

Anchin Alert

Anchin, Block & Anchin LLP
Accountants and Advisors



August 14, 2018

Proposed “Pass Through” Deduction Regulations - What does It mean for My Business?

The Pass Through deduction established as part of the Tax Cuts and Jobs Act (TCJA) allows sole proprietors and non-corporate owners of pass-through entities a maximum deduction up to 20% of their Qualified Business Income (QBI). The deduction is limited to the lesser of 20% of the QBI or the greater of 50% of the amount of wages paid to employees or 25% of wages paid to employees plus 2.5% of the unadjusted cost of qualified property. It may be further limited by taxable income at the taxpayer (individual) level.

On August 8, 2018, the Treasury released proposed regulations relating to the pass-through deduction. These regulations may be relied upon by taxpayers until final regulations are published.

The proposed regulations help clarify some of the ambiguities/questions that were inherent in the TCJA with respect to the new pass-through deduction. Taxpayers now have guidance to rely on to help maximize this deduction. Below are some of the key provisions that are contained within these regulations.

This alert will cover the following areas: Fiscal Year Entities, clarification of certain services that are not eligible for the pass-through deduction, trades or business operated through multiple entities, Wages, Qualified Property, and other considerations.

1. Question: My partnership or S-corporation is a fiscal year entity. Will my income for the entire year ending in 2018 be eligible for the pass-through deduction?

Answer: The proposed regulations clarify entities that have fiscal years ending in 2018 will include all of the income, wages and property when computing the pass-through deduction.

2. Question: Will my business qualify for the pass-through deduction?

Answer: Upon passage of the TCJA, there were many questions as to what types of trade or businesses would or would not qualify for the pass-through deductions. Trade or businesses involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees are not eligible for the pass through deduction. However, these trades or businesses will qualify for the pass-through deduction only if the taxable income does not exceed \$157,500 for taxpayers not filing jointly and \$315,000 for married taxpayers filing joint returns, plus phase out amounts of \$50,000/\$100,000 respectively. The proposed regulations clarify what these services are for purposes of the pass-through deduction.

a. *Consulting Services* means the professional advice and counsel to assist a client in achieving goals and solving their problems. The sale of consulting services embedded in or, ancillary to the sale of goods or performance of services on behalf of a trade or business that is not one enumerated above is not consulting for purposes of the pass through deduction.

b. *Financial Services* include services provided by financial advisors, investment bankers, wealth planners, retirement advisors and other similar professionals, but does not include taking deposits or making loans.

c. *Brokerage Services* include services in which a person arranges transactions between a buyer and seller with respect to securities for a commission or a fee. The term brokerage does not include real estate/insurance agents or brokers.

d. *Reputation or skill* of one or more employees or owners is considered to be capitalizing on the name, image or likeness of the individual's identity or other similar aspects, e.g. - paid endorsements or license fees with respect to that person's image.

e. *Investment management* services consist of investing and/or investment management as a trade or business that receives a commission, flat fee, or an investment fee calculated as a percentage of assets under management. The service of investing and investment management does not include directly managing real property.

Trades or businesses that include these services as part of their business will not be limited if less than 10% of their gross receipts are from these services as long as their gross income is less than \$25,000,000 or less than 5% of their gross receipts are from these services as long if their gross income is more than \$25,000,000.

3. Question: My business is operated through multiple entities. Will I be able to aggregate all of these entities when calculating the pass-through deduction?

Answer: The regulations allow individuals that operate their business through multiple entities the ability to aggregate entities for purposes of the 20% deduction, so long as it can be demonstrated that the same individual(s) own 50% or more of each trade or business for the majority of the taxable year, none of the businesses to be aggregated perform any of the services mention previously and meet 2 out of 3 of the following tests:

- i. Provide products or services that are the same or customarily offered together
- ii. Share facilities or significant centralized business functions (personnel, accounting, HR, IT, etc.)
- iii. Operations are coordinated/relied upon in one or more of the businesses within the group (e.g. supply chain interdependencies).

4. Question: Does the manner in how I pay wages or allocate the wages within the entity affect how my pass-through deduction will be calculated?

Answer: Yes, prior to the issuance of the regulations there was a concern that wages paid by a third party payer, e.g. - a PEO would not be allowed in calculating the pass-through deduction. The regulations allow taxpayers that utilize third party payers to compensate their employees to utilize these wages in calculation the pass through deduction. The regulations also indicate that entities involved in multiple trades or businesses must allocate wages to each trade or business in a reasonable method that should be maintained from year to year. Each pass-through entity must also report their wages allocable to each trade or business or they will be presumed to be zero.

5. Question: Are there any limitations on property for the 2.5% limitation that were clarified in the regulations?

Answer: The regulations also clarified that basis adjustments on the purchase or inheritance of a partnership interest would not be considered qualified property for purposes of calculating the pass through deduction.

The regulations also included guidance on how to calculate the qualified basis of property acquired in a like-kind exchange. The adjusted basis or net book value of the relinquished property in a like kind exchange will be used in calculating the 2.5% limitation of the deduction. Any additional basis acquired in the exchange will be a new asset that is qualified property. The exchange property will be deemed placed in service based on the date of when the relinquished property was first placed in service. The additional basis acquired in the exchange will

be deemed placed in service on the date the replacement property is acquired. If an election out of MACRS is made, the replacement date will apply to both the replacement property and excess basis property.

6. Question: Are there any other issues clarified in the regulations that may affect me?

Answer: The regulations also clarified the following open questions:

- a. Self-Employment Income is not reduced by the 20% pass-through deduction
- b. Net Investment Income is not reduced by the 20% pass-through deduction
- c. Alternative Minimum Tax Income is not adjusted for the 20% pass-through deduction
- d. Net Operating Losses (“NOL”) are not taken into account in computing QBI
- e. Gain from the sales of business property treated as capital gains will not be included in calculating QBI.

For more insight on these proposed regulations, please contact your Anchin Relationship Partner or a member of Anchin’s Tax Department.



Anchin, Block & Anchin LLP
Accountants and Advisors
212.840.3456 • www.anchin.com

