The same employees and office space are used for the medical services and the sale of skin care products. As the gross receipts from the sale of the skin care products are more than 5% of the total gross receipts of the dermatology practice, the income from the sale of the skin care products is not treated as part of the dermatology practice, which is an SSTB under the proposed regulations.

The IRS has scheduled a public hearing on the proposed regulations for October 16, 2018. The period for submitting written comments to the IRS on the proposed regulations ends September 30, 2018. As a result of the feedback that the IRS receives via the hearing and comment process, it is possible that the Section 199A regulations, when issued in final form, will differ from the proposed version in important ways. Until the final regulations are published, taxpayers may rely upon the proposed rules. However, taxpayers should be cautious in implementing planning with respect to Section 199A that is contrary to the proposed regulations.

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