TABLE OF CONTENTS

SECTION 199A AND ITS APPLICATION TO PASS-THROUGH ENTITIES

1.1. Introduction

The Tax Cuts and Jobs Act ("TCJA") made significant changes to the Internal Revenue Code of 1986, as amended ("Code"). Two of the most significant changes made by the TCJA are the new deduction available to certain pass-through entities and sole proprietorships under Section 199A, as well as the reduction of the tax rate applicable to "C" corporations to a flat 21%.

This outline will examine the new deduction available to many pass-through entities and sole proprietorships, specifically including S corporations, both to so-called "qualified trades or businesses" and to "specified service trades or businesses." Additionally, the outline will discuss new terms used in Section 199A, as well as the many unanswered questions and open issues under Section 199A that are primarily attributable to the speed at which the TCJA was drafted, revised and passed into law, leaving little, if any, legislative history regarding the interpretation of Section 199A.

These unanswered questions and open issues have been left to be answered by the Internal Revenue Service ("IRS"), which after receiving substantial input from practitioners, industry groups and tax professional groups, including the American Bar Association Section of Taxation and the American Institute of Certified Public Accountants ("AICPA"), issued Proposed Regulations on Section 199A on August 8, 2018 (the "Proposed Section 199A Regulations"). Although many of the open issues and unanswered questions were addressed in the Proposed Section 199A Regulations, clarifications are still needed in a number of areas and comments on the Proposed Section 199A Regulations have already been made by some groups and will be forthcoming by many other groups, including the American Bar Association Section of Taxation.

Lastly, this outline will briefly discuss the effect Section 199A, as well as the reduction in the corporate tax rate to a flat 21%, could have on choice of entity decisions. First, some of the anomalies of Section 199A will be examined to demonstrate how Section 199A may apply differently to S corporations, partnerships and sole proprietorships under identical factual situations, thus affecting choice of entity just among those entities. The outline will also briefly look at the broader question of whether an entity should be operated as a pass-through entity versus a C corporation in light of the changes made by the TCJA.

1.2. Overview of the Proposed Section 199A Regulations

In General.

The Proposed Section 199A Regulations address computational, definitional and anti-abuse guidance and are generally favorable to taxpayers. The Proposed Regulations contain six substantive areas. The operational rules for application of Section 199A are set forth in Proposed Reg. § 1.199A-1, and provide guidance on the computation of the deduction for individuals with taxable income at, below, or above the threshold amount ($315,000 for married taxpayers filing jointly and $157,500 for other taxpayers), including application of Section 199A to taxpayers within the phase-in range above the threshold amount (between $315,000 and $415,000 for married taxpayers filing jointly and between $157,500 and $207,500 for other taxpayers). Once a taxpayer's taxable income exceeds the fully phased-in amounts ($415,000 for married taxpayers filing jointly and $207,500 for other taxpayers), the wage and capital limitations fully apply to owners of qualified trades or businesses ("QTBs"), and owners of specified service trades or businesses ("SSTBs") are not eligible for the Section 199A deduction at all.

In the event that an owner of a QTB is fully subject to the wage and capital limitations, those limitations provide that the 20% of QBI deduction shall be limited to the greater of (1) the taxpayer's allocable share of 50% of the W-2 wages of the QTB; or (2) the taxpayer's allocable share of 25% of the W-2 wages of the QTB plus 2.5% of the unadjusted basis immediately after acquisition of the "qualified property" used in such trade or business.

An individual's §199A deduction will in no case exceed 20% of the amount by which the individual's taxable income exceeds such individual's net capital gain for the taxable year. Prop. Reg. §1.199A-1(d)(i).

<u>Wages and UBIA of Qualified Property</u>.

Rules on determining W-2 wages and the unadjusted basis of qualified property ("UBIA") are set forth in Proposed Reg. § 1.199A-2. In conjunction with the release of the Proposed Regulations, the IRS also released Notice 2018-64, which provides for three methods for calculating W-2 wages (which are similar to the rules previously prescribed for determining W-2 wages under former Section 199 as set forth in Rev. Proc. 2006-22). Wages will generally be included in determining the wage and capital limitation of a QTB as long as the QTB is the common law employer of an employee, even if a different entity (such as a certified professional employer organization under Section 7705) issues the W-2 to the employee. This is very welcome guidance as any other interpretation would have likely resulted in costly business restructurings.

<u>QBI, Qualified Real Estate Investment Trust Dividends and Qualified Publicly Traded Partnership Income</u>.

Guidance on determining QBI, qualified real estate investment trust dividends, and qualified publicly traded partnership income is set forth in Proposed Reg. § 1.199A-3, and the IRS has requested comments on reasonable methods for allocation of items not clearly attributable to a single trade or business, and whether any safe harbors may be appropriate.

<u>Aggregation Rules</u>.

A new set of aggregation rules (surprisingly <u>not</u> the aggregation rules under Section 469 for passive activity losses which many commentators had requested be applied) are provided under Proposed Reg.§ 1.199A-4. Consequently, taxpayers will be permitted to aggregate separate trades or businesses (even if conducted in different legal entities), provided certain requirements are met.

<u>Specified Service Trades or Businesses</u>.

On the critical question of whether a business constitutes a QTB or SSTB, Proposed Reg. § 1.199A-5 sets forth definitions for the following enumerated professions: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. Proposed Reg. § 1.199A-5 also defines what constitutes investing and investment management, trading, and dealing in securities, partnership interests or commodities. For the most part, the Proposed

Regulations are taxpayer-friendly and side with the majority of commentators by narrowly defining what constitutes a SSTB.

Additionally, the Proposed Regulations take a very narrow view as to what is included as a SSTB where the principal asset of the business is the reputation or skill of one or more of its employees or owners.

RPEs, PTPs and Trusts and Estates.

Relevant pass-through entities ("RPEs"), publicly traded partnerships ("PTPs"), trusts and estates are addressed in Proposed Reg. § 1.199A-6. RPEs are a new term introduced by the Proposed Section 199A Regulations.

Anti-Abuse Rules

Although as stated above, the Proposed Section 199A Regulations are generally taxpayer-friendly, anti-abuse provisions largely prohibit the so-called "Crack-and-Pack" strategy, which involves spinning-off a portion of an SSTB to a separate entity so that the spun-off entity can claim the Section 199A deduction as a QTB. Additionally, Proposed Regulations under Section 643 crack down on the multiple-trust strategy, where multiple trusts are formed or funded with a significant purpose of receiving a deduction under Section 199A (and could be applied in a variety of other situations).

Fiscal Year Taxpayers

The Proposed Regulations also address how to treat income received from a fiscal-year pass-through when part of the income received by an individual is received before January 1, 2018. The Proposed Regulations allow an individual to take a deduction for all of the income received from a fiscal-year filer, which could include income earned by the pass-through entity in 2017.

Effective Dates

The rules under the Proposed Regulations generally apply to tax years ending after the date the Final Regulations are published, and the anti-abuse rules contained in the Proposed Regulations are proposed to apply to tax years ending after December 22, 2017. Additionally, the provisions of the Proposed Regulations under Section 643 to prevent abuse through the utilization of multiple trusts generally apply to tax years ending after the date the Proposed Regulations were published (August 8, 2018). A hearing on the Proposed Regulations is currently scheduled for October 16th.

1.3. Tax Rates

Ordinary Income Tax Rates

[a] The TCJA retains seven rate brackets, but changes five of the rates, including the top rate. Furthermore, the Act changes the thresholds for each bracket. The new rates are set forth below:

2017 Rates	TCJA Rates
10%	10%
15%	12%
25%	22%
28%	24%
33%	32%
35%	35%
39.6%	37%

[b] The top marginal rate applies to taxable income above $500,000 (up from $418,400) for single taxpayers and head of household filers and $600,000 (up from $470,700) for married individuals filing joint returns and surviving spouses.

Tax Rate on Qualified Business Income.

Assuming that a taxpayer can fully utilize the Section 199A deduction without being subject to any limitations, the maximum tax rate on the "Qualified Business Income" is 29.6%[1].

Capital Gain Tax Rates.

The capital gains tax rates of 0%, 15%, and 20% remain unchanged. However, the income levels at which the different rates apply are now indexed using Chained CPI-U.

Tax Rate on Qualified Dividends.

The maximum tax rate applicable to qualified dividends remains unchanged at 20%.

Reductions in Corporate Tax Rates.

[a] Effective for all tax years of a C corporation beginning after 12/31/17, all corporate taxable income will be subject to tax at a flat 21% rate.

[b] Previously, under Code § 11(b), corporations were taxed at a rate of (i) 15% on taxable income between $0 - $50,000; (ii) 25% on taxable income between $50,001 - $75,000; (iii) 34% on taxable income between $75,001 - $10,000,000; and (iv) 35% on taxable income in excess of $10,000,000.

[c] Unlike most of the other changes under the Act, this change is "permanent."

[1] $100 QBI x 20% deduction = $20. $80 ($100 - $20 QBI Deduction) x 37% = 29.6%.

Tax Rate on C Corporation Earnings Distributed to Shareholders.

The maximum marginal federal tax rate on a C corporation's income that is distributed (or deemed distributed), as a dividend to its shareholders is 36.8%[2], or in the event the 3.8% net investment income tax is applicable, will be 39.8%[3]. Additionally, the maximum marginal tax rate will be even higher in states such as Florida that impose state income taxes on C corporations but not on pass-through entities or individuals. Thus, the maximum marginal tax rate on a C corporation's income that is distributed or deemed distributed as a dividend to its shareholders in Florida will be 43.11%.

1.4. Choice of Entity Statistics.

Although LLCs have gained increasing popularity over the last decade, the number of entities taxed as S corporations still exceeds the number of entities taxed as partnerships for federal tax purposes, and it is projected to stay that way for the foreseeable future, as set forth in the table below published by the IRS (Document 6292, Office of Research, Analysis and Statistics, Fiscal Year Return Projections for the United States: 2018-2025, Rev. 6/2018):

Statistics Regarding Choice of Entity

	2017 (Actual)	**2019 (Projected)**	**2022 (Projected)**	**2025 (Projected)**
Form 1065	4,046,325	4,222,700	4,498,600	4,774,500
Form 1120S	4,842,706	4,988,300	5,275,000	5,590,900
Form 1120	1,649,386	1,677,200	1,623,100	1,571,900

This is the first table issued by the IRS since Congress passed the TCJA, and it was expected that there would be a large increase in the projected number of "C" corporations due to the dramatic decrease in the tax rate applicable to "C" corporations. Perhaps the Fall projections will be more reflective of this when they are issued in late September.

1.5. Deduction for Qualified Business Income of S Corporations, Partnerships, LLCs and Sole Proprietorships

Effective January 1, 2018, the Tax Act enacts new Code Section 199A which generally provides a deduction of 20% of the "Qualified Business Income" ("QBI") from an S corporation, partnership, LLC (taxed as a partnership) or a sole proprietorship. Although new Section 199A also provides rules for dividends from qualified real estate investment trusts, dividends from qualified cooperatives and

---

[2] $100.00 x 21% tax = $21 tax at corporate level. $79 ($100 - $21 corporate level tax) x 20% qualified dividend rate = $15.8. 21 + 15.8 = 36.8%.

[3] $100 x 21% = $21 tax at corporate level. $79 ($100 - $21 corporate level tax) x 23.8% = $18.80. 21 + 18.80 = 39.8%.

income from publicly traded partnerships, this outline will focus on the "QBI Component" of the deduction applicable for owners of S corporations, partnerships, LLCs and sole proprietorships. The driving force behind the TCJA (and the bulk of the tax savings) go to large publicly traded multi-national C corporations because of the reduction of the corporate tax rate to a flat 21%. Many industry groups and practitioners campaigned hard to achieve some parity for pass through entities and sole proprietorships in light of the huge rate reductions being given to C corporations in the TCJA. This is extremely important because pass through entities and sole proprietorships make up the largest number of entities in the U.S. far outnumbering C corporations, and employing approximately 57% of the work force. To make the playing field more level due to the tax cut from 35% to a flat 21% for C corporations, and to provide for "Main Street" businesses versus "Wall Street" businesses, Congress was pressured by these industry groups and practitioners into doing something for pass through entities and sole proprietorships. Although the House version contained a different tax break for pass through entities and sole proprietorships, the final version of the TCJA ended up being in the form of a deduction being generally equal to 20% of an owner's allocable share of the QBI of the entity.

In order to determine a taxpayer's QBI deduction, the taxpayer and practitioner must make their way through a maze of rules, limitations, thresholds, new defined terms, phased-ins and phased-outs of limitations, and a plethora of unanswered questions.

The Deduction in General. For taxable years beginning after December 31, 2017 and before January 1, 2026, taxpayers (including estates and trusts) other than corporations generally may deduct 20% of the QBI of an S corporation, partnership, LLC or a sole proprietorship **allocable** to such shareholder, partner, member or sole proprietor.

In order to obtain the full benefit of the deduction without being subject to the wage and capital limitations discussed below, the taxable income of the shareholder, partner, member or sole proprietor must be less than $157,500 or less than $315,000 in the case of a married taxpayer filing jointly (the "Threshold Amounts"). Consequently, a taxpayer receiving the full benefit of the deduction would see a reduction in such taxpayer's top marginal tax rate on QBI to 29.6% (37% top marginal individual tax rate x 20% = 7.4% deduction; 37% - 7.4% = 29.6%).

> *Example #1: Sole Proprietor (Single-Member LLC) In a Qualified Trade or Business with Taxable Income Less than Threshold Amount. Assume A is the sole owner of a qualified trade or business through a single-member disregarded LLC. The business has no employees and no substantial fixed assets. The QBI from the business is $200,000 and A's wife has taxable income of $100,000 so that their combined taxable income is $300,000.*
>
> *Because the taxable income of the taxpayer is below the Threshold Amount of $315,000 for married individuals filing jointly, A's deduction will be equal to $40,000 (20% x $200,000 of QBI).*

1.6. Operational Rules and Definitions

Overview. Proposed Reg. § 1.199A-1 provides operational rules for calculating the § 199A qualified business income deduction and provides a number of definitions that apply for purposes of § 199A and Proposed Reg. § 1.199A-1 through § 1.199A-6. For purposes of applying the rules of Proposed Reg. § 1.199A-1 through § 1.199A-6, the Proposed Regulations provide that a reference to an "individual" includes a reference to a trust (other than a grantor trust) or an estate to the extent that the § 199A deduction is determined by the trust or estate under the rules of Proposed Reg. § 1.199A-6.

Definitions. Proposed Regulations § 1.199A-1(b) sets forth a number of definitions under the Proposed Regulations.

[a] An aggregated trade or business means two or more businesses that have been aggregated pursuant to the aggregation rules of Proposed Reg. § 1.199A-4.

[b] The term Applicable Percentage means, with respect to any taxable year, 100% reduced (but not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the Threshold Amount, bears to $50,000 (or $100,000 in the case of a joint return).

[c] The term Phase-In Range means a range of taxable income, the lower limit of which is the Threshold Amount, and the upper limit of which is the Threshold Amount plus $50,000 (or $100,000 in the case of a joint return).

[d] The term Qualified Business Income ("QBI") means the net amount of qualified items of income, gain, deduction and loss with respect to any trade or business and is discussed in more detail below in connection with the provisions of Proposed Reg. § 1.199A-3(b).

[e] The term QBI Component means the amount determined under Proposed Reg. § 1.199A-1(d)(2). This outline will focus on the QBI Component.

[f] The term Qualified PTP Income is discussed in more detail below in connection with the provisions of Proposed Reg. § 1.199A-3(c)(3).

[g] The term Qualified REIT Dividends is discussed in more detail below in connection with the provisions of Proposed Reg. § 1.199A-3(c)(2).

[h] The term Reduction Amount means, with respect to any taxable year, the "excess amount" multiplied by the ratio that the taxable income of the individual for the taxable in excess of the Threshold Amount, bears to $50,000 (or $100,000 in the case of a joint return). In general, the excess amount is 20% of the QBI over the greater of 50% of W-2 wages or the sum of 25% of W-2 wages plus 2.5% of the UBIA of qualified property.

[i] A new term, Relevant Pass-Through Entity ("RPE"), means a partnership (other than a PTP) or an "S" corporation that is owned, directly or indirectly by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, Qualified REIT Dividends and/or Qualified PTP Income.

[j] The term Specified Service Trade or Business ("SSTB") will be discussed in more detail below in connection with the provisions of Proposed Reg. § 1.199A-5.

[k] The Threshold Amount means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). For any taxable year beginning after 2018, the Threshold Amount is the dollar amount mentioned above increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under § 1(f)(3) for the calendar year in which the taxable year begins. The amount of any increase is rounded as provided in § 1(f)(7).

[l] The term Total QBI Amount means the net total QBI from all trades or businesses (including an individual's share of QBI from trades or businesses conducted by RPEs).

[m] Proposed Reg. § 1.199-1(b)(13) defines a Trade or Business for purposes of § 199A as a § 162 trade or business other than the trade or business of performing services as an employee. Additionally, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a § 162 trade or business will nevertheless be treated as a trade or business for purposes of § 199A if the property is rented or licensed to a trade or business which is commonly controlled under Proposed Reg. § 1.199A-4(b)(1)(i), regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under the rules of Proposed Reg. § 1.199A-4.

[n] The unadjusted basis immediately after acquisition ("UBIA") of qualified property will be discussed in more detail below in connection with Proposed Reg. § 1.199A-2(c) below.

[o] The term W-2 Wages means a trade or business's W-2 Wages properly allocable to QBI as will be discussed in more detail in connection with Proposed Reg. § 1.199A-2(b).

Computation of § 1.199A Deduction for Individuals with Taxable Income Not Exceeding Threshold Amount. If an individual's taxable income does not exceed the applicable "Threshold Amount", such individual's § 199A deduction is determined by adding 20% of the QBI Amount (including QBI attributable to an SSTB) and 20% of the combined amount of Qualified REIT Dividends and Qualified PTP Income (including the individual's share of Qualified REIT Dividends, and Qualified PTP Income from RPEs). That amount is then compared to 20% of the amount by which the individual's taxable income exceeds the individual's net capital gain for the taxable year, and the lesser of these two amounts is the individual's § 199A deduction. Prop. Reg. § 1.199A-1(c)(i).

[a] Negative QBI. If the total QBI Amount is less than zero, the portion of the individual's § 199A deduction related to QBI is zero for the taxable year and the negative total QBI Amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of § 199A. A similar rule and separate calculation applies where the combined amount of REIT Dividends and Qualified PTP Income is less than zero. Prop. Reg. § 1.199A-1(c)(ii).

<u>Computation of the § 199A Deduction for Individuals With Taxable Income Above the Threshold Amount</u>.

[a] <u>In General</u>. The § 199A deduction is determined for individuals with taxable income for the taxable year that exceeds the Threshold Amount by adding the QBI Component and 20% of the combined amount of Qualified REIT Dividends and Qualified PTP Income, and comparing such amount to 20% of the amount by which the individual's taxable income exceeds his or her net capital gain for the taxable year. The lesser of those two amounts is the individual's § 199A deduction. Prop. Reg. § 1.199A-1(d)(1).

[b] <u>Computational Rules</u>. The QBI Component is determined by applying the following computational rules in the following order, for an individual with taxable income for the taxable year that exceeds the Threshold Amount:

[i] If the individual's taxable income is within the Phase-In Range, then only the "applicable percentage" of QBI, W-2 Wages and UBIA of Qualified Property for each SSTB is taken into account for purposes of determining the individual's § 199A deduction. Where the individual's taxable income exceeds the Phase-in Range, then the individual's § 199A deduction is zero with respect to an SSTB. Prop. Reg. § 1.199A-1(d)(2)(i).

[ii] When an individual chooses to aggregate trades or businesses under the rules of Proposed Reg. § 1.199A-4, the individual must combine the QBI, W-2 Wages, and UBIA of qualified property of each trade or business within an aggregated trade or business **prior** to applying the wage and capital limitations (sometimes referred to as the W-2 Wages and UBIA of qualified property limitations). Prop. Reg. § 1.199A-1(d)(2)(ii).

[iii] If an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. The W-2 Wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are **not** taken into account for purposes of determining the § 199A deduction for the taxable year and are **not** carried over to the subsequent year. Prop. Reg. § 1.199A-1(d)(2)(iii)(A). If an individual's QBI from **all** trades or businesses combined is less than zero, the QBI component is zero for the taxable year, and the negative amount is treated as negative QBI from a separate trade or business in the succeeding year of the individual for purposes of § 199A. Additionally, the W-2 Wages and UBIA of qualified property from the trades or businesses which produce negative QBI are **not** taken into account for purposes of computing the § 199A deduction are **not** carried over to the subsequent year. Prop. Reg. § 1.199A-1(d)(2)(iii)(B).

[iv] The <u>QBI Component</u> is the sum of such amounts determined for each trade or business. For each trade or business (including trades or businesses operated through RPEs), the individual must determine the lesser of (1) 20% of the QBI for that

trade or business; or (2) the greater of 50% of W-2 Wages with respect to that trade or business, or the sum of 25% of W-2 Wages with respect to such trade or business plus 2.5% of the UBIA of qualified property with respect to such trade or business. Prop. Reg. § 1.199A-1(d)(2)(iv)(A).

[v] Where an individual's taxable income is within the Phase-In Range and the amount determined under the wage and capital imitations is less than 20% of the QBI with respect to such trade or business, the QBI component for the trade or business will be reduced by the "reduction amount". Prop. Reg. § 1.199A-1(d)(2)(iv)(B). For an example of how the phase-in rules work for Qualified Trades of Businesses ("QTBs"), see Example 3 below, and for an example of how the phase-in rules work for SSTBs, see Example 5 below.

[c] Negative Combined Qualified REIT Dividend/Qualified PTP Income. If the combined amount of REIT Dividends and Qualified PTP Income is less than zero, the portion of the individual's § 199A deduction related to Qualified REIT Dividends and Qualified PTP Income will be zero for the taxable year, and the negative combined amount will be carried forward and used to offset the combined amount of REIT Dividends/PTP Income in the succeeding taxable year of the individual for purposes of § 199A. Prop. Reg. § 1.199A-1(d)(3).

Special Rules.

[a] Effect of Deduction. In the case of a partnership or "S" corporation, § 199A is applied at the partner or shareholder level. The § 199A deduction has **no** effect on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an "S" corporation, or an "S" corporation's accumulated adjustments account. Prop. Reg. § 1.199A-1(e)(1).

[b] Self-Employment Tax and Net Investment Income. The § 199A deduction does **not** reduce net earnings from self-employment under § 1402 or the amount of net investment income under § 1411. Prop. Reg. § 1.199A-1(e)(2).

[c] Income from Commonwealth of Puerto Rico. If all of an individual's QBI from sources from within the Commonwealth of Puerto Rico is taxable under § 1 for a taxable year, then for purposes of determining the QBI of such individual for such taxable year, the term "United States" will include the Commonwealth of Puerto Rico. Prop. Reg. § 1.199A-1(e)(3).

[d] Coordination With Alternative Minimum Tax. For purposes of determining alternative minimum taxable income under § 55, the deduction allowed under § 199A(a) for a taxable year is equal in amount to the deduction allowed under § 199A(a) in determining regular taxable income for such taxable year. In other words, the § 199A deduction is allowable for both regular tax and alternative minimum tax purposes. Prop. Reg. § 1.199A-1(e)(4).

[e] Imposition of Accuracy-Related Penalty and Underpayments. Section 6662(a) provides a penalty for an underpayment of tax required to be shown on a return. Under § 6662(b)(2), the penalty applies to the portion of any underpayment that is attributable to a substantial understatement of income tax. A substantial understatement of income tax is defined under § 6662(d)(1) as an understatement that exceeds the greater of 10% of the tax required to be shown on the return, or $5,000. Section 6662(d)(1)(C) provides a special rule in the case of any taxpayer who claims the deduction allowed under § 199A for the taxable year, which requires that § 6662(d)(1)(A) is applied by substituting 5% for 10%. Section 6662(d)(1)(C). The purpose of lowering the percentage from 10% to 5% in order for the § 6662(a) penalty to apply, was that Congress believed this would discourage taxpayers from "playing games" or manipulating the § 199A deduction.

[f] Reduction for Income Received from Cooperatives. Proposed Reg. §1.199A-1(c)(6) discusses the computation of the § 199A deduction in the case of any trade or business of a patron of a specified agricultural or horticultural cooperative. Prop. Reg. § 1.199A-1(e)(6).

1.7. Qualified Business Income

The term "QBI" generally means the net amount of "qualified items of income, gain, deduction and loss" with respect to any "qualified trade or business" of the taxpayer. Qualified items of income, gain, deduction and loss mean items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States. In other words, QBI only includes domestic income and not foreign income. However, in the case of a taxpayer who otherwise has QBI from sources within the commonwealth of Puerto Rico, provided all of the income is taxable, the taxpayer's income from Puerto Rico will be included in determining the individual's QBI.

Definition of "Trade or Business" Section 199A leaves open what constitutes a "trade or business" for purposes of determining the deduction. There are a number of different interpretations of what constitutes a trade or business under the Code, with the highest standard being that of a Section 162 trade or business. In order for an activity to achieve that standard, the business must be regular, continuous and substantial. As discussed above, Prop. Reg. §1.199A–1(b)(13) chose to define a "trade or business" for purposes of Section 199A as a trade or business under Section 162. It should be noted that in decades of litigation under Section 162, no "bright line" test has been established as to what constitutes a "trade or business" under §162, thus leaving many unanswered questions. For example, would the ownership of a single piece of commercial real estate rented out on a triple net lease basis qualify as a "trade or business" for purposes of the Section 199A QBI deduction?

Investment Related Income Excluded From QBI. Qualified items also do not include investment-related income, deductions or loss. Specifically, qualified items do not include, among other things, short-term capital gain or loss, long-term capital gain or loss, dividend income or interest income.

Reasonable Compensation and Guaranteed Payments Excluded From QBI. Additionally, QBI does not include any amount paid by an S corporation that is treated as reasonable compensation to the taxpayer, nor does it include any guaranteed payments made by a partnership to a partner for services rendered with respect to the trade or business or any other amounts paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.

[a] Where a qualifying trade or business does not have depreciable property or any wages other than those paid to the owner or owners of the business, a determination should be made on the amount of Form W-2 compensation to be paid to the owner so that the W-2 limit is not zero, while at the same time leaving some QBI on which to apply the 20% since any reasonable compensation will reduce QBI.

[b] The formula for obtaining the maximum deduction is 20% (y - x) equal to 50% of x, where y is the income prior to the payment of wages and x is the amount of W-2 wages. Consequently, approximately 28.57% of income should be paid as wages in order to maximize the deduction. For example, assume $1,000,000 of QBI, with the same taxable income and no wages paid to employees other than shareholders (and no significant qualified property). If the qualifying trade or business is formed as an S corporation and wages are paid to the taxpayer, approximately 28.57% of the QBI should be paid as income to the shareholder in order to maximize the deduction, as this would result in a deduction of approximately $142,850 ($1,000,000 of QBI minus $285,700 W-2 wages to S corporation shareholder results in $714,300 of QBI x 20% = $142,860, while the W-2 wage limitation would be equal to 50% of $285,700, or $142,850). <u>Keep in mind that this formula is applicable only to an S corporation with no employees other than the Shareholders</u>.

<u>Qualified Trade or Business</u>. As discussed in more detail below, a qualified trade or business means a trade or business <u>other than</u> an SSTB and <u>other than</u> the trade or business of being an employee.

[a] <u>Trade or Business of Performing Services as an Employee</u>. Proposed Regulations § 1.199A-5(d)(1) provides that the trade or business of performing services as an employee is not a trade or business for purposes of Section 199A and the Regulations thereunder. Consequently, no items of income, gain, loss and deduction from the trade or business of performing services as an employee constitute QBI within the meaning of Section 199A and proposed Reg. § 1.199A-3. The common law relationship of employer and employee exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. The Preamble to the Proposed Regulations provides that it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so.

[b] <u>Presumption for Former Employees</u>. Proposed Regulations § 1.199A-5(d)(3)(i) provides that solely for purposes of Section 199A(d)(1)(B), an individual that was properly treated as an employee for federal employment tax purposes by the person to which he or she provided services and who was subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted upon a showing by the individual that, under federal tax law, regulations and principles (including common-law employee classifications rules), the individual is performing services in a capacity other than as an employee. The presumption also applies regardless of whether the individual provides services directly or indirectly through an entity or entities. Example 3 of Proposed Reg. § 1.199A-5(d)(3)(ii) sets forth an example of where such presumption is rebutted where an employee becomes a partner in an engineering firm so that his status as a partner will be respected and such person will not be treated as an employee under Section 199A.

Mechanics of Deduction. The deduction reduces a taxpayer's taxable income but not his or her adjusted gross income (i.e., it is a "below the line" deduction). However, the deduction is available whether one itemizes deductions or takes the standard deduction.

Carryover of Loss to Reduce QBI in Subsequent Taxable Year. Under Section 199A(c)(2), if the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount will be treated as a loss from a qualified trade or business in the succeeding taxable year. Consequently, even if such loss is used in computing taxable income in Year 1, when you get to Year 2, that QBI loss carries over and reduces the QBI for Year 2 solely for purposes of computing the 20% of QBI deduction. Additionally, under Section 172(d)(8), if a taxpayer has a Section 199A deduction in a year in which such taxpayer has a net operating loss, the taxpayer's net operating loss does not include the Section 199A deduction.

Qualified Business Income and Proposed Regulations Section 1.199A-3. This outline focuses primarily on the provisions of proposed § 1.199A-3 used in determining the QBI Component for an individual.

[a] In General. QBI must be determined and reported for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of Proposed Reg. § 1.199A-4.

[b] Definition of QBI. Proposed Reg. § 1.199A-3(b)(1) provides that the term QBI means, for any taxable year, the net amount of qualified items of income, gain, deduction and loss with respect to any trade or business of the taxpayer, provided the other requirements of § 199A are satisfied.

[i] Gain or loss attributable to assets of a partnership giving rise to ordinary income under § 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and as such, is taken into account for purposes of computing QBI.

[ii] The proposed § 199A regulations provide that income attributable to a guaranteed payment for the use of capital is **not** considered to be attributable to a trade or business, and consequently is not taken into account for purposes of computing QBI. However, the partnership's deduction associated with the guaranteed payment for the use of capital will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.

[iii] Section 481 adjustments (whether positive or negative) will be taken into account for purposes of computing QBI to the extent that the requirements of § 199A are otherwise satisfied, but only if the adjustment arises in taxable years after December 31, 2017.

[iv] In general, losses or deductions which were previously disallowed (including under § 465, § 469, § 704(d) and § 1366(d)), which are allowed in the

taxable year are also taken into account for purposes of computing QBI for such taxable year. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable ending before January 1, 2018 are **not** taken into account in a later taxable year for purposes of computing QBI.

[v] In general, a deduction under § 172 for a net operating loss is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, to the extent the net operating loss is disallowed under § 461(l), the net operating loss is taken into account for purposes of computing QBI.

[c] <u>Qualified Items of Income, Gain, Deduction and Loss</u>. This term generally means items of gross income, gain, deduction, and loss to the extent that such items are effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the taxable year. Prop. Reg. § 1.199A-3(b)(2)(i).

[i] Proposed Reg. § 1.199A-3(b)(2)(ii) specifies that the following items are **not** taken into account as a qualified item of income, gain, deduction or loss in computing QBI:

a. Any item of short-term capital gain, short-term capital loss, long-term capital gain, long-term capital loss, including any item treated as one of such items, <u>such as gains or losses under § 1231 which are treated as capital gains or losses</u>.

b. Any dividend, income equivalent to a dividend or payment in lieu of dividends described in § 954(c)(1)(G).

c. Any interest income other than interest income which is properly allocable to a trade or business. <u>The Proposed Regulations specifically provide that interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.</u>

d. Any item of gain or loss described in § 954(c)(1)(C) (transactions in commodities) or § 954(c)(1)(D) (excess foreign currency gains) applied in each case by substituting “trade or business” for “controlled foreign corporation”.

e. Any item of income, gain, deduction or loss taken into account under § 954(c)(1)(F) (income for notational principal contracts) determined without regard to § 954(c)(1)(F)(ii) and other than items attributable to notational principal contracts entered into transactions qualifying under § 1221(a)(7).

f. Any amount received from an annuity which is not received in connection with a trade or business.

g. Any qualified REIT Dividends or Qualified PTP Income.

h. Reasonable compensation received by a shareholder from an "S" corporation. Note that the "S" corporation's deduction for such reasonable compensation will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.

i. Any guaranteed payment described in § 707(c) received by a partner with respect to the trade or business. However, the partnership's deduction for such guaranteed payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.

j. Any payment described in § 707(a) received by a partner for services rendered with respect to the trade or business. Again, however, the partnership's deduction for such payment will reduce QBI if the deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.

[d] <u>Income from Puerto Rico</u>. For purposes of determining QBI, the term "United States" will include the Commonwealth of Puerto Rico in the case of any taxpayer with QBI for any taxable year from sources within the Commonwealth of Puerto Rico if all of such receipts are taxable under § 1 for such taxable year. Prop. Reg. § 1.199A-3(b)(3).

[e] Expenses for all wages paid (or incurred in case of an accrual basis taxpayer) must be taken into account in computing QBI regarding of the application of the W-2 Wage limitation. Prop. Reg. § 1.199A-3(b)(4).

[f] In the case of an individual or RPE directly conducting multiple trades or businesses, where such items of QBI are properly attributable to more than one of the trades or businesses, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a "reasonable method" based on all the facts and circumstances. The proposed § 199A regulations provide that the individual RPE may use a different reasonable method for different items of income, gain, deduction and loss, but that the chosen reasonable method for each item must be consistently applied from one taxable year to the next and must clearly reflect the income and expenses of each trade or business. The books and records maintained for a trade or business also must be consistent with any allocations of items of QBI thereunder. Proposed Reg. § 1.199A-3(b)(5).

[g] Proposed Reg. § 199A-3(c) sets forth the meanings of Qualified REIT Dividends and Qualified PTP Income, and provides that the rules applicable to the determination of QBI also applies to the determination of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP.

1.8. Wage and Capital Limitations

For businesses other than a "specified service trade or business" (which will be discussed below), and for which the taxpayer's taxable income exceeds $207,500 ($157,500 + $50,000 phase-in amount), or $415,000 ($315,000 + $100,000 phase-in amount) if married filing jointly, the deducible amount for each qualified trade or business carried on by the S corporation, partnership, LLC or sole proprietorship is as discussed above, the lesser of (1) 20% of the taxpayer's allocable share of QBI with respect to the qualified trade or business; or (2) the greater of (a) the taxpayer's allocable share of 50% of the W-2 wages with respect to the qualified trade or business, or (b) the taxpayer's allocable share of the sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all "qualified property" (the "wage and capital limitations," or sometimes referred to as the W-2 and UBIA of qualified property limitations).

W-2 Wages. W-2 wages are wages paid to an employee, including any elective deferrals into a Section 401(k)-type vehicle or other deferred compensation. W-2 wages do not include, however, things like payments to an independent contractor or management fees. This definition raises issues for employees employed by an affiliated management company that leases the employees to an operating business or businesses. The question is whether wages paid by the management company or other third party can be taken into account with respect to each qualified trade or business even though it is operated in a separate taxable entity. The Proposed Section 199A Regulations answer this question affirmatively so long as the individual or RPE is the common law employer of such employees. Additionally, because a partner is not an "employee" of the partnership under Rev. Rul. 69-184, 1969-1 C.B. 256, and a sole proprietor is not an "employee" of the sole proprietorship, neither guaranteed payments made to a partner nor any other payments made to a partner or a sole proprietor appear to qualify as W-2 wages (which can either be advantageous or disadvantageous depending upon the circumstances).

[a] Section 199A(b)(4) specifically defines W-2 wages by reference to Sections 6051(a)(3) and (8). This mirrors, in part, the language in Section 199(b) as it existed prior to TCJA relating to the Domestic Production Activities Deduction. Guidance on wage issues had been issued under prior Section 199 in Rev. Proc. 2006-22, 2006-1 C.B. 1033 and in the Section 199 Regulations. Revenue Procedure 2006-22 provided three safe harbors for determining the definition of wages for purposes of old Section 199: (1) the "Modified Box Method" which uses the lesser of Box 1 or Box 5 of the Form W-2; (2) the "Modified Box 1 Method" which adds a modified Box 1 amount subtracting amounts not subject to federal income tax withholding, added to the deferrals reported in Box 12; and (3) the "Tracking Method" where the amounts subject to federal income tax withholding are tracked, deferrals are added, and other modifications made. The Proposed Section 199A Regulations, as well as Notice 2018-64, which was also issued by the IRS on August 8, 2018, essentially adopted the prior regulations issued under Section 199 and Rev. Proc. 2006-22 in determining what constitutes "wages" for purposes of Section 199A. The definition of "wages" as defined in the Proposed Section 199A Regulations and in Notice 2018-64 will be discussed in more detail below.

[b] Section 199A wages do not include any amount which is not properly included in a return filed with the Social Security Administration on or before the sixtieth (60^{th}) day after the due date, including extensions, for such return. Consequently, compliance with such reporting rules is necessary to get credit for the maximum amount of W-2 wages.

Allocable Share. If there is more than one owner of the pass-through entity, it must be kept in mind that the owners are only entitled to their "allocable share" of QBI, W-2 wages and UBIA of qualified property. For an S corporation, a shareholder's allocable share will be equal to his or her percentage ownership of the stock of the S corporation. For partnerships, where special allocations may be made under Section 704(b), a partner's allocable share of QBI and of W-2 wages will be equal to the amount of wages of the qualifying trade or business allocated to such partner by the partnership.

W-2 Wages and Proposed Regulations Section 1.199A-2.

Proposed Reg. § 1.199A-2(b) provides further guidance on calculating the trade or business's W-2 Wages properly allocable to QBI.

[a] W-2 Wages. The determination of W-2 Wages must be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of Proposed Reg. § 1.199A-4. Any W-2 Wages paid by an RPE must be determined and reported by the RPE for each trade or business it conducts. If not so determined and reported for each trade or business, W-2 Wages will be assumed to be zero. Prop. Reg. § 1.199A-2(b)(1) provides a 3-step process for determining the W-2 Wages paid with respect to a trade or business that are properly allocable to QBI.

[i] First, each individual or RPE must determine its total W-2 Wages paid for the taxable year.

[ii] Second, each individual or RPE must allocate its W-2 Wages between or among one or more trades or businesses.

[iii] Third, each individual or RPE must determine the amount of such wages with respect to each trade or business that are allocable to the QBI of the trade or business.

[b] Definition of W-2 Wages. The term "W-2 Wages" means with respect to any person for any taxable year of such person, the amounts described in § 6051(a)(3) and § 6051(a)(8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. As such, the term "W-2 Wages" includes the total amount of wages as defined in § 3401(a) plus the total amount of elective deferrals within the meaning of § 402(g)(3), the compensation deferred under § 457, and the amount of designated ROTH contributions (as defined in § 402(a)). Prop. Reg. § 1.199A-2(b)(2)(i).

[c] Employees Taken Into Account For W-2 Wage Limitations. In general, the Form W-2, "Wage and Tax Statement," or any subsequent form or document used in determining the amount of W-2 wages are those issued for the calendar year during individual's or RPE's taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE. Employees of the individual or RPE are limited to employees of the individual or RPE as defined in Section 3121(d)(1) and (2), and for purposes of Section 199A, includes officers of an S corporation and employees of an individual or RPE under common law.

[i] Of critical importance, the Proposed Section 199A Regulations provide that in determining W-2 wages, an individual or RPE may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. Under such circumstances, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person. The Proposed Section 199A Regulations specifically provide that persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under Section 7705, statutory employers under Section 3401(d)(1) and agents under Section 3504. Prop. Reg. § 1.199A-2(b)(2)(ii).

[ii] The Proposed Section 199A Regulations reiterate that the term W-2 wages does not include any amount that is not properly included in a return filed with the Social Security Administration on or before the sixtieth (60) day after of the due date (including extensions) for such return. Prop. Reg. § 1.199A-2(b)(2)(iii).

[d] Acquisition or Disposition of a Trade or Business. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be the employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 Wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, "Wage and Tax Statement." Prop. Reg. § 1.199A-2(b)(2)(iv)(B)(1). The term "acquisition or disposition" includes an incorporation, a formation, a liquidation, a reorganization or a purchase or sale of assets. Prop. Reg. § 1.199A-2(b)(2)(iv)(B)(2).

[e] Allocation of Wages to Trades or Businesses. After calculating total W-2 Wages for a taxable year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W-2 Wages must be allocated to the trade or business that generated those wages. Where W-2 Wages are allocable to more than one trade or business, Prop. Reg. § 1.199A-2(b)(3) provides that the portion of the W-2 Wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under Proposed Reg. § 1.199A-3(b)(5).

[f] Allocation of Wages to QBI. Once W-2 Wages for each trade or business have been determined, each individual RPE must identify the amount of W-2 Wages properly allocable to QBI for each trade or business. Prop. Reg. § 1.199A-2(b)(4) provides that W-2 Wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under Proposed Reg. § 1.199A-3.

[g] Non-Duplication Rule. Amounts that are treated as W-2 Wages for a taxable year under any method cannot be treated as W-2 Wages of any other taxable year. Additionally, an amount cannot be treated as W-2s by more than one trade or business. Prop. Reg. § 1.199A-2(b)(5).

Qualified Property. For purposes of Section 199A, "qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, which is used in the production of QBI sometime during the taxable year, and for which the depreciable period has not expired before the close of the taxable year. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the **later** of (a) the date ten years after such date; or (b) the last day of the full year in the asset's normal depreciation period. Again, with respect to a shareholder of an S corporation, such shareholder's "allocable share" of the unadjusted basis of qualified property will be equal to his or her percentage ownership in the stock of the S corporation. However, with respect to partners of a partnership (including LLCs taxed as partnerships), the partner's allocable share of the unadjusted basis of qualified property will be equal to the percentage of tax depreciation allocated to such partner by the partnership.

Example #2. LLC Taxed as a Partnership in a Qualified Trade or Business with Income in Excess of Threshold Amount Plus Phase-In Amounts. A is a 30% owner of an LLC which has QBI of $3,000,000. The LLC paid wages of $1,000,000 and the LLC's unadjusted basis in qualified property is $200,000.

A's deduction will be equal to the lesser of:

1.	Total QBI	Allocable Share (30%)	20% Deduction
	$3,000,000	$900,000	$180,000
	and the greater of:		
2(a)	Total W-2 Wages	Allocable Share (30%)	50% Limitation
	$1,000,000	$300,000	$150,000
	or		
2(b)	Total W-2 Wages	Allocable Share (30%)	25% Limitation
	$1,000,000	$300,000	$75,000
	plus		
	Unadjusted Basis	Allocable Share (30%)	2.5% Limitation
	$200,000	$60,000	$1,500
	TOTAL		$76,500

Thus, A is entitled to a deduction of $150,000.

UBIA and Proposed Regulation Section 1.199A-2.

Proposed Reg. § 1.199A-2(a)(3) provides that the determination of the UBIA of qualified property must be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of proposed § 1.199A-4. In the case of qualified property held by an RPE, each partner or shareholder's share of the UBIA of qualified property is an amount which bears the same proportion to the total UBIA of qualified property as the partner or shareholder's share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year. In the case of qualified property held by a partnership which does not produce tax depreciation during the year, each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to § 704(b) and § 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. In the case of qualified property held by an "S" corporation which does not produce tax depreciation during the year, each shareholder's share of the UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the "S" corporation held by the shareholder over the total shares of the "S" corporation. If the UBIA of the qualified property is not determined and reported for each trade or business, the UBIA of such qualified property is presumed to be zero.

[a] UBIA of Qualified Property. Consistent with the definition of qualified property set forth in § 199A(a)(6), Proposed Reg. § 1.199A-2(c)(1)(i) provides that the term qualified property means, with respect to any trade or business of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation under § 167(a):

[i] which is held by, and available for use in, the trade or business at the close of the taxable year;

[ii] which is used at any point during the taxable year in the trade or business's production of QBI; and

[iii] the depreciable period of which has not ended before the close of the individual or RPE's taxable year.

[b] Improvement to Qualified Property. In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service. Prop. Reg. § 1.199A-2(c)(1)(ii).

[c] Adjustments Under §734(b) and § 743(b). Proposed Reg. § 1.199A-2(c)(1)(iii) provides that partnership special basis adjustments (such as basis adjustments under § 734(b) and § 743(b)), are **not** treated as separate qualified property. The IRS felt that treating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property. Many commentators disagree.

[d] Property Acquired Near Year-End. Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer can demonstrate that the principal purpose of the acquisition and disposition was a purpose other than increasing the § 199A deduction. Prop. Reg. § 1.199A-2(c)(1)(iv).

[e] Carryover Basis Property and Other Rules. The Proposed Regulations clarify that additional first-year depreciation allowable under § 168 will not affect the applicable recovery period for the qualified property. Additionally, UBIA of qualified property is determined without regard to any adjustments described in § 1016(a)(2) or § 1016(a)(3), any adjustments for tax credits claimed by the taxpayer, or any adjustments for any portion of basis for which the taxpayer has elected to treat as an expense (for example, under § 179). For qualified property contributed to a partnership in a § 721 transaction and immediately placed in service, UBIA of the qualified property generally will be its basis under § 723 (a carryover basis). Likewise, for qualified property contributed to an "S" corporation in a § 351 transaction and immediately placed in service, UBIA of the qualified property generally will be its basis under § 362 (a carryover basis). The use of the carryover basis as the UBIA of qualified property in such non-recognition transactions rather than its original cost basis is somewhat controversial and can lead to unusual results. For example, where a sole proprietor initially acquired qualified property for $100,000, and later incorporates as an "S" corporation, when the adjusted tax basis (after depreciation) of the qualified property is $40,000, the sole proprietor will be "penalized" by only getting to use the depreciated basis of the property as of the date of the incorporation ($40,000) rather than its original cost of $100,000 which would have been the UBIA of such property if the taxpayer had not incorporated.

[f] Depreciable Period of Qualified Property. The term depreciable period means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of the date that is ten years after such date, or the last day of the last full year in the applicable recovery period that would apply to the property under § 168(c). Prop. Reg. § 1.199A-2(c)(2)(i).

[g] Qualified Property Acquired in Transactions Subject to § 1031 or § 1033. The IRS believes that existing general principles used for like-kind exchanges and involuntary conversions under Reg. § 1.168(i)-(6) provide a useful analogy for administrable rules that are appropriate for purposes of § 199A. As such, Proposed Reg. § 1.199A-2(c)(2)(iii) generally follows the rules of Reg. § 1.168(i)-6 to provide that qualified property that is acquired in a like-kind exchange, or in an involuntary conversion, is treated as replacement Modified Accelerated Cost Recovery System ("MACRS") property whose depreciable period generally is determined as of the date the relinquished property was first placed in service. Accordingly, subject to one exception, the date the "exchanged basis," as defined in Reg. § 1.168(i)-6(b)(7), in the replacement MACRS property was first placed in service by the trade or business is the date on which the relinquished property was first placed in service by the individual or RPE, and the date the "excess basis," as defined in Reg. § 1.168(i)-6(b)(A), in the replacement MACRS property was first placed in service by the individual or RPE is the date on which the replacement property was first placed in service by the individual or RPE. Consequently, and unless the exception (discussed below) applies, qualified property acquired in a like-kind exchange or involuntary conversion will have two separate placed in service dates under the Proposed Regulations for purposes of determining the UBIA of the property. As a result, the depreciable period under Section 199A for the exchanged basis of the replacement qualified property will end before the depreciable period for the excess basis of the replacement qualified property ends.

The exception contained in Proposed Reg. § 1.199A-2(c)(2)(iii)(C), provides for purposes of determining the depreciable period, if the individual or RPE makes an election under Reg. § 1.168(i)-6(i)(1), the date the exchanged basis and excess basis in the replacement qualified property are first placed in service by the trade or business is the date on which the replacement qualified property is first placed in service by the individual or RPE, with UBIA determined as of that date. In such case, the depreciable periods under § 199A for the exchanged basis and the excess basis of the replacement qualified property will end on the same date.

1.9. Phase-In of Wage and Capital Limitations

For taxpayers having taxable income between $157,500 and $207,500 ($157,500 plus $50,000), or with respect to married individuals filing jointly having taxable income between $315,000 and $415,000 ($315,000 plus $100,000), the wage and capital limitations are phased in. Specifically, if the wage and capital limit is less than 20% of the taxpayer's QBI with respect to the qualified trade or business, the taxpayer's deductible amount is determined by reducing 20% of QBI by the same proportion of the difference between 20% of the QBI and the wage and capital limit as the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 ($100,000 in the case of a joint return). Once the taxpayer has $207,500 of taxable income, or $415,000 of taxable income in the case of a married individual filing a joint return, the wage and capital limitations apply fully to the taxpayer.

> *Example #3: S Corporation In a Qualified Trade or Business with Taxable Income Within the Phase-In Range.*
>
> *A and B are married. A's allocable share of the QBI of an S corporation is $300,000. A's allocable share of the W-2 wages paid by the S corporation is $40,000. A's allocable share of the unadjusted basis of the qualified property is $100,000. B earns wages from her job of $85,000 so that their taxable income is $385,000.*
>
> *Step 1: Determine what would A's deduction have been if the wage and labor limitation did not apply. 20% of $300,000 = $60,000.*
>
> *Step 2: Determine A's "Excess Amount" by looking at the difference between $60,000 and the amount which would be deductible if wage and capital limitations applied in full. Greater of:*
>
> ***1.*** *50% of $40,000 = $20,000; or*
>
> ***2.*** *(25% of $40,000) plus (2.5% of $100,000) = $12,500.*
>
> *A's Excess Benefit is $40,000 ($60,000 - $20,000).*
>
> *Step 3: Figure Percentage of Taxable Income of A over Threshold Amount:*
>
> *$385,000*
> *<$315,000>*
>
> *$70,000 /$100,000 = 70%*

<u>Step 4</u>: A loses 70% of $40,000 Excess Benefit or $28,000

A is therefore entitled to a deduction of:

20% of QBI	*$60,000*
Reduction of $40,000 Benefit	*<u><$28,000></u>*
	<u>$32,000</u>

1.10. <u>Specified Service Trade or Business</u>

Section 199A defines a "specified service trade or business" as any trade or business 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 or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. It should be noted that engineering and architecture services are specifically excluded from the definition of a specified service trade or business. Because a specified service trade or business includes both "consulting" businesses, brokerage businesses, and "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 or owners," there was (and to a lesser degree, still is) a great deal of uncertainty and unanswered questions as to whether certain businesses constitute a specified service trade or business, and thus a substantial amount of litigation was expected to ensue on this critical issue. Fortunately, as will be discussed in more detail below, the Proposed Section 199A Regulations answer many of the questions by narrowly defining specified service trades or businesses, including the "catch all" for 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 or owners. As with other areas of Section 199A, even after issuance of the Proposed Section 199A Regulations, there are a number of open issues dealing with the definition of a "qualified trade or business" versus a "specified service trade or business" and the effect each may have on the other.

<u>Deduction Allowed for Specified Service Trade or Business if Taxable Income Less than Threshold Amounts</u>. Even though an SSTB is not a qualified trade or business, such business will nevertheless be eligible for the 20% of QBI deduction provided that the taxpayer's taxable income is less than the Threshold Amounts of $315,000 in the case of married individuals filing joint returns and $157,500 for all other taxpayers.

Example #4: Specified Service Trade or Business with Taxable Income Below Threshold Amount.

A is a partner in a law firm operated as an LLC taxed as a partnership. A is married and has total taxable income of $300,000 with his wife. A's allocable share of the QBI of the law firm is $250,000, his allocable share of W-2 wages of the law firm is $60,000 and his allocable share of the unadjusted basis of the qualified property of the law firm is $40,000.

Even though A derives his income form a specified service trade or business, he will receive a deduction of $50,000 ($250,000 x 20%). Because A's taxable income is below the Threshold Amount of $315,000, the wage and labor limitation won't apply (the greater of $30,000 (50% of $60,000) or $16,000 (25% of $60,000 plus 2.5% of $40,000).

Phase-Out of Deduction For Specified Service Trades or Businesses. The ability to take the deduction for 20% of QBI for a specified service trade or business is phased out for a taxpayer having taxable income between $315,000 and $415,000 in the case of married individuals filing joint returns, and between $157,500 and $207,500 for all other taxpayers. Specifically, for a taxpayer with taxable income within the phase-out range, the taxpayer takes into account only the "applicable percentage" of qualified items of income, gain, deduction or loss, and of allowable W-2 wages. The "applicable percentage" with respect to any taxable year is 100% reduced by the percentage equal to the ratio of the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 (or $100,000 in the case of a joint return).

Example #5: Specified Service Trade or Business with Taxable Income Within the Phase-In (or Phase-Out) Range. A (a lawyer) and B are married. A's allocable share of the QBI of the law firm (an S corporation) is $300,000. A's allocable share of wages paid by the law firm is $40,000. A's allocable share of the unadjusted basis of the law firm's qualified property is $100,000. B earns wages of $85,000 so that their taxable income is $385,000.

Step 1: Determine what would A's deduction have been if the wage and labor limitation did not apply at all. 20% of $300,000= $60,000.

Step 2: Determine how much of A's $100,000 "phase-in" threshold has been exceeded:

$385,000
<$315,000>

$70,000 /$100,000 = 70%

Step 3: Determine A's "Applicable Percentage" by subtracting 70% from 100% = 30%.

QBI	Applicable Percentage (30%)
$300,000	$90,000

W-2 Wages	Applicable Percentage (30%)
$40,000	$12,000

Unadjusted Basis	Applicable Percentage (30%)
$100,000	$30,000

Step 4: Determine A's deduction using the "Applicable Percentage" numbers: equal to the lesser of:

1. *20% of QBI of $90,000 = $18,000; or*

2. *the greater of:*

(a) 50% of $12,000 = $6,000; or

(b) 25% of $12,000 plus 2.5% of $30,000 = $3,750.

Step 5: Determine the excess of the deduction allowed to A if W-2 limitation did not apply over amount deductible if wage limitation fully phased-in: $18,000 - $6,000 = $12,000.

Step 6: Determine Percentage of Taxable Income of A over Threshold Amount:

$385,000
<$315,000>

$70,000 /$100,000 = 70%

Step 7: A loses 70% of $12,000 benefit or $8,400:

A is therefore entitled to a deduction of:

20% of QBI	$18,000
Reduction of $12,000 Benefit	<8,400>
Total Deduction	$9,600

As can be seen from Example #5, the phase-in (or phase-out) rule for specified service trades or businesses is much harsher than the phase-in or phase-rule for qualified trades or businesses. In Example #3 dealing with a qualified trade or business, based on the identical facts contained in Example #5, the taxpayer was entitled to a deduction under Section 199A of $32,000, whereas in Example #5 dealing with a specified service trade or business, the taxpayer was allowed a deduction of only $9,600.

No Deduction Allowed if Specified Service Trade or Business and Taxable Income Exceeds Threshold Amount Plus Phase-In. The deduction for 20% of QBI is not available for shareholders, partners, members or sole proprietors of an SSTB whose taxable income is $207,500 or above, or in the case of married individuals filing a joint return, $415,000 or above.

Example #6: Specified Trade or Business with Taxable Income over Threshold Plus Phase-In (Phase-Out) Range.

A is a partner in a law firm. A is married and has taxable income of $1,000,000. A's allocable share of income of the law firm is $700,000, his allocable share of the W-2 wages of the law firm is $200,000 and his share of the unadjusted basis of qualified property is $100,000.

A is entitled to no deduction at all because the law firm is a specified service trade or business and A's taxable income exceeds $415,000. A is completely "phased-out" of any deduction.

If, on the other hand, the business had been a qualified trade or business, A's deduction would be equal to the lesser of:

1. *20% of $700,000 = $140,000; or*

2. *the greater of:*

(a) 50% x $200,000 = $100,000, or

(b) 25% x $200,000 plus 2.5% x $100,000 = $52,500.

A would therefore be entitled to a deduction of $100,000 if the business had not been an SSTB.

Specified Service Trades or Business and Proposed Regulations Section 1.199A-5.

On the critical question of whether a business constitutes a QTB or SSTB, Proposed Reg. § 199A-5 sets forth definitions for the following enumerated professions: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services and brokerage services, Proposed Reg. § 1.199A-5 also defines what constitutes investing in investment management, trading, and dealing in securities, partnership interests or commodities. These trades or businesses, including any trade or business where the principal or asset of such trade or business is the reputation or skill of one or more of its employees or owners, are treated as "Listed SSTBs" under Proposed Reg. § 1.199A-5(b)(1). The Proposed Section 199A Regulations are mostly taxpayer-friendly and side with the majority of commentators by narrowly defining what constitutes a Listed SSTB. Additionally, the proposed § 199A regulations take a very narrow view as to what is included as an SSTB where the principal asset of the business is the reputation or skill of one or more of its employees or owners. In the Preamble to the Proposed Section 199A Regulations, the IRS states that Section 199A is a new Code provision intended to benefit a wide range of businesses, and makes references to Section 1202(e)(3)(A), Section 448(d)(2) and Regulations Section 1.448-1T(e)(4)(i), and provides that although the sections are not definitive for purposes of determining whether a trade or business is an SSTB, guidance can be taken from such sources. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting and provides qualified personal service corporations generally are not subject to the prohibition from using the cash method. The definition of an SSTB under Section 199A is substantially similar to the list of service trades or businesses provided in Section 448(d)(2)(A) and Reg. Section 1.448-1T(e)(4)(i). The Preamble goes on to provide that Section 448(d)(2) emphasizes the direct provision of services by the employees of a trade or business, rather than the application of capital. Consistent with the ordinary rules of statutory construction and the legislative history of Section 199A, proposed Regulations Section 1.199A-5(b) draws upon the existing guidance under Section 448(d)(2) when appropriate for purposes of Section 199A and generally follows the guidance issued under Section 448(d)(2) with some modifications. The Preamble states that case law under Section 448 provides that whether a service is performed in a qualifying field under Section 448(d)(2) is to be decided by examining all relevant indicia and is not controlled by state licensing laws, and that this approach is also appropriate for Section 199A purposes. Although the Preamble extensively discusses Section 448 and the Regulations thereunder, as well as Section 1202, the proposed Section 199A Regulations themselves contain no reference to Section 448.

[a] Meaning of Services Performed in the Fields of Health. The performance of services in the field on health means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar health care professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient). The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. As an example of an excluded service, the Proposed § 199A Regulations provide that the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices. Prop. Reg. § 1.199A-5(b)(2)(ii).

[b] Meaning of Services Performed in the Field of Law. The performance of services in the field of law means performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators and similar professionals performing services in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services. Prop. Reg. § 1.199A-5(b)(2)(iii).

[c] Meaning of Services Performed in the Field of Accounting. The performance of services in the field of accounting means performance of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such. The field of accounting does not include, however, payment processing and billing analysis. Prop. Reg. § 1.199A-5(b)(2)(iv).

[d] Meaning of Services Performed in the Field of Actuarial Science. The performance of services in the field of actuarial science means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such. However, the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial cost of risks or uncertainty of events. Prop. Reg. § 1.199A-5(b)(2)(v).

[e] Meaning of Services Performed in the Field of Performing Arts. The performance of services in the field of the performing arts means performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Likewise, the performance of services in the field of performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public. Prop. Reg. § 1.199A-5(b)(2)(vi).

[f] Meaning of Services Performed in the Field of Consulting. The performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting specifically includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses. The determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business, including the manner in which the taxpayer is compensated for the services provided. The performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of the trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services. Prop. Reg. § 1.199A-5(b)(2)(vii).

[g] Meaning of Services Performed in the Field of Athletics. The performance of services in the field of athletics means the performance of services by individuals who participate in athletic competition such as athletes, coaches and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards and racing. Again, the performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Likewise, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public. Prop. Reg. §

1.199A-5(b)(2)(viii). Quite controversially, the preamble to the Proposed Section 1.199A Regulations provides that if a partnership owns a professional sports team, a partner's distributive share of income from the partnership's athletic trade or business is not QBI, regardless of whether the partner participates in the partnership's trade or business.

[h] Meaning of Services Performed in the Field of Financial Services. The performance of services in the field of 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 by underwriting, or acting as a client's agent in the issuance of securities or similar services. This includes services provided by financial advisors, investments bankers, wealth planners and retirement advisors and other similar professionals performing services in their capacity as such. Banking is specifically excluded from the definition of an SSTB. Prop. Reg. § 1.199A-5(b)(2)(ix).

[i] Meaning of Services Performed in the Field of Brokerage Services. The performance of services in the field of brokerage services include services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in § 475(c)(2))) for a commission or a fee. This would include services provided by stock brokers and similar professionals, but specifically exclude services provided by real estate agents and brokers or insurance agents or brokers. Prop. Reg. § 1.199A-5(b)(2)(x).

[j] Meaning of Services Performed in the Field of Investing and Investment Management. The performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The performance of services of investing and investment management does not include directly managing real property. Prop. Reg. § 1.199A-5(b)(2)(xi).

[k] Meaning of the Provision of Services in Trading. The performance of services that consist of trading means a trade or business of trading in securities, commodities or partnership interest. Whether a person is a trader in securities, commodities or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others or any combination thereof. The Proposed Section 199A Regulation specifically provide that a taxpayer such as a manufacturer or a farmer, who engages in hedging transactions as part of their trade or business of manufacturing or farming, is not considered to be engaged in a trade or business of trading commodities. Prop. Reg. § 1.199A-5(b)(2)(xii).

[l] Meaning of the Provision of Services In Dealing. The performance of services that consist of dealing in securities means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions and securities with customers in the ordinary course of a trade or business. The Proposed Section 199A Regulations provide that a taxpayer that regularly originate loans in the ordinary course of a trade or business of making loans but engages in no more that negligible sales of the loans, is **not** dealing in securities.

The performance of services that consist of dealing in commodities means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions and commodities with customers in the ordinary course of a trade or business. Prop. Reg. § 1.199A-5(b)(2)(xiii).

The performance of services that consist of dealing in partnership interests means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

[m] <u>Meaning of Trade or Business where the Principal Asset of Such Trade or Business is the Reputation or Skill of One or More Employees or Owners</u>. The fear of many commentators that this provision could sweep in a large range of service businesses as SSTBs has been allayed by the Proposed Section 199A Regulations taking a very narrow view as to what is included as an SSTB where the principal asset of the business is the reputation or skill of one or more of its employees or owners. Specifically, the Proposed Reg. § 1.199A-5(b)(2)(xiv) provides that the term "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 or owners" means any trade or business that consist of the following (or any combination thereof):

[i] A trade or business in which a person receives fees, compensation or other income for endorsing products or services;

[ii] A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's likeness, name, signature, voice, trademark or other symbol associated with the individual's identity; or

[iii] Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format. The term fees, compensation or other income includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain or loss from the partnership, or the receipt of stock of an "S" corporation and the corresponding income, deduction, gain or loss from the "S" corporation stock.

[n] <u>De Minimus Rule</u>. For a trade or business with gross receipts of $25 million or less for the taxable year, a trade or business is **not** an SSTB if less than 10% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB. For purposes of determining whether this 10% test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field. Prop. Reg. § 1.199A-5(c)(1)(i). For a trade or business with gross receipts of greater than $25 million for the taxable year, a trade or business is not an SSTB if less than 5% of the gross receipts of the trade or business or attributable to the performance of services in an SSTB. Prop. Reg. § 1.199A-5(c)(1)(ii)

[o] <u>"Crack and Pack" Strategy</u>. The IRS is aware that some taxpayers have contemplated a strategy to separate out parts of what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the § 199A deduction. The IRS feels that such a strategy is inconsistent with the purpose of § 199A, and as such, Proposed Reg. § 1.199A-5(c)(2) provides that an SSTB includes any trade or business that provides 80% or more of its property or services to an SSTB if there is 50% or more common ownership of the trades or businesses. Additionally, if a trade or business provides less than 80% of its property or services to an SSTB and there is 50% or more common ownership of the trades or businesses, that portion of the trade or business providing property or services to the 50% or more commonly-owned SSTB is treated as a part of the SSTB. For example, a dentist owns a dental practice and also owns an office building. The dentist rents half of the building to the dental practice and half the building to unrelated persons. Under these facts, the renting of half of the building to the dental practice would be treated as an SSTB. 50% or more common ownership includes direct or indirect ownership by related parties within the meaning of § 267(b) or § 707(b).

[p] Trade or Business Incidental to SSTB. Additionally, Proposed Regulations § 1.199A-5(c)(3) provides a rule that if a trade or business (that would not otherwise be treated as an SSTB) has 50% or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, it is treated as incidental to an SSTB and, thus, as an SSTB, if the trade or business (that would normally not be an SSTB) represents no more than 5% of gross receipts of the combined business. As an example of this situation, the Proposed Regulations set forth a situation where a dermatologist provides medical services to patients through an LLC, an additionally sells skin care products to patients through the same LLC. The same employees and office space are used for the medical services and the sale of skin care products and the gross receipts with respect to the skin care product sales do not exceed 5% of the gross receipts of the LLC as a whole. Accordingly, the sale of skin care products is treated as incidental to the SSTB of performing services in the field of health and is treated as part of such SSTB.

1.11. Overall Limitation

In addition to the other limitations described above, the maximum amount of deduction available under new Section 199A (for all of a taxpayer's qualified trades or businesses) cannot exceed 20% of the excess of the taxpayer's taxable income less any capital gain for the taxable year.

Example #7: Taxable Income Limitation Applies. A is married and has $100,000 of QBI. A has $200,000 of long-term capital gains, $30,000 of wages, and $50,000 of itemized deductions, resulting in taxable income of $280,000. A's deduction is limited to the lesser of:

1. *20% of QBI of $100,000 = $20,000; or*

2. *20% of ($280,000 taxable income less $200,000 of capital gain) = $16,000.*

1.12. Aggregation Rules and Proposed Regulations Section 1.199A-4

Although a great number of practitioners argued that the grouping rules under § 469 should be adopted and applied in the § 199A context, the IRS felt that the § 469 grouping rules were not appropriate for determining a trade or business for purposes of § 199A. Although finding that the grouping rules under § 469 were not appropriate to apply to § 199A, the IRS agreed with practitioners that some amount of aggregation should be permitted since it is not uncommon for what are commonly thought of as single trades or businesses to be operated across multiple entities. They are structured in this fashion for various legal, economic or other non-tax reasons. The IRS stated that allowing taxpayers to aggregate trades or businesses offer taxpayers a means of combining their trades or businesses for purposes of applying the W-2 Wage and UBIA of qualified property limitations and potentially maximizing the deduction under § 199A. Additionally, if such aggregation was not permitted, taxpayers could be forced to incur costs to restructure solely for tax purposes. Further, the IRS found that business and non-tax law requirements may not permit many taxpayers to restructure their operations, and as such, believed that the aggregation of separate trade or businesses, which meet certain requirements, should be allowed. As illustrated in the examples to the Proposed Section 199A Regulations, the use of the aggregation rules can be either beneficial or detrimental in determining the amount of an individual's QBI deduction depending on the facts and circumstances. Thus, the practitioner must give considerable thought on whether and how to aggregate trades or businesses if aggregation is available under Proposed Reg. § 1.199A-4.

General Aggregation Rules**.** Proposed Reg. § 1.199A-4(b)(1) provides that trades or business may be aggregated only if an individual can demonstrate that: (1) the same person or group of persons, directly or indirectly, owns 50% or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an "S" corporation, 50% or more of the issued and outstanding shares of stock of the corporation, or, in the case of such trades or businesses operated by a partnership, 50% or more of the capital or profits in the partnership; (2) the ownership described in (1) above exists for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income; (3) all of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years; (4) none of the trades or businesses to be aggregated are an SSTB; and (5) the trades or businesses to be aggregated satisfy at least two of the following factors based on all the facts and circumstances: (a) the trades or businesses provide products and services that are the same or customarily offered together; (b) the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or (c) the trades or businesses are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

Operating Rules. An individual may aggregate trades or businesses operated directly and the individual's share of QBI, W-2 Wages and UBIA of qualified property from trades or businesses operated through RPEs. Multiple owners of an RPE need not aggregate in the same manner. For those trades or businesses directly operated by the individual, the individual computes QBI, W-2 Wages and UBIA of qualified property for each trade or business before applying the aggregation rules. If an individual aggregates multiple trades or businesses, the individual must combine the QBI, W-2 Wages and UBIA of qualified property for all aggregated trades or businesses for purposes of applying the W-2 Wage and UBIA of qualified property limitations. Prop. Reg. § 1.199A-4(b)(2).

Family Attribution. For purposes of determining ownership, an individual is considered as owning the interest in each trade or business owned, directly or indirectly, by or for the individual's spouse, and the individual's children, grandchildren, and parents. Prop. Reg. § 1.199A-4(b)(3).

Reporting and Consistency.

[a] General Rules. Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. An individual may, however, add a newly created or newly acquired trade or business to an existing aggregated trade or business if the aggregation rules are otherwise satisfied. If, in a subsequent year, there is a change in facts or circumstances such that an individual's prior aggregation of trades or businesses no longer qualifies for aggregation, then the trades or businesses will no longer be aggregated, and the individual must reapply the aggregation rules to determine a new permissible aggregation (if any). Prop. Reg. § 1.199A-4(c)(1).

[b] Individual Disclosure. For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated under Proposed Reg. § 1.199A-4, and the statement must contain:

[i] a description of each trade or business;

[ii] the name and EIN of each entity in which a trade or business is operated;

[iii] information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed or during the taxable year; and

[iv] such other information as the IRS may require on forms, instructions or other published guidance.

If an individual fails to attach the statement required hereunder, the IRS may disaggregate the individual's trades or businesses. Prop. Reg. § 1.199A-4(c)(2).

1.13. RPEs, PTPs, Trusts and Estates and Proposed Regulation Section 1.199A-6

This Proposed Section 199A Regulations provide special rules for RPEs, PTPs, trusts and estates necessary for the computation of the § 199A deduction of their owners or beneficiaries.

Computational and Reporting Rules for RPEs. An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for the owners to determine their § 199A deduction. Specifically, under Proposed Reg. § 1.199A-6(b)(2), an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their § 199A deduction as follows:

[a] First, the RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB.

[b] Second, the RPE must apply the rules in Proposed Reg. § 1.199A-3 to determine the QBI for each trade or business engaged in directly.

[c] Third, the RPE must apply the rules in § 199A-2 to determine the W-2 Wages and UBIA of qualified property for each trade or business engaged in directly.

[d] Fourth, the RPE must determine whether it has any qualified REIT Dividends earned directly or through another RPE. The RPE must also determine the net amount of qualified PTP Income earned directly or indirectly through investments in PTPs.

Reporting Rules for RPEs. An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business engaged in directly by the RPE:

[a] each owner's allocable share of QBI, W-2 Wages and UBIA of qualified property attributable to each such trade or business; and

[b] whether any trades or businesses constitute an SSTB.

Additionally, an RPE must also report on an attachment to the Schedule K-1, any QBI, W-2 Wages, UBIA of qualified property, or SSTB determinations reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocated share of any qualified REIT Dividends or Qualified PTP Income or loss received by the RPE (including through another RPE). If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to any owner any items described above, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 Wages and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will presumed to be zero. Prop. Reg. § 1.199A-6(b)(3).

Computational and Reporting Rules for PTPs. Each PTP must determine its QBI under the rules of Proposed Reg. § 1.199A-3 for each trade or business in which the PTP is engaged in directly. The PTP must also determine whether any of the trades or businesses it is engaged in directly is an SSTB. Additionally, each PTP is required to separately identify and report the information on Schedules K-1 issued to its partners. Each PTP must also determine and report any qualified REIT Dividends or Qualified PTP Income or loss received by the PTP including through an RPE, a REIT or another PTP. A PTP is not required to determine or report W-2 Wages or the UBIA of qualified property attributable to trades or businesses it is engaged in directly. Prop. Reg. § 1.199A-6(c).

Application to Trusts, Estates and Beneficiaries.

[a] In General. A trust or estate computes its § 199A deduction based on the QBI, W-2 Wages, UBIA of qualified property, Qualified REIT Dividends, and Qualified PTP Income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W-2 Wages, UBIA of qualified property, Qualified REIT Dividends and Qualified PTP Income allocated from a trust or estate in calculating the beneficiary's § 199A deduction in the same manner as though the items had been allocated from an RPE. A trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items. Prop. Reg. § 1.199A-6(d)(1).

[b] Grantor Trust. To the extent that the grantor or other person is treated as owning all or a part of a trust under § 671 through § 679, such person computes its § 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or another person. Prop. Reg. § 1.199A-6(d)(2).

[c] Non-Grantor Trusts and Estates. A trust or estate must calculate its QBI, W-2 Wages, UBIA of Qualified Property, Qualified REIT Dividends, and Qualified PTP Income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in § 199A(c)(3) in accordance with the classification of those deductions under Reg. § 1.652(b)-3(a), and deductions not directly attributable within the meaning of Reg. § 1.652(b)-3(b) are allocated in a manner consistent with the rules of Reg. § 1.652(b)-3(b). Any depletion and depreciation deductions described in § 642(e) and any amortization deductions described in § 642(f) that are otherwise properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code. Prop. Reg. § 1.199A-6(d)(3)(i).

[d] Allocation Among Trust or Estate and Beneficiaries. The QBI, W-2 Wages, UBIA of Qualified Property, Qualified REIT Dividends and Qualified PTP Income of a trust of estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust or estate's distributable net income ("DNI") for the taxable year that it is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. The trust or estate's DNI is determined with regard to the separate share rule of § 663(c), but without regard to § 199A. If the trust or estate has no DNI for the taxable year, any QBI, W-2 Wages, UBIA of Qualified Property, Qualified REIT Dividends and Qualified PTP Income are allocated entirely to the trust or estate. Prop. Reg. § 1.199A-6(d)(3)(ii).

[e] Threshold Amount. The Threshold Amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. Thereafter, the Threshold Amount is $157,500 increased by the cost of living adjusted provided in Proposed Reg. § 1.199A-1(b)(11). The taxable income of a trust or estate is determined before taking into account any distribution deduction under § 651 or § 661. Prop. Reg. § 1.199A-6(d)(3)(iii).

[f] Electing Small Business Trusts. Proposed Reg. § 1.199A-6(d)(3)(iv) provides that an electing small business trust ("ESBT") is entitled to the deduction under § 199A. The S portion of the ESBT must take into account the QBI and other items from any "S" corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets owned by a grantor or another person of a trust under § 671 through § 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT.

Anti-Abuse Rule for Creation of Multiple Trusts to Avoid Exceeding the Threshold Amount. Under Proposed Reg. § 1.199A-6(d)(3)(v), a trust formed or funded with a significant purpose of receiving a deduction under § 199A will not be respected for purposes of § 199A. This prevents taxpayers from creating multiple non-grantor trusts, each of which has taxable income below the Threshold Amount, in order to maximize the § 199A deduction. It has also been suggested that this anti-abuse rule, as contrasted with the anti-abuse rules set forth in Prop. Reg. § 1.643(f)-1(a), may apply to the formation of a single trust. Further anti-abuse rules are set forth in Proposed Regulations Section 1.643(f)-1.

1.14. Anti-Abuse Rules for Multiple Trusts

General Rule. Proposed Reg. § 1.643(f)-1(a) provides that for purposes of Subchapter J, two or more trusts will be aggregated and treated as a single trust if such trust has substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trust or for contributing additional cash or other property to such trust is the avoidance of federal income tax.

A Principal Purpose. A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of the separate trust.

1.15. Observations and Anomalies Created By Section 199A

Clearly, the rules for the new deduction under Section 199A available to owners of S corporations, partnerships, LLCs and sole proprietorships are extremely complex (and certainly did not simplify the Code), especially where the taxpayer's taxable income exceeds the threshold amounts ($157,500 or $315,000) discussed above. These new rules can result in different (and presumably unintended) results between S corporations, partnerships and sole proprietorships having the same amount of income, and thus may affect the taxpayer's choice of entity decisions. These different results are primarily attributable to two factors.

Introduction. Because the Federal Insurance Contributions Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes may be substantial, many shareholder-employees of S corporations have employed a strategy of decreasing the amount of wages that they receive from the S corporation and correspondingly increasing the amount of S corporation distributions made to them. One of the major advantages of operating as an S corporation rather than as a partnership (or LLC taxed as a partnership) is the ability to limit Social Security taxes or at least to have some clarity as to when and how Social Security taxes apply (as opposed to LLCs where the application of the self-employment tax to the members of an LLC is unclear at best.)

[a] Social Security Taxes on Wages. As part of FICA, a tax is imposed on employees and employers up to a prescribed maximum amount of employee wages. This tax is comprised of two parts, the Old-Age, Survivor, and Disability Insurance (OASDI) portion and the Medicare Hospital Insurance (HI) portion. The HI tax rate is 1.45% on both the employer and the employee, and the OASDI tax rate is 6.2% on both the employer and the employee. The maximum wages subject to the OASDI tax rate is $128,400 for 2018.

RRA '93 repealed the dollar limit on wages and self-employment income subject to the HI portion of the FICA tax as well as the self-employment tax. Thus, employers and employees will equally be subject to the 1.45% HI tax on ***all*** wages, and self-employed individuals will be subject to the 2.9% HI tax on ***all*** self-employment income.

Beginning in 2013, the HI portion of the Social Security tax increased from 2.9% (combined employer and employee) to 3.8% (combined employer and employee) for wages in excess of $250,000 for married individuals filing jointly and in excess of $200,000 for other taxpayers. Additionally, beginning in 2013, a taxpayer having modified adjusted gross income in excess of $250,000 in the case of married individuals filing jointly and $200,000 for other taxpayers is subject to the 3.8% net investment income tax.

[b] Health Care and Education Reconciliation Act of 2010. The Health Care and Education Reconciliation Act of 2010,[4] imposes a tax on unearned income on partners, members of LLCs taxed as partnerships and S corporation shareholders. Specifically, Section 1411(a)(1) imposes a 3.8% tax on the lesser of (a) "net investment income" or (b) the excess of modified adjusted gross income over $250,000 in the case of taxpayers filing a joint return and over $200,000 for other taxpayers.[5] Under Section 1411(c)(A)(i), "net investment income" includes gross income from interest, dividends, annuities, royalties, and rents other than such income which is derived in the ordinary course of a trade or business.[6] Consequently, items of interest, dividends, annuities, royalties, and rents which pass through a partnership, LLC or S corporation to its partners, members or shareholders, will retain their character as net investment income and will be subject to the 3.8% tax on net investment income.

Additionally, the term "net investment income" includes: (1) any other gross income derived from a trade or business if such trade or business is a passive activity within the meaning of Section 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under Section 469 with respect to the taxpayer.

The Health Care and Education Reconciliation Act of 2010 also increased the Medicare portion of the FICA tax by .9% (to 3.8%) on wages in excess of $250,000 in the case of taxpayers filing a joint return and more than $200,000 for other taxpayers, as well as the Medicare portion of the self-employment tax by .9% (to 3.8%) on earnings from self-employment in excess of $250,000 in the case of taxpayers filing a joint return and more than $200,000 for other taxpayers.

These tax provisions are effective for tax years beginning after January 31, 2012.

[c] Social Security Taxes and S Corporations. In order for shareholder-employees of S corporations to realize employment tax savings by withdrawing funds in the form of distributions rather than compensation, such distributions must not be recharacterized as "wages" for FICA purposes or as NESE for purposes of the SE Tax. For FICA and FUTA purposes, Sections 3121(a) and 3306(b), respectively, define the term "wages" to mean all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

Although it might appear at first glance that a shareholder's distributive share of income from an S corporation constitutes NESE since a general partner's distributive share of the income of any trade or business carried on by a partnership of which he is a member generally constitutes NESE subject to the SE Tax, in Rev. Rul. 59-221, the IRS found that an S corporation's income does not constitute

[4] Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

[5] *Id.* at sec. 1402, § 1411, 124 Stat. at 1061.

[6] *Id.*

NESE for purposes of the SE Tax.[7] Additionally, Section 1402(a)(2) specifically excludes from the definition of NESE dividends on shares of stock issued by a corporation.[8]

Consequently, neither a shareholder's distributive share of income passed through from the S corporation under Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute NESE subject to the SE Tax. In Rev. Rul. 66-327, the IRS found that the taxable income of an S corporation included in its shareholders' gross income is not income derived from a trade or business for purposes of computing the shareholders' net operating losses under Section 172(c).[9] Similarly in PLR 8716060, the IRS concluded that the income derived by a shareholder-employee from an S corporation did not constitute net earnings from self-employment for self-employment tax purposes and that such taxpayer was not eligible to adopt a qualified pension plan based on the income derived from his S corporation since such income did not constitute earned income.[10]

Because wages paid to shareholder-employees of S corporations are subject to Social Security taxes while S corporation distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions rather than wages. Prior to advising an S corporation with shareholder-employees to undertake such a tax planning strategy, however, the tax practitioner should analyze the economic and tax consequences that such a strategy will have on the S corporation and its shareholders.[11]

Although the amount of funds available for distribution to an S corporation's shareholder-employees will increase as the wages paid to them decrease, all distributions made by the S corporation to its shareholders must be made in proportion to the number of shares held by such shareholders under Section 1361(b)(1)(D). Thus, if an S corporation which has both shareholders who are employees and shareholders who are not employees adopts a tax strategy to reduce Social Security taxes by minimizing wages and maximizing distributions, the increase in the amount of distributions received by the shareholders who are employees will be less than the amount by which their wages were reduced (since distributions must also be made to the shareholders who are not employees). Additionally, a program that minimizes the amount of wages paid to shareholder-employees will increase: (1) purchase price formulas based on earnings; and (2) bonus formulas based on earnings.

---

[7] Rev. Rul. 59-221, 1959-1 C.B. 225.

[8] Section 1402.

[9] Rev. Rul. 66-327, 1966-2 C.B. 357.

[10] PLR 8716060 (Jan. 21, 1987).

[11] *See generally* Stephen Looney & Ronald Levitt, "Reasonable Compensation Issues for Closely-held and Service Companies," 61st N.Y.U. Ann. Inst. Fed. Tax'n 16 (2003); Looney & Comiter, "Reasonable Compensation: Dividends vs. Wages - A Reverse in Positions," 7 J. Partnership Tax'n 364 (Winter 1991); Clements & Streer, "How Low Can Owner-Employee Compensation be Set to Save on Employment Taxes?" 2 J. S. Corp. Tax'n 37 (1990); Andrews, "Current Non-Stock Executive Compensation and Fringe Benefit Issues," 1 S. Corp.: J. Tax, Leg. & Bus. Strategies 3 (1989); Spradling, "Are S Corp. Distributions Wages Subject to Withholding?" 71 J. Tax'n 104 (Aug. 1989).

Decreasing the amount of wages paid to shareholder-employees of S corporations also will reduce the contribution base for contributions to the corporation's qualified plans.

S Corporations and Unreasonably Low Compensation - Reclassification Risks. In Rev. Rul. 74-44, two shareholders of an S corporation withdrew ***no salary*** from the corporation and arranged for the corporation to pay them dividends equal to the amount that they would have otherwise received as reasonable compensation for services performed.[12] This arrangement was made for the express purpose of avoiding payment of federal employment taxes. Based on the expansive definition of wages for FICA and Federal Unemployment Tax Act ("FUTA") purposes (which includes all remuneration for employment), the IRS found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes. Rev. Rul. 74-44 did not, however, address the issue of what constitutes reasonable compensation in the S corporation context since the ruling expressly stated that the dividends were received by the shareholder-employees in lieu of the reasonable compensation that would have otherwise been paid to them. Despite this shortcoming, Rev. Rul. 74-44 clearly indicates that the payment of ***no*** compensation will be unreasonable where shareholder-employees provide substantial services to the corporation.[13]

[a] In *Radtke v. United States*,[14] the court recharacterized distributions made to the sole shareholder (an attorney) of an S corporation (a law firm) as wages subject to FICA and FUTA taxes, where the shareholder made all of his withdrawals from the S corporation in the form of S corporation distributions and received no salary from the S corporation during the tax year. The court relied on a broad definition of wages for FICA and FUTA purposes as all remuneration for employment, and concluded that the dividend payments were remuneration for services performed by the shareholder for the S corporation. Likewise, in Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990), the court recharacterized dividend distributions made to a shareholder (an accountant) of an S corporation (an accounting firm) as wages subject to FICA and FUTA taxes where the shareholder received no salary during the tax year.

[b] Additionally, in *Esser, P.C. v. United States*,[15] the court recharacterized amounts received by the sole shareholder, officer and director of a legal services S corporation, as wages subject to FICA and FUTA taxes, rather than as distributions. As in the *Radtke* and *Spicer Accounting* cases, the shareholder received ***no salary*** from the S corporation during the tax year.

---

[12] Rev. Rul. 74-44, 1974-1 C.B. 287.

[13] *See also* Rev. Rul. 71-86, 1971-1 C.B. 285 (president and sole shareholder of closely-held corporation found to be an "employee" of the corporation for employment tax purposes); Rev. Rul. 73-361, 1973-2 C.B. 331 (officer-shareholder of an S corporation who performed substantial services as an officer of the S corporation is an "employee" of the corporation for purposes of FICA, FUTA and income tax withholding); PLR 7949022 (Aug. 31, 1979) (shareholder-employees of S corporation who perform substantial services for S corporation treated as "employees" for employment tax purposes).

[14] *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990).

[15] *Esser, P.C. v. United States*, 750 F. Supp. 421 (D. Ariz. 1990).

[c] In *Cave v. Commissioner*,[16] the court held that all of the non-shareholder attorneys, as well as a law clerk, of a law firm were common law employees rather than independent contractors, and also recharacterized the distributions made to the sole shareholder of the law firm, who was determined to be a statutory employee, as wages subject to Social Security taxes.

[d] In *Watson P.C. v. United States*,[17] the Eighth Circuit Court of Appeals affirmed the decision of the district court recharacterizing a significant portion of dividend distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes.

During the years in issue, 2002 and 2003, David E. Watson, CPA ("Watson"), provided accounting services to a partnership ("LWBJ") and its clients as an employee of David E. Watson P.C., an S corporation (the "S Corporation"). The S Corporation was a 25% partner in LWBJ. The IRS made assessments against Watson after it determined that portions of the dividend distributions from the S Corporation to Watson should be recharacterized as wages subject to employment taxes. Specifically, the IRS contended that $130,730.05 out of a total of $203,651 of dividend payments to Watson for 2002 should be recharacterized as wages subject to employment taxes, and that $175,470 out of a total of $203,651 of dividend payments to Watson for 2003 should be recharacterized as wages subject to employment taxes. In both years, Watson received a salary of $24,000 in addition to the dividend distributions.

In his Motion for Summary Judgment, Watson argued that the intent of the S Corporation was controlling in determining the characterization of the payments from the S Corporation to Watson. Because the S Corporation clearly intended to pay Watson compensation of only $24,000 per year, Watson contended that any amounts distributed in excess of the $24,000 were properly classified as dividends. In support of his position, Watson cited *Electric & Neon, Inc. v. Commissioner, Paula Constr. Co. v. Commissioner*, and *Pediatric Surgical Associates, P.C. v. Commissioner*.[18]

Citing Rev. Rul. 74-44, *Radtke*, *Spicer Accounting* and *Veterinary Surgical Consultants*, the district court found that the intent of the S Corporation was not controlling in determining the character of the payments, but rather that the analysis turns on whether the payments at issue were made as remuneration for services performed.[19] Consequently, the court denied Watson's Motion for Summary Judgment because it found that there was a genuine issue of material fact as to whether the dividends paid to Watson by the S Corporation were remuneration for services performed subject to employment taxes.

---

[16] *Cave v. Commissioner*, 476 F. App'x 424 (5th Cir. 2012), *aff'g per curiam*, T.C. Memo 2011-48.

[17] *Watson P.C. v. United States.*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010).

[18] *Electric & Neon Inc. v. Commissioner*, 56 T.C. 1324 (1971); *Paula Constr. Co. v. Commissioner*, 58 T.C. 1055 (1972); *Pediatric Surgical Assocs. v. Commissioner*, T.C. Memo 2001-81.

[19] Citing *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting v. United States*, 918 F.2d 90 (9th Cir. 1990); *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), *aff'd sub nom., Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 (2nd Cir. 2002); Rev. Rul. 74-44, 1974-1 CB 287.

After denying the taxpayer's Motion for Summary Judgment, the district court held a bench trial on the merits. At trial, the government's expert opined that the market value of Watson's accounting services was approximately $91,044 per year for 2002 and 2003. The government's expert was a general engineer with the IRS and had worked on approximately 20 to 30 cases involving reasonable compensation issues. In forming his opinion as to Watson's salary, the government's expert relied on several compensation surveys and studies particularly relating to accountants. The district court ultimately adopted the government expert witness's opinion and determined that the reasonable amount of Watson's remuneration for services performed totaled $91,044 for each of 2002 and 2003.

In addition to determining the issues of what constituted reasonable compensation to the sole shareholder of the S corporation and whether intent was the determinative factor in determining whether payments from an S corporation to its sole shareholder should be characterized as wages or as dividend distributions, the court first addressed the taxpayer's argument that the district court erred in allowing the government's expert to testify on the issue of reasonable compensation because he was not competent to testify on that issue. Specifically, the taxpayer asserted that the government's expert witness was not qualified, changed his opinion, relied on insufficient underlying facts, and used flawed methods in rendering his opinion. After reviewing all of these factors in detail, the court of appeals determined that the district court did not abuse its discretion in admitting the testimony of the government's expert witness, and found the taxpayer's arguments meritless.

In reaching its decision, the Eighth Circuit cited Rev. Rul. 74-44, *Radtke*, *Spicer Accounting* and *Veterinary Surgical Consultants* cases (discussed above), and concluded that the district court properly determined that the characterization of funds disbursed by an S corporation to its shareholders turns on an analysis of whether the payments at issue were made as remuneration for services performed.[20] The court went on to state that the district court found that the S corporation understated wage payments to its sole shareholder by $67,044 in each year based on a variety of factors. These factors included the following evidence: (1) Watson was an exceedingly qualified accountant with an advanced degree and nearly 20 years in accounting and taxation; (2) Watson worked 35-45 hours per week as one of the primary earners in a reputable firm, which had earnings much greater than comparable firms; (3) the partnership had gross earnings of over $2M in 2002 and nearly $3M in 2003; (4) $24,000 is unreasonably low compared to other similarly situated accountants; (5) given the financial position of the partnership, Watson's experience and his contributions to the partnership, a $24,000 salary was exceedingly low when compared to the roughly $200,000 the partnership distributed to Watson's S corporation in 2002 and 2003; and (6) the fair market value of Watson's services was $91,034.

The Eighth Circuit next addressed the taxpayer's argument that instead of focusing on reasonableness, the district court should have focused on the S corporation's intent. While acknowledging that Section 162(a)(1) provides that the deductibility of compensation is a two prong test in that the compensation must both be reasonable in amount and in fact payments purely for services, the court, citing *Elliotts, Inc. v. Commissioner*,[21] stated that courts usually only need to examine the first prong since the reasonableness prong generally subsumes the inquiry into compensatory intent in most

---

[20] Id.

[21] *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983), *rev'g* T.C. Memo 1980-282.

cases. The court did state however, that in certain rare cases where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness.

In the case, the taxpayer cited *Pediatric Surgical Associates* in support of his position that taxpayer intent controls in FICA tax characterization cases. The Eighth Circuit found that even if intent does control, after evaluating all the evidence, the district court specifically found that the shareholder's assertion that the S corporation intended to pay him a salary of only $24,000 a year to be less than credible. Additionally, the Eighth Circuit Court of Appeals went on to reject the argument made by the taxpayer that *Pediatric Surgical Associates* limited the amount that could be characterized as wages to the amount of revenue each shareholder-employee personally generated less expenses since, like *Pediatric Surgical Associates*, nonshareholder-employees also contributed to the S corporation's earnings. The Eighth Circuit Court of Appeals brushed this argument aside by saying that although they thought evidence of shareholder-employee billings and collections may be probative on the issue of compensation, in light of all the evidence presented to the district court in the case, they saw no error and affirmed the decision of the district court.

[e] In *Herbert v. Commissioner*,[22] the Tax Court recharacterized a portion of the amounts the taxpayer claimed were used to pay business expenses as wages subject to Social Security taxes, finding the taxpayer's salary was unreasonably low. However, the Tax Court expressly rejected the IRS's contention that the taxpayer's salary be increased by $52,600, primarily based on the salary paid by the S corporation to the shareholder in a prior year in which the business was not owned by the taxpayer.

In reaching this decision, the Tax Court believed and accepted the taxpayer's testimony that the taxpayer in fact paid significant expenses of the corporation with cash funds received from the corporation. Additionally, the court found that in spite of limited evidence before them, they believed that it was improper and excessive to charge the taxpayer with receipt from the corporation in 2007 of $52,600 in additional wages. On the other hand, the court stated that the taxpayer's reported wages of $2,400 was unreasonably low.

Consequently, citing *Mayson Mfg. Co. v. Commissioner*,[23] the Tax Court averaged the taxpayer's wages for 2002 through 2006, and used the average amount as the total for the taxpayer's 2007 wages subject to employment taxes ($30,445).

[f] In *Sean McClary Ltd., Inc. v. Commissioner*,[24] the Tax Court recharacterized the distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes where the shareholder received no salary from the S corporation and also found that the annual compensation formula contained in the Board of Directors minutes setting a salary of $24,000 was unreasonably low.

---

22 *Herbert v. Commissioner,* T.C. Summ. Op. 2012-124.

23 *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).

24 *Sean McClary Ltd., Inc. v. Commissioner*, T.C. Summ. Op. 2013-62.

Mr. McClary was the president, secretary, treasurer, sole director and sole shareholder of his S corporation. He managed all aspects of the S corporation's operations, including recruiting and supervising sales agents, conducting real estate sales, procuring advertising, purchasing supplies, and maintaining basic books and records, Mr. McClary often worked 12-hour days with few days off. For the year in issue, Mr. McClary supervised eight sales agents, four of whom generated sales commissions for the S corporation that year, but most of the S corporation's gross receipts were attributable to sales commissions generated by Mr. McClary himself.

For the year in issue, the S corporation did not issue a form W-2, Wage and Tax Statement, to Mr. McClary, nor did it claim a deduction for the amount paid to Mr. McClary as wages or compensation for services. During such year, Mr. McClary transferred a total of $240,000 from the S corporation's account to his personal account.

In determining what portion of the $240,000 of distributions should be recharacterized as wages, the IRS's expert witness found that $100,755 represented reasonable compensation for services rendered by Mr. McClary for the year in issue. On the other hand, Mr. McClary argued that even though he did not pay himself a salary, the salary of $24,000 set forth in the compensation arrangement in the corporation's minutes should be the only amount characterized as wages subject to Social Security taxes.

The Tax Court, citing the multi-factor test used in determining reasonable compensation for shareholder employees of C corporations, found that reasonable compensation for Mr. McClary's services during the year in issue was $83,200, and as such, recharacterized $83,200 of the $240,000 distributed by the S corporation to Mr. McClary as wages subject to Social Security taxes.

[g] In *Glass Blocks Unlimited v. Commissioner*,[25] the Tax Court recharacterized the total distributions made by an S corporation to its president, sole shareholder and only full-time employee, of $30,844 in 2007 and $31,644 in 2008, as wages subject to Social Security taxes.

Citing *Veterinary Surgical Consultants P.C. v. Commissioner*,[26] an officer who performs more than minor services for a corporation and receives remuneration in any form for those services is considered an employee, and his or her wages are subject to the employer's payment of federal employment taxes. The court went on to find that the taxpayer was the S corporation's only officer, and sole full-time worker in 2007 and 2008 and performed substantially all the work necessary to operate the business.

The Tax Court went on to reject the taxpayer's argument that the distributions constituted repayment of shareholder loans, and the taxpayer's argument that the characterization of all distributions from the S corporation to him as wages constituted unreasonably high compensation to him, citing the multi-factor test used in *Elliotts, Inc. v. Commissioner*.[27] Consequently, the Tax Court found that the

---

[25] *Glass Blocks Unlimited v. Commissioner*, T.C. Memo 2013-180.

[26] *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001), *aff'd sub. nom.*, *Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 (2nd Cir. 2002).

[27] *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983) *rev'g* T.C. Memo 1980-282.

total amount of distributions made by the S corporation to its sole shareholder constituted wages subject to Social Security taxes for the years in issue.

[h] The *Watson* case, the *Herbert* case and the *McClary* case are the first reported decisions in which the court was presented with a situation which was not clearly abusive such as those presented in *Radtke* and *Spicer Accounting* (i.e., where ***all*** of the earnings of the S corporations were paid to the sole shareholder as dividend distributions and no salary was paid to the shareholder by the S corporation). The *Watson*, *Herbert*, and *McClary* cases likewise involve situations where only a portion of amounts not treated as wages are recharacterized as wages subject to Social Security taxes, ***and each involves different methods in determining what constitutes "reasonable compensation" to the shareholder-employees of an S corporation***. Consequently, the *Watson*, *Herbert* and McClary decisions represent important victories for the IRS in being able to recharacterize dividend distributions as wages where at least some (but less than a reasonable) salary has been paid to the shareholder-employees of the S corporation. On the other hand, these cases can be viewed as favorable to taxpayers as they allowed personal service S corporations to distribute significant amounts of their income ***without*** being subject to Social Security taxes. However, the *Watson* case is somewhat troubling in its rejection of the decision reached in the *Pediatric Surgical Associates*, *P.C.* case (in which the IRS sought to recharacterize wages of a C corporation as dividend distributions rather than vice versa), in that the court did not seem to take into account the fact that dividend distributions can indeed be generated by the services of nonshareholder-employees of an S corporation or from other ancillary services not provided by the shareholder-employees of the S corporation.

[i] The *Radtke*, *Spicer Accounting* and *Esser* cases indicate that in ***abusive situations***, such as ***where the shareholders*** of an S corporation make all withdrawals from the S corporation in the form of S corporation distributions and ***receive no salary from the S corporation*** during the tax year, the courts can and will recharacterize such distributions as wages subject to Social Security taxes. These earlier cases have been followed in more recent cases.[28]

In non-abusive situations, however, the IRS may have difficulty in successfully asserting that distributions made by S corporations to shareholder-employees should be recharacterized as wages subject to Social Security taxes. In order for the IRS to recharacterize S corporation distributions as wages subject to Social Security taxes in non-abusive situations, the IRS would have to overcome: (i) the lack of express authority for its position (unlike the express authority granted to the IRS under Section 1366(e) to recharacterize dividend distributions as wages in the family context); (ii) the burden of overcoming the initial characterization of the payment as a distribution; and (iii) the uncertainty surrounding the utilization of Section 162(a)(1) by the IRS in the employment context to bring salaries ***up*** to a reasonable level.

The key is obviously determining what is an abusive situation versus a non-abusive situation regarding reasonable compensation in the S corporation context. In IRS Fact Sheet 2008-25, August,

[28] *See Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 14 (2001); *Van Camp & Brennion v. United States*, 251 F.3d 862 (9th Cir. 2001); *Olde Raleigh Realty Corp. v. Commissioner*, T.C. Summ. Op. 2002-61; *David E. Watson P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010); *Herbert v. Commissioner*, T.C. Summ. Op. 2012-124; *Sean McClary Ltd., Inc. v. Commissioner*, T.C. Summ. Op. 2013-62; *Glass Blocks Unltd. v. Commissioner*, T.C. Memo 2013-180.

2012, the IRS provides that although there is no "bright line" test for determining what constitutes "reasonable compensation" to S corporation shareholder-employees, a multi-factor type analysis similar to the factors set forth in *Mayson Manufacturing Co.* should be used.[29] In *Herbert*, the court expressly stated that it was applying a multi-factor test to determine reasonable compensation, but actually used an average salary approach in determining the reasonable compensation of the shareholder-employee. The court in the *Watson* case relied on expert witness testimony as to the reasonableness of compensation, and in the *McClary* and *Glass Blocks* cases, the court cited that the multi-factor test was being used to determine the reasonableness of compensation without going into an in-depth analysis of those factors in such cases. In any event, it would seem absolutely inappropriate to apply the independent investor test to determine the reasonableness of compensation in the S corporation context, as that would result in all of the amounts being received by the shareholder-employees of an S corporation being characterized as wages other than the amounts determined to be a reasonable rate of return payable to the hypothetical independent investor.

[j] In IRS Fact Sheet FS-2008-25, the IRS clarified information that small business taxpayers should understand regarding the tax law for corporate officers who perform services for S corporations.[30] In the Fact Sheet, the IRS points out that just because an officer is also a shareholder of the S corporation, it does not change the requirement that payments to the corporate officer must be treated as wages, and that courts have consistently held that S corporation officer-shareholders who provide more than minor services to the corporation and who receive or are entitled to receive payments are employees whose compensation is subject to federal employment taxes.

The Fact Sheet goes on to discuss that although there are no "bright line" tests for determining what constitutes "reasonable compensation" to S corporation officer-shareholders, the following factors have been considered by the courts in determining reasonable compensation:

- Training and experience.
- Duties and responsibilities.
- Time and effort devoted to the business.
- Dividend history.
- Payments to non-shareholder employees.
- Timing and manner of paying bonuses to key people.
- What comparable business pay for similar services.
- Compensation agreements.
- The use of a formula to determine compensation.

Consequently, in non-abusive situations, a tax strategy of decreasing wages and correspondingly increasing distributions to shareholder-employees could result in substantial employment tax savings**.**

---

29 IRS, FS-2008-25, "Wage Compensation for S Corporation Officers" (August 2008), http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers (last updated Aug. 18, 2012).

30 Id.

As a result of this tax planning technique, the IRS, the Joint Committee on Taxation, the Department of Treasury, Congress and the press have issued reports and notices, introduced legislation and issued comments addressing the use of S corporations as a means of avoiding the self-employment tax.

[k] In PMTA 2017-005[31], the IRS determined that the Tax Court does not have jurisdiction under Section 7436 to review a determination that a corporation is liable for additional employment taxes due to the IRS' recharacterization of payments made to, or on behalf of, corporate officers who were treated as employees.

In a number of prior cases[32], the Tax Court has addressed the issue of whether an S corporation has paid unreasonably low compensation to its shareholder-employees so that it may reclassify distributions made by the S corporation to its shareholder-employees as wages subject to Social Security Taxes. In none of these prior cases has the IRS ever raised the issue that the Tax Court did not have jurisdiction over the case.

Section 7436(a) provides the Tax Court with jurisdiction to review certain employment tax determinations made by the IRS and the proper amount of employment tax under such determinations. Specifically, the Tax Court has jurisdiction to review determinations that (1) individuals are employees for purposes of employment taxes under Subtitle C of the Code (i.e., requiring reclassification of a non-employee to employee status); or (2) the person for whom services are performed is not entitled to relief under Section 530.

In PMTA 2017-005, the IRS reasoned that the dispute in issue was limited to the correct amount of payments required to be treated as "wages" for employment tax purposes, as opposed to a dispute as to whether the corporate officers were employees of the taxpayer under Section 3121(d)(1). Additionally, the IRS found that there was no dispute concerning entitlement to Section 530 relief. The Tax Court has previously held that it had jurisdiction with respect to an employment status controversy when four required elements are present: (1) an examination in connection with the audit of any person; (2) a determination by the IRS that "one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or such person is not entitled to the treatment under subsection (a) of Section 530 of the Revenue Act of 1978 with respect to such individual"; (3) "an actual controversy" involving the determination as part of the examination; and (4) the filing of an appropriate pleading in the Tax Court.[33]

Consequently, the IRS concluded that because it was not making a determination regarding the employment status of the corporate officers when it recharacterized certain payments as wages that were not treated as wages but rather as distributions from the S corporation, and was also not making a determination with respect to entitlement to Section 530 relief, the Tax Court lacked jurisdiction to

---

31 March 30, 2017.

32 <u>See</u> *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990); *Esser, P.C. v. United States*, 750 F. Supp. 421 (D Ariz 1990); *Watson P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012); *Herbert v. Commissioner.*, T.C. Summ. Op. 2012-124; *Sean McClary Ltd., Inc. v. Commissioner*, T.C. Summ. Op. 2013-62; and *Glass Blocks Unlimited v. Commissioner*, T.C. Memo 2013-180.

33 *American Airlines, Inc. v. Comm'r*, 144 T.C. 24 (2015).

determine the correct amount of employment taxes due as a result of the employment tax assessment under Section 6201 on the additional wages.

The IRS went on to state that the position taken in PMTA 2017-005 was consistent with two recent Tax Court Orders. First, the IRS cited *Martin S. Azarian P.A. v. Comm'r*[34], where the taxpayer, an S corporation treated its sole owner and officer, Mr. Azarian, as an employee during the taxable periods at issue and reported wages paid to Mr. Azarian on forms W-2. The IRS sent the taxpayer Forms 4668, Employment Tax Examination Changes Report, which (1) concluded that the taxpayer failed to report reusable compensation paid to Mr. Azarian for the taxable periods in issue; (2) proposed increased annual wages to Mr. Azarian for those periods; and (3) concluded that taxpayer was liable for proposed employment tax increases and addition to taxes.

The taxpayer filed a petition requesting the Tax Court to overturn respondent's findings and the IRS filed a Motion to Dismiss for Lack of Jurisdiction on the grounds that (1) no Notice of Determination of Worker Classification was sent to the taxpayer, and (2) no other determination was made by the IRS which conferred jurisdiction on the Court. On February 21, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction finding that the IRS did not make a determination under Section 7436(a)(2) regarding whether the taxpayer was entitled to relief under Section 530, and that since Mr. Azarian was treated as an employee for the taxable years in issue, the IRS did not make a determination that Mr. Azarian was an employee of the S corporation under Section 7436(a)(1). The Court stated that Section 7436(a)(1) only confers jurisdiction upon the Tax Court to determine the ["]correct and the proper amount of employment tax[“] when respondent makes a worker classification determination, not when respondent concludes that petitioner underreported reasonable wage compensation, as is the case here."

Similarly, in *Patricia Arroyo, DDS Corp, Alex Mansilla and Mercedes P. Arroyo v. Comm'r*[35], the Tax Court dismissed the case with respect to Patricia Arroyo, DDS, Corp for lack or jurisdiction finding that the IRS had not made any determinations for purposes of Section 7436. Again, the IRS determined that the amounts treated as salaries paid to the corporate officers and reported on Form W-2 as wages were artificially low, recharacterized higher amounts as salaries, and thus as wages, and assessed additional employment taxes. On February 23, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction stating that the taxpayer consistently treated the corporate officers as employees and contested only the IRS' determination that the compensation paid to the corporate officers was inadequate. Again, the Tax Court stated that because the IRS did not make a determination with respect to either of the two requisite matters specified in Section 7436(a)(1) or (2), the Court lacked jurisdiction to determine the correct amount of employment taxes due as a result of the IRS' determination that the S corporation underreported the corporate officer's wages during the tax years at issue.

[l] In ILM 201735021, the IRS reaffirmed its position set forth in PMTA 2017-005, ruling that an employment tax audit of a business did not involve a worker classification issue related to payments made to a corporate officer, finding that the business treated the officer as an

---

34 Docket No. 28957-15, which was subsequently affirmed by the Eighth Circuit Court of Appeals (__ F3d __ (8th Cir. 2018), 122 AFTR2d 2018-5279).

35 Docket No. 5874-15.

employee by withholding taxes from wages paid directly to the officer or through a professional employer organization (PEO).

The business was selected for an employment tax audit, and the IRS determined that wages paid to the corporate officer were unreasonably low. The IRS proposed recharacterizing portions of the distributions made by the business directly to the officer as wages and assessing additional employment taxes.

The position taken in ILM 201735021, that the audit of the S corporation taxable periods and taxable year does not involve worker classification, is consistent with the Tax Court's decision in *Martin S. Azarian P.A. v. Comm'r* (which was affirmed by the Eighth Circuit Court of Appeals), and the Tax Court's dismissal of the case for lack of jurisdiction in *Patricia Arroyo, DDS Corp, Alex Mansilla and Mercedes P. Arroyo v. Comm'r* (both of which were also cited in PMTA 2017-005). The IRS went on to state that these cases were dismissed by the Tax Court for lack of jurisdiction on the basis the IRS had not made any determinations for purposes of Section 7436 when the corporations treated the officers as employees by issuing them a Form W-2 reporting wages and did not claim entitlement to Section 530 relief. The Court stated that Section 7436 only confers jurisdiction on the court to determine the correct amount of employment tax when the IRS makes a worker classification determination or a determination that a taxpayer was not entitled to Section 530 relief, not when the IRS concludes that a taxpayer underreported reasonable wage compensation.

[m] If PMTA 2017-005 and ILM 201735021 are followed by the Tax Court, which they undoubtedly will in light of the Eighth Circuit's affirmation of the Tax Court's order of dismissal in the *Azarian* case discussed above, where the IRS recharacterizes a portion of the distributions made by an S corporation to its shareholder-employees as wages subject to social security taxes, taxpayers will have no choice but to pay the tax and file in District Court for a tax refund, putting taxpayers at a significant procedural and economic disadvantage in such cases. It is interesting to note that PMTA 2017-005 and ILM 201735021, as well as the two cases cited in those memorandums, seem contrary to a number of decisions previously issued by the Tax Court on the reclassification of distributions as wages where the IRS contended that the S corporation paid unreasonably low compensation to its shareholder-employees and where the Tax Court never questioned its jurisdiction in such matters.[36] Requiring taxpayers to pay the alleged tax and file for refund in District Court would result in the IRS having a substantial advantage in S corporation reclassification cases, and if followed, Congress should take action to grant the Tax Court expanded jurisdiction under Section 7436 so that it has jurisdiction to determine employment tax disputes where the issue is limited to the correct amount of payments required to be treated as "wages" for employment tax purposes.

W-2 Wages Cannot be Paid to Partners of a Partnership or Sole Proprietors. As discussed above, unlike S corporations which pay W-2 wages to their shareholder-employees, W-2 wages cannot be paid to a partner of a partnership or to a sole proprietor, which can be a disadvantage where the business has no outside employees resulting in the wage limitation being equal to zero, or can be an advantage where the taxable income of the owners is below the threshold since there is no

[36] *See* note 32, *supra*.

requirement for partnerships or sole proprietorship to make reasonable compensation payments to their owners.

Example #8: High Income Qualified Trade or Business with No Outside Employees. Assume that a qualified trade or business generates $600,000 of QBI and that the $600,000 is also A's taxable income.

1. *Sole Proprietorship. Because a sole proprietor cannot pay himself a salary, and because A's taxable income is over the Threshold Amount as fully phased-in, the W-2 limitation will apply and A's deduction will be equal to 50% of zero W-2 wages, or zero.*

2. *Partnership. Even if A pays himself a guaranteed payment of $150,000, that amount presumably will still not qualify as W-2 wages, so again the amount of the deduction would be equal to 50% of zero W-2 wages, or zero.*

3. *S Corporation. Since S corporation shareholders are required to pay themselves "reasonable compensation", assume A pays himself $150,000. In such case, A's deduction would be equal to the lesser of:*

(a) 20% of $450,000 of QBI ($600,000 QBI $150,000 salary), or $90,000.

(b) 50% of $150,000 W-2 wages, or $75,000.

Example #9: Low Income Qualified Trade or Business With No Outside Employees. Assume that A's business only generates $300,000 of QBI and that the $300,000 is also A's taxable income.

1. *Sole Proprietorship. Because A's taxable income is below $315,000, A will be entitled to a deduction of 20% of $300,000, or $60,000, because the wage limitations will not apply.*

2. *Partnership. Assuming no guaranteed payments are made by the partnership to A, A will likewise be entitled to a deduction equal to 20% of $300,000 or $60,000.*

3. *S Corporation. A still has to pay himself "reasonable compensation", so assume A pays himself $100,000. That will reduce A's share of QBI from $300,000 to $200,000, so that in this situation A's deduction would only be $40,000 (20% of $200,000).*

Example #10: High Income Qualified Trade or Business With Sufficient Outside Employees.

Assume that a qualified trade or business generates 600,000 of QBI and that the $600,000 is also A's taxable income. Also assume that the *qualified trade or business has outside employees (i.e., non-owner employees) to which it pays sufficient wages so that the wage and capital limitation under Section 199A does not apply and the owners therefore receive the full benefit of the 20% of QBI deduction under Section 199A.*

1. *<u>Sole Proprietorship</u>. Because a sole proprietor cannot pay himself a salary, and because the W-2 limitation will not apply, A's deduction will be equal to 20% of $600,000 of QBI, or $120,000.*

2. *<u>Partnership</u>. Assuming A pays himself so guaranteed payments (and A is not required to pay himself a "reasonable" guaranteed payment), the amount of the deduction would again be equal to 20% of $600,000 of QBI, or $120,000.*

3. *<u>S Corporation</u>. Since S corporation shareholders are required to pay themselves "reasonable compensation," assume A pays himself $150,000 in salary. In such case, the $150,000 would be excluded from the QBI, and A's deduction would be equal to 20% of 450,000 of QBI ($600,000 QBI - $150,000 salary, or $90,000.*

Clearly, in this context, the partnership or sole proprietorship would be advantageous to an S corporation from the point of view of maximizing the deduction available under Section 199A for 20% of QBI.

It is doubtful that Congress actually intended to have the 199A deduction be different depending on the type of entity the taxpayer is using where such entities are producing identical income. Although some practitioners thought it was possible that a "reasonable compensation" standard could be applied to partnerships and sole proprietorships the same as for S corporations (with such amounts being treated as W-2 wages) so that businesses having the same income would receive the same deduction under Section 199A, the Proposed Section 199A Regulations expressly provide that reasonable compensation principles were meant only to apply to S corporations and will **not** be extended to partnerships or sole proprietorships, so that the anomalous results discussed above will continue to exist among different types of pass-through entities.

A possible "work around" in the case of a partnership with no outside employees would be to form a tiered partnership structure, so that the upper-tier partnership would own a lower-tier partnership, and the lower-tier partnership could then pay "wages" to partners of the upper-tier partnership. The Preamble to the Proposed Section 199A Regulations indirectly address this scenario by providing that a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient. However, the Proposed Section 199A Regulations do not seem to address this issue head-on by addressing whether the lower-tier partnership could pay "wages" to the partners of the upper-tier partnership. The IRS previously expressed doubt as to a similar type arrangement utilizing a disregarded entity to enable a partner to be treated as an employee for withholding purposes. Under the purported structure, a partnership creates a wholly-owned entity that is disregarded for federal income tax purposes, and has the partners of the partnership become employees of the disregarded entity, which for employment tax purposes, is treated as the employer having its own employer identification number and subject to W-2 withholding. On June 13, 2014, Curtis Wilson, IRS Associate Chief Counsel (Pass-Throughs and Special Industries) stated that the IRS is looking at this issue but that if use of the disregarded entity works, "it makes it pretty easy to get around what would otherwise be the general rule, and so … we think it's a stretch."[37]

1.16. Open Issues and Unanswered Questions After the Proposed Section 199A Regulations

Set forth below are a number of open issues, unanswered questions and comments on the Proposed Regulation, which are primarily derived from preliminary comments to the Proposed Regulations made by the ABA Tax Section. On October 1, 2018, the AICPA also submitted comments to the Proposed Regulations.[38]

SSTBs

[a] Exclusion For Services Described in Sections 1202(3)(a)(B)-(E). The Final Regulations should clarify whether (and possibly provide a safe harbor for) qualifying businesses described in the four subparagraphs in section 1202(e)(3) – *i.e.*, subparagraphs (B) through (E) - and not cross referenced in Section 199A or otherwise referenced directly or indirectly in section 199A:

[i] any banking, insurance, leasing, or similar business,

[ii] any farming business (including the business of raising or harvesting trees),

[iii] any business involving the production or extraction of products of a character with respect to which a deduction is allowable under sections 613 or 613A, and

[iv] any business of operating a hotel, motel, restaurant, or similar business.

[b] Specific Clarification For Certain Trades or Businesses. The Final Regulations should clarify whether the SSTBs described in section 1202(e)(3)(A) and specifically cross referenced by section 199A(d)(2)(A) (the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services (collectively, the "Listed Businesses")) include the following related trades or businesses:

[i] Field of health –

(1) An ambulatory surgical center, dialysis center, or lithotripsy center operated in a separate entity where the entity is compensated for the patient's use of the center through so-called "facility or technical"

---

[37] *See* Elliot, "IRS Concerned About Dual Partner/Employee Workaound," 2014 TNT 115-8 (June 16, 2014).

[38] See Nellen, "AICPA calls for changes to Proposed Section 199A Regs," 2018 TNT 191-11 (October 2, 2018).

fees. Professional services provided by physicians and other health care professionals are billed for separately.

(2) Businesses providing research, development, testing, manufacturing and commercialization of drugs for pharmaceutical companies, or testing services and lab reports for the use of physicians in treating patients, and similar businesses previously permitted to qualify under rulings issued under section 1202. For example, in PLR 201436001 (September 5, 2014), a health-related business that provided research, development, testing, manufacturing and commercialization of drugs for pharmaceutical companies was not excluded from section 1202 status when it utilized its own physical and intangible property to supply its products and services. Similarly, in PLR 201717010 (April 28, 2017), a business that provided testing services and lab reports at the request of physicians was not precluded from section 1202 treatment. Neither health-related business addressed in the private letter rulings was directly involved in the diagnosis or treatment of patients by licensed professionals, nor did the business receive revenue that was earned in connection with patient medical care.

[ii] Field of Sports – Should a professional sports franchise which employs professional athletes and competes in a professional sports league, but is not otherwise involved in the "performance of services in the field of athletics," be expressly exempted from SSTB status? The Preamble to the Proposed Section 199A Regulations indicates that a person's distributive share of income from a partnership operating a professional sports franchise constitutes income from an SSTB.

[iii] Brokerage Services – Whether brokerage businesses not involving securities, in addition to real estate and insurance brokerage businesses referenced in the Proposed Regulations, qualify as QBI under section 199A (for example, a mortgage brokerage business assisting taxpayers in securing mortgages secured by real property, including mortgages for the purchase and refinancing of personal residences).

[iv] Performing Arts – should producers be excluded from the definition of an SSTB?

[c] Other Trades or Businesses. In addition to the guidance issued in the Proposed Section 199A Regulations, the IRS should publish an expanded list of business types that are treated as SSTBs or not SSTBs, consistent with the guidance and objective criteria set forth in the Final Regulations.

[d] Prop. Reg. § 1.199A-5(c)(2)(special rules – services or property provided to an SSTB) – when is common ownership tested (anytime during year or at year end) and whose taxable year do we look to (business providing services to SSTB or other commonly owned entity)?

[e] Clarify example 9 where J contributes her/his likeness to the partnership with a Shoe Company. Is the partnership a SSTB or just J's distributive share? How does this square with Example 2 that a partnership that owns and operates a professional sports team is an SSTB and a passive investor's distributive share of income is not eligible for the 199A deduction?

<u>QBI</u>

[a] Proposed Section 199A Regulations provide that section 707(a) payment is not QBI, but if individual operated DRE and provided the same service to customer it would be QBI, how do we reconcile? Example, individual has lawn company and customers pay individual for lawn services, payments are QBI. If individual partner has lawn company and provides services to its partnership, shouldn't the payment be treated as QBI? Should it matter if individual is a partner, since he is not providing services as a partner? Whether there are situations in which it is appropriate to include Section 707(a) payments in QBI.

[b] Should interest on working capital, reserves and similar accounts be QBI?

[c] Should guaranteed payments for the use of capital be QBI? If guaranteed payment for use of cash, then may be interest like. Should it depend on whether partner is in trade or business of lending? If guaranteed payment is for use of property, then may be more like rent. Same question?

[d] Whether for purposes of allocating expenses among multiple trade or businesses, "reasonable method" should be defined to include the direct tracing method, allocations based on gross income, or other methods, within appropriate parameters, and whether any safe harbors would be appropriate?

[e] How should suspended losses arising after 1/1/18 be allocated between trades or businesses? Pro rata?

<u>UBIA</u>

[a] Does it make sense to allocate UBIA consistent with tax depreciation? Would require it to be calculated on a property by property basis taking into account 704(c). It is more administrable to allocate in accordance with 704(b) depreciation – could group all depreciation together and allocate appropriate percentage to the partners.

[b] For properties fully depreciated, but still within the ten years, the regulations require a hypothetical liquidation at FMV to determine how the gain is allocated for purposes of determining each partner's share of qualified basis. This is burdensome as partnerships would have to do a valuation of each fully depreciated property each year and run two waterfalls with and without hypothetical gain. It is also complicated by the fact that you may have segments under 706 due to varying interests. Would be more administrable to just allocate in proportion to overall partnership income?

[c] Should Section 743(b) and Section 734(b) adjustments be treated as separate qualified property when determining UBIA?

[d] Does Section 1.199A-2(c)(3) make sense? The rule reduces the UBIA of qualified property to adjusted basis rather than cost upon a transaction under Section 1031, Section 721 and similar non-recognition transactions. The IRS may view these transactions as an acquisition at the cost of the carryover basis when contribution or be worried that noncontributors get UBIA credit for basis paid by someone else? Should a step in the shoes approach apply to allow the contributor's UBIA carryover like the contributor's holding period?

Aggregation

[a] Should RPE be permitted to aggregate (as under Section 469) and bind partners? Particularly relevant in the large fund context where owners would not have sufficient information about underlying business. Is an RPE a person for this purpose?

[b] For purposes of allocating expenses among multiple trade or businesses, should "reasonable method" be defined to include the direct tracing method, allocations based on gross income, or other methods, within appropriate parameters, and whether any safe harbors would be appropriate?

[c] Can trades or businesses be aggregated through tiered entities? If so, what types of entities you can look through (partnerships, S corps, C corps.)?

[d] Prop. Reg. § 1.199A-4(b)(1)(i) states that the same person or group of persons, directly or indirectly, must own 50% or more of each trade or business. Can a "person" be a RPE? For example, an RPE is a series partnership and has one series owned by AB and one by BC and RPE owns two trades or businesses, each series lines up with each trade or business but only owns 50%, can it be aggregated?

[e] The Proposed Regulations address how items allocated to a trust that are relevant from a 199A perspective are taken into account by the trust itself and trust beneficiaries, but little is said that would make clear whether aggregation is permissible under the Prop. Reg. §1.199A-4 aggregation rules where the ownership structure includes not only individuals (and/or corporations and partnerships owned by individuals) but also trusts.

[f] Proposed Reg. § 1.643(f)-1(c) Example 1(ii) requires treating the trust as one trust despite having different beneficiaries, but Proposed Reg. §1.643(f)-1(a) indicates that two or more trusts will be aggregated and treated as a single trust if they have substantially the same primary beneficiary or beneficiaries. How does the example square with the rule?

[g] Whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the Section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction? Should include explanations of how amounts that may give rise to the Section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in Section 664(c) would apply to such amounts. Such comments should include explanations of how amounts that may give rise to the

Section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in Section 664(c) would apply to such amounts.

Miscellaneous

[a] Does the rebuttable presumption (found in Prop. Reg. §1.199A-5(d)) that a former employee is not an independent contractor or partner for purposes of 199A make sense? Should rule be limited to employee/independent contractor context and not employee/partner context?

[b] What standard should be applied for identifying trades or businesses? Preamble refers to Section 1.446-1(d)(1). If this is the standard, then it should be included in the text of the regulation.

[c] What rental real estate activities rise to the level of a trade or business? Is owner of property subject to a triple net lease in a trade or business? What if owner has multiple properties subject to a triple net leases?

Correction to Section 1.199A-1(d)(2)(iv)(A)(4) Example 11. The math with respect to the adjusted QBI of Business Z is correct, but the reference to "one-third" of the carryover loss should instead be 42.86%.

1.17. Effect of Tax Act on Choice of Entity.

As a result of the reduced corporate tax rate for C corporations to a flat 21%, as well as the deduction for 20% of QBI of pass-through entities and sole proprietorships, choice of entity and structuring considerations may be affected, especially where the entity is not planning on distributing available cash to its owners. This portion of the outline focuses on the issue of determining whether a pass-through entity or a corporation is the better vehicle for operation of a business. The outline only raises some of the broader issues involved in such a choice of entity decision, focusing primarily on tax rates, and is by no means a comprehensive examination of the advantages and disadvantages of operating as a pass-through entity versus a "C" corporation.

Double Tax on Earnings Imposed on C Corporations. Although C corporations will continue to be subject to the so-called "double-tax" on their earnings, once at the corporate level and again at the shareholder level when the earnings of the corporation are distributed to its shareholders, the maximum combined double-tax rate will be reduced significantly from 48% (or 50.47% if the Net Investment Income tax is applicable), to 36.8% (or 39.8% if the Net Investment Income Tax is applicable). Additionally, in states like Florida which impose a corporate income tax (5.5%) on C corporations but not on S corporations, partnerships, LLCs or sole proprietorships, the maximum marginal tax rate on distributed earnings will be even higher than 39.8% (e.g., approximately 43.11% in Florida). This should be contrasted to a top marginal tax rate of 37% on the income of a pass-through entity or sole proprietorship even if the taxpayer derives no benefit whatsoever from the deduction available under Section 199A, or a maximum marginal tax rate of 29.6% on the QBI of a pass-through entity or sole proprietorship where the taxpayer receives the full benefit of Section 199A without being subject to the wage and capital limitations. To the extent that a C corporation is not distributing its earnings, however, consideration also must be given to the possible application of reasonable compensation arguments, the accumulated earning tax under Section 531 or the personal holding company tax under Section 541.

[a] Reasonable Compensation. Although traditionally unreasonable compensation arguments have been applied in the C corporation context to re-characterize unreasonably high compensation paid to shareholder-employees as dividends subject to double tax, it is possible that the IRS will apply unreasonably low compensation arguments (that have been applied in the S corporation area) to C corporations where the C corporation is retaining earnings taxed at the 21% flat tax rate and not paying any (or unreasonably low) compensation to its shareholder-employees, which would be taxed at a maximum marginal tax rate of 37% and also be subject to FICA taxes.

[b] Accumulated Earnings Tax. S corporations and other pass-through entities are not subject to the Accumulated Earnings Tax imposed under Section 531.

[i] General. The accumulated earnings tax is a penalty tax imposed upon C corporations that accumulate earnings in excess of the reasonable needs of the business, rather than pay them out to shareholders, with the purpose of avoiding taxes at the shareholders level.

[ii] Tax Base. The accumulated earnings tax applies to accumulated taxable income at a tax rate of 20%. Accumulated taxable income is the corporation's taxable income, subject to certain adjustments (as provided in Section 535(b)), reduced by: (A) the dividends-paid deduction, if any, and (B) the accumulated earnings credit.[39] The adjustments, as provided in Section 535(b), include: (A) income taxes accrued to the corporation for the year; (B) corporate charitable contributions over the 10% deduction limit under Section 170(b)(2); (C) the corporation's capital losses disallowed under Section 1211; and (D) the corporation's net capital gain for the year. The accumulated earnings credit is an amount that starts at $250,000 but could be higher if justified by the reasonable business needs of the corporation. In other words, the accumulated earnings credit is designed to allow corporations to retain at least $250,000 and as much of earnings as is supported by the reasonable needs of the business.[40] The minimum accumulated earnings credit is determined annually as the excess of $250,000 over the corporation's accumulated earnings at the end of the preceding tax year.[41] Thus, if a corporation had no prior years' accumulated earnings, the current year's minimum accumulated earnings credit would be $250,000. If the corporation's prior year accumulated earnings were $100,000, however, the minimum credit would be $150,000 ($250,000 minus $100,000). Note that corporations performing services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting may claim a minimum accumulated

---

39 Section 531(a).

40 Section 535(c).

41 Section 535(c)(2).

earnings credit of only the excess of $150,000 (rather than $250,000) over accumulated earnings at the end of the preceding tax year.

[iii] Reasonable Business Needs. As mentioned above, there are two basic elements that must be present in order for the accumulated earnings tax to apply. First, there must be an accumulation of earnings beyond the reasonable needs of the business. Second, the earnings had to have been accumulated for the purpose of avoiding shareholder level taxes. Thus, a corporation is generally able to avoid the accumulated earnings tax if it can demonstrate that it retained the earnings for its reasonable business needs. Whether particular grounds indicate that earnings have been accumulated for reasonable business needs or beyond depends on the specific circumstances.[42] Generally, an accumulation of earnings is excessive if it is more than what "a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business."[43] In addition, the retained earnings must be directly connected with the needs of the corporation and must be for bona fide business purposes. The "business" of a corporation includes not only that which it has previously carried on but also any line of business it may undertake.[44]

[iv] Tax Avoidance Purpose. Even if a corporation has accumulated earnings beyond its reasonable needs, the earnings must have been retained for the purpose of avoiding taxes at the shareholder level in order for the accumulated earnings tax to apply. Note, however, that unreasonable accumulations create a presumption of a tax-avoidance purpose, rebuttable by the corporation.[45] Tax avoidance needs only be one of the purposes, not the sole or dominating purpose, of the accumulation.[46] Although the Code does not specify the person or persons whose purpose is relevant in determining liability for the accumulated earnings tax, it is presumably the purpose of those who control the corporation, through stock ownership or otherwise, that is key. The following factors are among those considered in determining whether a corporation's retention of earnings was motivated by a tax-avoidance purpose:

---

42 Reg. § 1.537-2(a).

43 Reg. § 1.537-1(a).

44 Reg. § 1.537-3(a). *See also* Reg. § 1.537-2(b) for examples of specific grounds for accumulations most frequently encountered in reasonable business needs cases.

45 Section 533(a).

46 *U.S. v. Donruss Co.***,** 393 US 297 (1969).

1. Dealings between the corporation and its shareholders, including loans and advances to shareholders and expenditures of corporate funds for the shareholders' personal benefit (rather than paying dividends).[47]

2. Investing undistributed earnings in assets having no reasonable connection to the corporation's business.[48]

3. A dividend history demonstrating that shareholder taxes were avoided by the corporation's failure to make distributions.[49]

4. Corporate loans to friends or relatives of shareholders, as well as to other corporations owned directly or indirectly by the shareholders.[50]

[i] Exceptions. The accumulated earnings tax imposed under Section 531 does not apply to a personal holding company within the meaning of Section 542, a foreign personal holding company within the meaning of Section 552, a corporation exempt from tax under Subchapter F, and a passive foreign investment company within the meaning of Section 1296.[51]

[ii] Recent Guidance. Although the accumulated earnings tax has not previously been a major consideration because of the higher corporate tax rate, the new flat 21% corporate tax rate applicable to "C" corporations may result in a resurgence of the accumulated earnings tax. A fairly recent Chief Counsel Advice demonstrates that even when the corporate tax rates were higher and the corporation did not have liquid assets, the IRS may assert the accumulated earnings tax.

In CCA 201653017[52], the IRS concluded that a corporation may be subject to the accumulated earnings tax even though it lacked liquidity from which to make distributions to its sole shareholder. This development is one of the most current developments addressing the accumulated earnings tax (as the number of entities operating as C corporations has been dramatically less than the number of entities taxed as S corporations, partnerships or sole proprietorships), and should be considered by taxpayers who are currently considering forming or converting to C corporation status as a result of the reduction in the corporate tax rate to a flat 21% by the recently passed Tax Cuts and Jobs Act.

Under the facts of the CCA, a shareholder transferred to the corporation his entire interest in several partnerships. All the income and essentially all of the expenses reported by the corporation were

---

47 *See* Internal Revenue Manual 4.10.13.2.2 (03/16/2015).

48 Id.

49 Id.

50 Reg. § 1.537-2(c).

51 Section 532(b).

52 Dec. 30, 2016.

flow-through items from the various partnerships. Since its inception and during the years in issue, the corporation conducted no business activity other than holding and maintaining the various partnership interests contributed to it by the shareholders. The corporation reported retained earnings for the tax years at issue that would have resulted in additional tax to the shareholder if distributed.

The taxpayer argued that it was not liable for the accumulated earnings tax because it did not have control over distributions from the partnerships in which it invests, and specifically did not have liquid capital from which to distribute earnings to its shareholders and, therefore, should not be subject to the accumulated earnings tax.

The IRS pointed out that the taxpayer seemed to suggest that accumulated surplus must be represented by cash that is available for distribution. However, the accumulated earnings tax is based on accumulated taxable income and it is not concerned with the liquid assets of the corporation. The IRS also found that the consent dividend procedures provided by Section 565 would have allowed the taxpayer and shareholder to avoid the accumulated earnings tax irrespective of any lack of liquidity.

The IRS concluded in the legal memorandum that there was prima facie evidence that the corporation was formed to avoid income tax with respect to its shareholder and would be subject to the accumulated earnings tax irrespective of its lack of liquidity and lack of control over the partnerships in which it invests.

Observation.

As a result of the substantial reduction of the tax rate applicable to C corporations to a flat 21% by TCJA, there has been substantial discussion regarding converting sole proprietorships and pass-through entities to C corporations (or forming new entities as C corporations rather than as a pass-through entity or sole proprietorship). However, as demonstrated by CCA 201653017, where a corporation does not distribute its earnings so as to incur the second level of tax at the shareholder level (<u>even when it has no liquid assets to make such distributions</u>), such corporation may well indeed be subject to the accumulated earnings tax imposed under Section 531.

[b] <u>Personal Holding Company Tax</u>. S corporations and other pass-through entities are not subject to the Personal Holding Company Tax imposed under Section 541.

[i] <u>General</u>. A closely held corporation whose income is largely of investment character may be a personal holding company (PHC), in which case a penalty tax is imposed on the "personal holding company income" if not distributed. The personal holding company tax is designed to prevent corporations from accumulating earnings rather than distributing the earnings as taxable dividends. The personal holding company tax is equal to 20% of the undistributed personal holding company income.

[ii] <u>Definition</u>. A corporation is a personal holding company if: (i) at least 60% of its adjusted ordinary gross income (as defined in Section 543(b)(2)) for a taxable year is personal <u>holding</u> company income, and (ii) at any time during the last

half of the taxable year, more than 50% in value of the corporation's stock is owned, directly or indirectly, by or for not more than five individuals.[53]

[iii] PHC Income. Personal holding company income generally includes dividends, interest, royalties (including mineral, oil and gas royalties and copyright royalties), annuities, rents, produced film rents, compensation for use of corporate property by shareholders, personal service contract income, and income from estates and trusts.[54] In general, undistributed personal holding company income means "taxable income" (as adjusted by the items set forth in Section 545(b)), less the dividends paid deduction (as defined in Section 561).[55] Adjustments to taxable income generally include negative adjustments for federal income taxes, certain net operating losses, and net capital gains less the attributable taxes.

Taxation of Gain Upon Sale of Assets of Corporation. The maximum marginal combined rate for a C corporation selling its assets is the same as the maximum double tax on earnings of a C corporation which are distributed to its shareholders (36.8% or 39.8% if the 3.8% Net Investment Tax is applicable). Again, in some states such as Florida, a corporate income tax (5.5% in Florida) is imposed on C corporations but not on S Corporations, partnerships, LLCs or sole proprietorships, which will increase the maximum marginal double tax on the sale of assets (e.g., to approximately 43.11% in Florida). This should be contrasted with the sale of assets by an S corporation, partnership or LLC taxed as a partnership, or a sole proprietorship, where typically the bulk of the sales price is allocated to capital assets (such as goodwill), so that the maximum marginal rate to which the gain on the sale of the assets will be subject will either be 20% (the maximum capital gains tax), or, if the taxpayer does not materially participate in the trade or business carried on by the entity, 23.8% with the addition of the Net Investment Tax.

[a] Avoidance of Double Tax by Allocation to Personal Goodwill.

C corporations have used a strategy of allocating the bulk of any sales proceeds to personal goodwill in order to avoid the double tax normally incurred on the sale of assets by a C corporation. Several recent cases suggest that the personal goodwill strategy may not always be successful.

[i] *Muskat v. Commissioner*

In *Muskat v. Commissioner*,[56] the First Circuit Court of Appeals rejected taxpayer's refund suit based on the taxpayer's claim that payments contractually delineated as payments for taxpayer's covenant not to compete and originally reported by the taxpayer as ordinary income, actually were payments for taxpayer's personal goodwill, taxable as capital gain.

---

53 Section 542(a).

54 Section 543(a).

55 Section 545(a).

56 103 AFTR2d 2009-666 (1st Cir. 2009).

Irwin Muskat (TP) was the CEO of JacPac Foods, Ltd., a family business. In 1993, an agreement was reached between JacPac and a subsidiary of Corporate Brand Foods America, Inc. (CBFA) for purchase of JacPac's assets for approximately $45,000,000 plus assumption of JacPac's liabilities. As part of the sale, TP entered into an employment agreement, a noncompetition agreement and a subscription agreement (under which he invested $2,000,000 in the purchaser). Under the noncompetition agreement, the purchaser agreed to pay TP $3,955,599 for a covenant not to compete over a 13 year period. The first installment of $1,000,000 was paid at closing with the remainder payable over the 13 years. These payments survived TP's death.

TP received the first installment in 1998 and reported the payment as ordinary income on his 1998 federal income tax return and paid self-employment taxes on the income. In 2002 however, TP filed an amended return for 1998 reclassifying the $1,000,000 payment as capital gain and seeking a refund of $203,434, which included $21,479 of self-employment tax. After the IRS denied TP's refund claim, he filed suit in the federal district court. The District Court denied TP's refund claim on the ground that he failed to present strong proof that the parties intended the payment to be a payment for TP's personal goodwill and denied TP's self-employment tax claim on the ground that it lacked jurisdiction over that claim because that claim was not part of TP's administrative refund claim.

Initially, the court reaffirmed the application of the "strong proof" rule in the First Circuit. Under this rule, when parties to a transaction have executed a written contract providing for allocation of sums to particular items and one party thereafter seeks to alter the written allocation, for tax purposes, the proponent must present "strong proof" that, at the time of execution of the contract, the contracting parties actually intended the payments to be compensation for something else.

The court found that TP did not produce strong proof that the contracting parties intended the challenged payment to be compensation for TP's personal goodwill. First, the court clarified that "strong proof" means that a taxpayer's evidence must approach "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake. The court found that the district court did not clearly err in holding that TP failed to adduce such strong proof. In this respect, the trial testimony revealed no discussion of TP's personal goodwill during the negotiations and none of the transaction documents, including early drafts of those documents, mentioned TP's personal goodwill. Further, the court found it significant that the noncompetition agreement referenced protection of JacPac's goodwill (purchased by purchaser for $16,000,000, which made it extremely unlikely that the contracting parties intended the payments under the noncompetition agreement to serve as de facto compensation for TP's personal goodwill.

The court rejected TP's argument that survivability of the noncompetition payments mandated a conclusion that the payments were for something other than refraining from competition. The court stated that other courts have classified agreements that contain survivability provisions as valid noncompetition agreements for tax purposes.

The court also rejected TP's argument that the terms of his employment and subscription agreement were so lucrative that they eliminated any realistic possibility that, at an advanced age, TP would compete with the purchaser. The court responded that proof that a written allocation does not have economic reality, does not in of itself, constitute strong proof that the parties intended some other allocation. Further, the court found that there was evidence that the noncompetition provisions were grounded in economic reality, including the fact that CBFA representatives testified that the noncompetition agreement was to prevent the possibility that TP would use his relationships with customers, suppliers and distributors to pursue competitive opportunities.

Finally, the court upheld the district court's rejection of TP's self-employment tax claim on the ground that it lacked subject matter jurisdiction over the claim. In this respect the court agreed that TP had substantially varied the legal theory and factual basis of his self-employment refund claim made to the IRS. TP's refund claim to the IRS was based on the argument that he had incorrectly characterized the claim as ordinary income and not capital gain. However, at trial, TP shifted gears and argued that sums paid in consideration of a covenant not to compete are not deemed to have been earned in the conduct of a trade or business and, thus, are not subject to self-employment tax. The court concurred with the district court that the taxpayer's refund claim filed with the IRS did not properly raise the revised self-employment tax claim and thus, was not within the subject matter jurisdiction of the court to address.

[ii] *Howard v. United States*

In *Howard v. United States*,[57] the Ninth Circuit Court of Appeals affirmed the district court's denial of the taxpayer's motion for a summary judgment and granting of the government's motion for summary judgment in finding that goodwill in connection with the sale of a dental practice was corporate goodwill rather than personal goodwill.

Under the facts of the case, the taxpayer incorporated his practice as the sole shareholder, officer and director in 1980, and also entered into an employment agreement and a covenant not to compete with the corporation. The covenant not to compete provided that for so long as the taxpayer held any stock and for a period of three years thereafter, he would not engage in any business which was competitive to that of the corporation within 50 miles of Spokane, Washington. In 2002, the taxpayer and his corporation sold the practice to another personal service corporation. In the Asset Purchase Agreement, the taxpayer was allocated $549,900 for his "personal goodwill" and $16,000 for consideration regarding a covenant not to compete with the acquiring personal service corporation. The selling corporation itself received $47,100 for its assets.

Following an audit by the IRS, the IRS recharacterized the sale of goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the acquiring personal service corporation as a dividend from the selling professional service corporation to the taxpayer. The government argued that the goodwill was corporate goodwill versus personal goodwill for three main reasons. First, the goodwill at issue was a corporate asset because the taxpayer was an employee of the corporation and had a covenant not to compete with the corporation. Second, the corporation earned the income and correspondingly earned the goodwill. Third, attributing the goodwill to the taxpayer would not comport with the economic reality of the taxpayer's relationship with his personal service corporation.

---

57 108 AFTR2d 2011-5993 (9th Cir. 2011).

The government, citing *Furrer v. Commissioner*,[58] *Martin Ice Cream v. Commissioner*,[59] *Norwalk v. Commissioner*,[60] and *MacDonald v. Commissioner*,[61] found that the goodwill was an asset of the corporation and not of the taxpayer personally primarily because of the contractual obligation of the taxpayer under his Employment Agreement to continue to work for and not to compete against his corporation. In granting summary judgment in favor of the government, the court found no merit in the taxpayer's argument that Washington state dissolution case law supported the proposition that professional goodwill is a community property right in dissolution cases, and as such, is of a personal nature.

[iii] *Kennedy v. Commissioner*

In *Kennedy v. Commissioner*,[62] the Tax Court held that payments received by a shareholder of an employee benefits consulting company which was a C corporation did not constitute payments for personal goodwill, and consequently, were taxable as ordinary income.

James Kennedy was the sole shareholder of an employee benefits consulting firm taxed as a C corporation for federal income tax purposes. Kennedy was approached by another company that proposed to acquire the assets of Mr. Kennedy's corporation. Early in the negotiations, the parties basically agreed that the purchase price should be 150% of the projected annual income to be generated from Mr. Kennedy's corporation with certain adjustments (approximately $660,000). Late in the negotiations, Mr. Kennedy's attorney consulted with a tax advisor who informed him that if the transaction was structured as an asset purchase, then the payment would be taxed twice, once at the corporate level and again at the shareholder level when distributed to Mr. Kennedy. On the other hand, if the transaction were instead structured as a purchase of the corporation's stock, there would be only one level of tax on which Mr. Kennedy would pay capital gain rates, but this would be disadvantageous to the purchaser because the purchaser would not be able to claim any deductions with respect to the purchase of the stock, and as such, would likely not agree to such an arrangement.

The tax advisor alternatively suggested that Mr. Kennedy take the position that he owned the personal goodwill of the business, and that he enter into an Agreement for Assignment of Know-How and Goodwill, an Asset Purchase Agreement and a Consulting Services Agreement. Only $10,000 of the purchase price was allocated to the assets of the C corporation, with the remaining amounts being allocated 75% to the sale of Mr. Kennedy's personal goodwill and the remaining 25% being allocated to the Consulting Services Agreement.

The taxpayer argued that under *Martin Ice Cream Company v. Commissioner*, 110 TC 189 (1998), the court was compelled to conclude that Mr. Kennedy owned personal goodwill and that the

---

58 566 F.2d 1115 (9th Cir. 1977).

59 110 TC 189 (1998).

60 TC Memo. 1998-279.

61 3 TC 720 (1944).

62 TC Memo. 2010-206.

payments he received from the purchaser were to purchase personal goodwill since Mr. Kennedy did ***not*** have a non-compete agreement with his corporation.

The Tax Court, despite the fact that Mr. Kennedy had no employment agreement or non-compete agreement with his corporation, held that the amounts paid were consideration for services rather than goodwill because there was no economic reality to the contractual allocation of payments to personal goodwill. Specifically, the court found that the allocation of 75% of the total consideration paid by the purchaser to personal goodwill was a "tax-motivated afterthought" that occurred late in the negotiations.

<u>The Cost of "Escaping" C Corporation Status</u>. There has already been substantial discussion that a number of S corporations, LLCs and sole proprietorships may convert to C corporation status as a result of the flat 21% tax rate imposed on C corporations. However, the owners of C corporations may not be able to "escape" the shareholder-level tax because of reasonable <u>compensation</u> arguments, the accumulated earnings tax or the personal holding company tax, as discussed above. Additionally, in the event Congress subsequently raises the corporate tax rate (although deemed a "permanent change"), taxpayers may find themselves "trapped" in C status. Once in the C corporation regime, there are number of "prohibitions" and "toll charges" on entities that want to convert back from a C corporation to a pass through entity or sole proprietorship.

If a C corporation converts to a partnership or a sole proprietorship, the conversion will be treated as a taxable liquidation. Where an S corporation has revoked its S election to become a C corporation, Section 1362(g) generally prohibits the corporation from reelecting S status for a period of five years. Even where a C corporation is allowed to convert to S corporation status, a number of unfavorable rules may apply to the S corporation which has converted from C corporation status, including the application of the LIFO recapture tax under Section 1363(d), the imposition of the tax on excess passive investment income imposed under Section 1375 for S corporations having subchapter C earnings and profits, the possible termination of the corporation's S election (where it has excess passive investment income and subchapter C earnings and profits for three consecutive taxable years) under Section 1362(d), the less favorable distribution rules applicable to S corporations having subchapter C earnings and profits versus S corporations having no subchapter C corporation earnings and profits and the possible loss of net operating losses under Section 172. Most importantly, the so-called built in gains tax under Section 1374 is imposed on C corporations which have converted to S corporation status (which effectively imposes a double tax to the extent of any built-in gain of such corporation at the time of conversion), if the assets of the corporation are sold or otherwise disposed of within the five (5) year period following the corporation's conversion to S status.

<u>Built-In Gain Tax Hurdle</u>.

Because of its nature, the greatest exposure facing a corporation upon conversion to S corporation status is the imposition of the built-in gains tax under IRC Section 1374. This can be especially disadvantageous for a cash-basis taxpayer having accounts receivable converting from C to S status where the collection of such accounts receivable following conversion to S status will be treated as built-in gain subject to the built-in gains tax. A brief discussion of the mechanics of the built-in gains tax will ensue and will be followed by an examination of the special problems facing the cash-basis service corporation converting to S corporation status.

[a] General Built-In Gain Tax Rules.

IRC Section 1374 imposes a corporate-level tax on the built-in gains of S corporations that were previously C corporations. IRC Section 1374 as originally enacted applies to built-in gains recognized by a corporation during the five-year period following such corporation's conversion to S status. The recognition period is the five-calendar year period, and not the five-tax year period, beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets under IRC Section 1374(d)(8) in a carryover basis transaction.[63] The tax rate is presently 21% (the highest rate of tax imposed under IRC Section 11(b)) of the S corporation's "net recognized built-in gain."[64]

The American Recovery and Reinvestment Act of 2009 (the "2009 Act"),[65] was signed into law by President Obama on February 17, 2009. Section 1261 of the 2009 Act amends IRC Section 1374 of the Code to provide for reduction of the recognition period during which corporations that converted from C corporation status to S corporation status are subject to the so-called built in gain tax from 10 years to 7 years under certain circumstances. IRC Section 1374 was further amended by the Small Business Jobs Act of 2010, H.R. 5297 (the "2010 Act"). Specifically, IRC Section 1374(d)(7)(B), *as amended by* the 2009 Act and the 2010 Act reads as follows:

[b] *Special Rules for 2009, 2010 and 2011.—No tax shall be imposed on the net recognized built-in gain of an S corporation—(i) in the case of any taxable year beginning in 2009 or 2010, if the 7th taxable year in the recognition period preceded such taxable year, or (ii) in the case of any taxable year beginning in 2011, if the 5th year in the recognition period preceded such taxable year.*

While the statutory language itself is short, it raises a number of questions that will need to be clarified regarding its scope and application.[66]

Some or all of these questions may have been answered by the 2012 Act. The 2012 Act again provides for a temporarily shortened recognition period and also provides a special rule for installment sales of built-gain assets during 2012 and 2013. For tax years beginning in 2012 and 2013, the recognition period is a five calendar year period. Consequently, if the S corporation acquired the built-in gain asset at least five calendar years before disposing of the assets in 2012 or 2013, IRC Section 1374 will not apply to the disposition. Additionally, new IRC Section 1374(d)(7)(E) provides that if an S corporation sells an asset and reports the income from the sale using the installment method under IRC Section 453, the treatment of all payments received will be governed by the provisions of IRC

---

63 IRC § 1374(d)(7)(A) and Treas Reg § 1.1374-1(d).

64 IRC § 1374(b)(1).

65 PL 111-5, 123 Stat 115 (Feb 17, 2009).

66 See Klein and Looney, "American Recovery and Reinvestment Act of 2009 Provides for Temporary Reduction of Built-In Gain Recognition Period—Clarification Still Needed," 11 BET 53 (May/June 2009).

Section 1374(d)(7) applicable to the tax year in which such sale was made. Consequently, this paragraph seems to clarify that if a disposition qualified for any of the special rules applicable to 2009, 2010, 2011, 2012 or 2013, the fact that sales proceeds are received in later years (which are within the original 10-year recognition period), the built-in gain tax proposed under IRC Section 1374 will not be imposed on such disposition. This is contrary to the general rule applicable to installment sales within the original 10-year recognition period. On December 19, 2014, President Obama signed H.R. 5771, the "Tax Increase Prevention Act of 2014" into law, which extends the reduced five-year recognition period for dispositions made in 2014.

On December 18, 2015, President Obama signed the Protecting Americans from Tax Hikes Act of 2015, which made permanent for 2015 and all years thereafter the shortened five-year recognition period under the built-in gains tax imposed under IRC Section 1374. As such, a corporation which converts from C status to S status will only be subject to the built-in gains tax if it sells its assets prior to the expiration of the five-year period following the date of its conversion to S corporation status. For those few C corporations that have hesitated in the past to convert from C status to S status because of the ten-year recognition period, this reduction to a five-year recognition period should cause more of such corporations to convert from C to S status.

[c] NUBIG Limitation.

IRC Section 1374(c)(2) provides that the net recognized built-in gain taken into account under IRC Section 1374 for any tax year may not exceed the NUBIG of all the corporation's assets less the built-in gains recognized by the corporation in prior years during the recognition period. IRC Section 1374(d)(1) provides that NUBIG is the amount by which the fair market value of all the corporation's assets as of the beginning of its first tax year as an S corporation exceeds the corporation's aggregate adjusted tax bases in such assets at such time. Treasury Regulation Section 1.1374-3(a) provides a more expansive definition of NUBIG as the total of the following amounts:

1) The amount that would be the amount realized if on the first day of the recognition period the corporation sold all of its assets at fair market value to an unrelated party which assumed all of its liabilities; decreased by

2) Any liability of the corporation that would be included in the amount realized but only if the corporation would be allowed a deduction on payment of such liability; decreased by

3) The aggregate adjusted bases of the corporation's assets on the first day of the recognition period; increased or decreased by

4) The corporation's IRC Section 481 adjustments on the first day of the recognition period; and increased by

5) Any recognized built-in loss that would not be allowed under IRC Section 382, 383 or 384.

Pursuant to the NUBIG limitation, the maximum amount of built-in gain subject to tax under IRC Section 1374 is generally limited to the amount of pre-C to S conversion appreciation in the corporation's assets and does not include any post-C to S conversion appreciation in such assets.

IRC Section 1374(d)(5)(C) also provides that a corporation's NUBIG is to be properly adjusted for amounts which would be treated as built-in gains under IRC Section 1374(d)(5)(A) or as built-in losses under IRC Section 1374(d)(5)(B). These built-in gain and loss items are included in the computation of NUBIG without regard to when or whether such items are actually recognized during the recognition period.

[d] Taxable-Income Limitation.

In addition to the limitation placed on the aggregate amount of net built-in gains that may be recognized by an S corporation under the NUBIG limitation, the taxable-income limitation limits the amount of net built-in gains recognized by an S corporation on an annual basis. Because a corporation's taxable income may serve as the base for the built-in gains tax, the maximum amount of net built-in gains (built-in gains less built-in losses) that must be recognized by an S corporation in a particular tax year within the BIG Period is limited to the amount of the corporation's taxable income for such year (the taxable-income limitation).[67]

Any recognized built-in gain that is not subject to the built-in gains tax because of the taxable income limitation must be carried forward and is subject to the built-in gains tax in the S corporation's succeeding tax years to the extent that it subsequently has other taxable income (that is not already subject to the built-in gains tax) for any tax year within the BIG Period. IRC Section 1374(d)(2)(B), *as amended by* IRC Section 1006(f)(5) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).[68] This modification reduced potential manipulation of timing post-conversion losses to avoid the built-in gains tax on the corporation's NUBIG, and applies only to corporations filing S elections on or after March 31, 1988.

[e] Built-In Income And Built-In Deduction Items.

An S corporation's recognized built-in gain includes gain recognized from the "disposition" of any asset.[69] The legislative history of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) clarified that the "disposition of any asset" includes not only sales and exchanges, but also other income recognition events that effectively dispose of, or relinquish, the taxpayer's right to receive income.[70] Specifically, any item of income that is properly taken into account during the recognition period but which is "attributable" to periods prior to the date of the corporation's conversion to S status will be treated as a recognized built-in gain for the tax year in which it is properly taken into account.[71] This type of item is generally referred to as a "built-in income item." Similarly, any amount which is allowable as a deduction during the recognition period but which is "attributable" to a period prior to the date of the corporation's conversion to S status will be treated as a recognized

---

67 IRC § 1374(d)(2)(A)(ii) and Treas Reg § 1.1374-2(a)(2).

68 Pub L No 100-647, 102 Stat 3342 (1988).

69 IRC § 1374(d)(3).

70 H R Rep No 795, 100th Cong, 2d Sess 63 (1988). See also Ann 86-128, 1986-51 IRB 5.

71 IRC § 1374(d)(5)(A).

built-in loss for the tax year for which it is allowable.[72] This type of item is generally referred to as a "built-in deduction item." In determining whether an item constitutes a built-in income or built-in deduction item under IRC Section 1374(d)(5)(A) and (B), the focus is therefore on whether such item is "attributable" to a period prior to the date of the corporation's conversion to S status.

The IRS adopted an "accrual method rule" in determining whether an income item or a deduction item is attributable to a period prior to the date of the corporation's conversion to S status. Specifically, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period by a taxpayer using the accrual method of accounting.[73] The most common example of a built-in income item subject to the built-in gains tax is the collection of accounts receivable by a cash-basis taxpayer. Likewise, any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period by a taxpayer using the accrual method of accounting.[74] The most common example of a built-in deduction item is the payment of accounts payable by a cash-basis taxpayer. Consequently, the benchmark for whether an item constitutes a built-in income or built-in deduction item under IRC Section 1374(d)(5), is whether such item would have been includable in income, or allowed as a deduction, prior to the corporation's conversion to S status if the corporation had been an accrual basis taxpayer.

In determining whether an item would have been includable in income, or allowed as a deduction, prior to the corporation's conversion to S status if the corporation had been an accrual basis taxpayer, the regulations generally provide that all rules applicable to an accrual basis taxpayer apply, specifically including IRC Section 267(a)(2) (relating to the timing of deductions by an accrual basis payor with respect to a cash basis payee that is a related party), and IRC Section 404(a)(5) (relating to the timing of deductions for deferred compensation).

IRC Section 267(a)(2) generally prohibits an accrual basis taxpayer from deducting an item payable to a cash basis payee until the amount is includable in the cash basis payee's income if the payor and payee are related within the meaning of IRC Section 267(b).

Similarly, IRC Section 404(a)(5) generally prohibits a corporation from taking a deduction for any amounts deferred under a non-qualified deferred compensation plan, until such amounts are includable in the employee's gross income.

Many commentators objected to the IRS's application of IRC Section 267(a)(2) and 404(a)(5) to preclude treatment of an item as a built-in deduction under IRC Section 1374(d)(5)(B). Specifically, the House Report which accompanied TAMRA, provides the following:

---

[72] IRC § 1374(d)(5)(B).

[73] Treas Reg § 1.1374-4(b)(1).

[74] Treas Reg § 1.1374-4(b)(2).

> As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax.[75]

In determining whether an item would be deductible by an accrual basis taxpayer for purposes of the built-in gains tax, however, the regulations modify the rules generally applicable to accrual basis taxpayers in three respects. First, any amounts properly deducted in the recognition period under IRC Section 267(a)(2), relating to payments to related parties, will be treated as recognized built-in loss to the extent that the following requirements are met:

1) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

2) The amount is paid in the first two and one-half months of the recognition period or is paid to a related party owning (under the attribution rules of IRC Section 267) less than 5% (by voting power and value) of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.[76]

Additionally, any amount properly deducted in the recognition period under IRC Section 404(a)(5), relating to payments for deferred compensation, will be treated as recognized built-in loss to the extent that the following requirements are met:

1) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

2) The amount is not paid to a related party to which IRC Section 267(a)(2) applies.[77]

The regulations also provide that in determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer, IRC Section 461(h)(2)(C) (which provides that economic performance does not occur for tort liabilities or worker's compensation

75 HR Rep No 100-795, 100th Cong, 2d Sess 63–64.

76 Treas Reg § 1.1374-4(c)(1).

77 Treas Reg § 1.1374-4(c)(2).

liabilities until payment has been made), and Treasury Regulation Section 1.461-4(g) (which provides that economic performance does not occur for liabilities arising out of breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts and taxes until payment is made), do not apply.[78] Thus, to constitute a built-in deduction item within the meaning of IRC Section 1374(d)(5)(B), only the all events test (and not the economic performance test) needs to be satisfied with respect to the liabilities referred to in IRC Section 461(h)(2)(C) and Treasury Regulation Section 1.461-4(g).

Treasury Regulation Sections 1.446-1(c)(1)(ii) and 1.451-1(a), provide that accrual method taxpayers recognize income for the tax year in which the following two requirements are met:

1) All of the events have occurred that fix the right to receive such income; and

2) The amount thereof can be determined with reasonable accuracy.

Similarly, Treasury Regulation Sections 1.446-1(c)(1)(ii) and 1.461-1(a)(2) provide that under the accrual method of accounting, deductions are allowable for the tax year in which:

1) All of the events have occurred that establish the fact of the liability giving rise to such deduction; and

2) The amount thereof can be determined with reasonable accuracy.

Under IRC Section 461(h)(1), the "all events" test is not considered to be met any earlier than when economic performance with respect to such item occurs. In circumstances involving services or property provided to a taxpayer, economic performance is deemed to occur under IRC Section 461(h)(2)(A) when the person provides such services or provides such property to the taxpayer. In circumstances where the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance is deemed to occur under IRC Section 461(h)(2)(B) as the taxpayer provides such property or services.

[f] <u>Effect of Classification of Item as Built-in Income or Built-In Deduction Item.</u>

An item that is classified as a built-in income item will be treated as a recognized built-in gain when taken into account by the S corporation during the BIG Period, and thus, potentially be subject to the built-in gains tax imposed under IRC Section 1374.[79] A built-in income item also has the effect of increasing the corporation's NUBIG.[80] Likewise, an item that is classified as a built-in deduction item will be treated as a recognized built-in loss when allowed as a deduction to the S corporation during the recognition period, and thus, will be available to offset any built-in gains recognized by

78 Treas Reg § 1.1374-4(b)(2).

79 IRC § 1374(d)(5)(A).

80 IRC § 1374(d)(5)(C).

the S corporation during such tax year.[81] A built-in deduction item also has the effect of decreasing the corporation's NUBIG under IRC Section 1374(d)(5)(C).

Even if an item does not constitute a built-in loss item within the meaning of IRC Section 1374(d)(5)(B), it still may potentially affect a corporation's NUBIG. For example, an accrued bonus payable to a C corporation's sole shareholder-employee that is not paid by the corporation within the first two and one-half months following the date of its conversion to S status would not constitute a built-in deduction item under IRC Section 1374(d)(5)(B) since, under both IRC Sections 267(a)(2) and 404(a)(5), such amount would not have been deductible by the corporation prior to the date of its conversion if it were an accrual basis taxpayer. The accrued bonus would, however, still serve to reduce the corporation's NUBIG limitation since Treasury Regulation Section 1.1374-3(a)(2) provides that NUBIG is decreased by the amount of any liability of the corporation to the extent the corporation would be allowed a deduction on payment of such liability. In other words, the accrual method rule does not apply in determining whether a liability decreases a corporation's NUBIG.

Example (1):

Assume a cash-basis corporation owns two buildings (Building "A" and "Building "B"), each of which has a built-in gain (excess of fair market value over basis as of the date of conversion to S status) of $100. Additionally, assume that prior to the corporation's conversion to S status, the corporation accrued a bonus to its sole shareholder-employee of $50. In its initial S year, the corporation sells Building "A" generating a recognized built-in gain of $100, pays the $50 accrued bonus to its shareholder-employee following the first two and one-half months of such year, and has other taxable income of $100.

Because the accrued bonus was not paid within the first two and one-half months following the corporation's conversion to S status, the accrued bonus will not constitute a recognized built-in deduction item under IRC Section 1374(d)(5)(B). As such, the corporation's pre-limitation amount (the amount which would be its taxable income if only recognized built-in gains and recognized built-in losses were taken into account) will be $100. If the accrued bonus had been treated as a built-in deduction item, however, the corporation's pre-limitation amount would only have been $50 ($100 recognized built-in gain on the sale of Building "A" less $50 recognized built-in loss on payment of the bonus). The accrued bonus will, however, decrease the corporation's NUBIG to $150 ($100 built-in gain on Building "A" plus $100 built-in gain on Building "B" less $50 liability for accrued bonus). Thus, if Building "B" is sold during the BIG Period and results in a recognized built-in gain of the full $100, only $50 will be subject to the built-in gains tax under IRC Section 1374, and the only adverse consequence of the accrued bonus not being treated as a built-in deduction item would be the acceleration of the corporation's built-in gains ($100 gain recognized on the disposition of Building "A" rather than $50). This example demonstrates that the effect of an item not being classified as a built-in deduction under IRC Section 1374(d)(5)(B), but which nevertheless reduces NUBIG, will be greatest where the corporation has several assets with built-in gain, only some of which are sold during the BIG Period. In such case, the corporation will pay more built-in gains tax than it otherwise would have paid if the item had been treated as a built-in deduction item and had been available to

81 IRC § 1374(d)(5)(B).

offset the recognized built-in gains of other assets. If all of the built-in gain assets are sold during the BIG Period, the only effect of an item not being classified as a built-in deduction item will be the acceleration of the built-in gains tax applicable to the corporation's assets. Finally, if none of the built-in gain assets are sold by the S corporation during the BIG Period, there will be no adverse effect from an item not being classified as a built-in deduction.

Although not as clear as in the case of a liability not qualifying as a built-in deduction item, an item that does not constitute a built-in income item because it would not have been recognized by the corporation prior to the date of its conversion to S status if the corporation had been on the accrual method of accounting, could possibly still increase the corporation's NUBIG limitation if such item was treated as an asset of the corporation on the date of conversion and the item had an ascertainable fair market value in excess of the corporation's basis in such item on the date of conversion. Possible examples of such items include an account receivable subject to a substantial doubt as to collectibility and a contingent or potential claim against a third party. The collection of an item that does not constitute a built-in income item under IRC Section 1374(d)(5)(A) would not trigger application of the built-in gains tax since the collection of such an item would not constitute a recognized built-in gain. Assuming that such an income item increased the corporation's NUBIG limitation, however, the corporation's overall exposure to the built-in gains tax might be increased to the extent the corporation has other built-in gain assets.

Example (2):

Assume that a cash-basis corporation owns Building "A", which has a built-in gain of $100, and Building "B", which has a built-in loss of $100. Additionally, the corporation has an account receivable in the face amount of $100 with respect to which there is sufficient doubt as to its collectibility so as to preclude the corporation (had it been an accrual basis taxpayer) from including the receivable in its income prior to the date of its conversion to S status. Further assume that the IRS can somehow show that the account receivable had some value (assume $20) as of the date of the corporation's conversion to S status, so that the corporation's NUBIG is increased to $20.[82]

In the event the corporation collects the full $100 account receivable in its first tax year as an S corporation, such amount would not constitute a recognized built-in gain subject to the built-in gains tax under IRC Section 1374 since the item did not constitute a built-in income item under IRC Section 1374(d)(5)(A). If, however, the corporation subsequently sells Building "A" with a built-in gain of $100 during the BIG Period, the corporation would have a net recognized built-in gain of $20 (the Corporation's NUBIG limitation) on which the built-in gains tax would be imposed. If, alternatively, the account receivable had no effect on the corporation's NUBIG, the corporation would not have been subject to the built-in gains tax on the disposition of Building "A" since its NUBIG would have been zero. This example illustrates that an item which does not constitute a built-in income item under IRC Section 1374(d)(5)(A), but which nevertheless increases a corporation's NUBIG, will have its greatest impact if the corporation has other built-in gain assets that are disposed of during the

82 If the receivable actually had an ascertainable fair market value of $20, then the receivable arguably might also constitute a built-in income item to the extent of $20. Bifurcating a single asset in this manner, however, seems inappropriate and not supported by IRC § 1374 (or the regulations promulgated under IRC § 1374).

recognition period that are not offset by corresponding dispositions of built-in loss assets during the same tax year.

[g] General Accounts Receivable Planning Opportunities.

Because the accounts receivable of a cash-basis corporation are included in determining a corporation's NUBIG, and the collection of such receivables is treated as a recognized built-in gain under IRC Section 1374, the cash-basis corporation, and particularly the cash-basis service corporation, is potentially subject to a substantial tax liability under IRC Section 1374 (a double tax of approximately 50.23%). Consequently, it is imperative that the cash-basis service corporation converting from C corporation status to S corporation status consider all available planning opportunities to minimize the impact of the built-in gains tax with respect to its accounts receivable.

[h] Zeroing Out of Taxable Income.

Since the base of the built-in gain tax is limited to a corporation's taxable income, one method of avoiding the built-in gain tax would be to zero out the corporation's taxable income for the entire 5-year built-in gain period. Such a strategy seems inadvisable in that it could very well subject the S corporation to the same unreasonable compensation arguments to which it would have been subject had it remained a C corporation. An S corporation would be susceptible to an unreasonable compensation argument in this context since the result of recharacterizing amounts paid as compensation to the shareholder-physicians as distributions would be to increase the corporation's taxable income above zero, and thus, subject it to the built-in gain tax.

[i] Bonus Accrual Method.

Due to the pass-through nature of an S corporation, the collection of accounts receivable by a cash-basis corporation that has converted from C corporation status to S corporation status, absent proper planning, will result in a forced double taxation on such receivables. As discussed above, one common method of avoiding the built-in-gain tax on the accounts receivable of a cash basis taxpayer is to accrue bonuses (in an amount equal to its receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in its first tax year as an S corporation. Although there are a number of open issues with regard to this strategy, Private Letter Ruling 200925005 confirms that this strategy does work.

In Private Letter Ruling 200925005, the IRS ruled that the payment of certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable of the corporation at the time of its conversion to S status would constitute built-in deduction items, specifically including the payment of compensation to shareholder-employees of the corporation within the first two and one-half months following the corporation's conversion to S corporation status.

Under the facts of the ruling, the taxpayer is a cash basis C corporation with a calendar tax year. The corporation is a personal service corporation which is wholly-owned by a number of professionals. The corporation bills its clients for the services performed by the professionals and when invoices are paid, the corporation pays salaries and wages to the professionals. Additionally, the corporation has other employees, such as non-shareholder clerical staff and non-shareholder professionals to which it pays wages.

The taxpayer will elect to be an S corporation and will have built-in gain from its outstanding accounts receivable. The taxpayer requested the letter ruling to determine whether certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable as of the date of the corporation's conversion to S status will qualify as built-in losses under IRC Section 1374, and specifically, whether the amounts paid to its shareholder-employees within the first two and one-half months of the recognition period under IRC Section 1374 of salary and wage expenses that are related to the production of accounts receivable that are outstanding as of the effective date of the S election will constitute built-in deduction items under IRC Section 1374(d)(5)(B).

The post-conversion collection of accounts receivable of a cash-basis corporation, particularly the cash-basis service corporation, is potentially subject to a substantial tax liability for the built-in gain tax imposed under IRC Section 1374. Due to the pass-through nature of an S corporation, the collection of accounts receivable by a cash-basis corporation that has converted from C corporation status to S corporation status, absent proper planning, will result in a forced double taxation on such receivables of approximately 50.23 percent.[83] Consequently, it is imperative that the cash-basis service corporation converting from C corporation status to S corporation status consider all available planning opportunities to minimize the impact of the built-in gain tax with respect to its accounts receivable.

Since built-in deduction items (such as accounts payable of cash-basis corporations) are taken into account in determining NUBIG of an S corporation under IRC Section 1374(d)(5)(C), and the payment of such amounts is treated as a recognized built-in loss that may be matched against built-in income items (such as a cash-basis corporation's accounts receivable), a common method that has been employed by practitioners to avoid the built-in gain tax imposed on the accounts receivable of a cash basis service corporation is to accrue bonuses (in an amount equal to its collectible receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in its first tax year as an S corporation. Even though such accrued bonuses may or may not be characterized as built-in deduction items (depending on whether they are paid in the first two and one-half months following conversion), the effect of accruing such bonuses nevertheless may be either to eliminate the potential application of the built-in gain tax altogether by

---

83 Assuming $100 of accounts receivable, the built-in gain tax would be $21 ($100 x 21%), and the shareholder-level tax (assuming the maximum marginal individual tax rate of 37%) would be $29.23 ($79 x 37%). Thus, total taxes on the $100 of accounts receivable would be $50.23 ($21 + $29.23), resulting in an effective federal tax rate of 50.23%. In addition, state corporate income taxes may be imposed on the corporate level gain. The 50.23% potential double tax on S corporations under both Section 1374 and the sting tax imposed on passive investment income under IRC § 1375 should be revised. The purpose of the built-in gain tax was expressly to avoid the repeal of the general utilities doctrine by way of a C corporation converting to S corporation status. It was meant to impose a tax on the S corporation and its shareholders in the same amount as would be taxed if the corporation had remained a C corporation and engaged in the proposed transaction. Because C corporation shareholders are now subject to a 20% tax rate on dividends, that same rate should be used for both the built-in gain tax imposed under IRC § 1374 and the tax on excess passive investment income imposed under IRC § 1375 in order to reach results equivalent to those that would be reached if the corporation had remained a C corporation. Using the current 37% ordinary income rates for S corporation shareholders results in the S corporation shareholders being taxed at a higher rate than had they remained a C corporation and engaged in the same transaction. Such a result is clearly inequitable.

reducing the corporation's NUBIG to zero, or alternatively, if the corporation has goodwill or other appreciated assets, to at least minimize recognition of any built-in gains by reducing the corporation's NUBIG by the amount of such accrued bonuses. There are a number of open issues regarding the mechanics of accruing such bonuses. These open issues include:

- whether such bonuses should be paid within the first two and one-half months so as to constitute built-in deduction items that offset the built-in income items (receivables), or whether such bonuses may be paid at any time during the corporation's first taxable year as an S corporation based on the position that the accrued bonuses reduce the corporation's NUBIG to zero;

- if the corporation intends to pay such bonuses in cash within the first two and one-half months and funds must be borrowed to pay such bonuses, whether the corporation or the shareholder-employees should borrow such funds;

- whether such bonuses could be paid by simply having the corporation distribute the accounts receivable attributable to the accrued bonuses within the first two and one-half months following conversion to S corporation status (as opposed to paying such bonuses out in cash);

- whether the regular salaries of the shareholder-employees should be "suspended" in order to enable the corporation to pay such bonuses;

- assessment of the effect of such bonuses on any buy-out provision in the event a shareholder-employee's employment is terminated after receipt of the bonus but prior to any loans funding such bonus being repaid;

- whether the employment agreements of the shareholder-employees should be amended to provide compensation for nonbillable services to support compensation paid in "C" years as well as accrual of the bonus;

- documentation of such accrued bonuses in the minutes of the board of directors as compensation for past services; and

- whether the corporation should continue zeroing out its taxable income for some period of time in order to support compensation amounts paid in prior "C" years as well as to provide a "back-up" for the bonus accrual strategy.

Although Private Letter Ruling 200925005 certainly does not answer all of these open questions, it certainly makes it clear that the built-in gain tax on accounts receivable can be avoided by the converted corporation paying out compensation related to such accounts receivable to its shareholder-employees within the first two and one-half months of the corporation's first tax year as an S corporation, which is the method that has been most commonly employed by practitioners in order to avoid imposition of the built-in gain tax on the accounts receivable of a cash basis service corporation.

The IRS expressly concludes in the ruling that the taxpayer's payments to its shareholder-employee of salary and wages relating to the production of accounts receivable on the effective date of the S election, if paid in the first two and one-half months of the recognition period, qualify as built-in loss items under IRC Section 1374(d)(5)(B). Additionally, the IRS found that the taxpayer's payments to its non-shareholder employees of salary and wages related to the production of outstanding accounts receivable on the effective date of the S election, if paid at any time during the recognition period, will qualify as built-in loss items under IRC Section 1374(d)(5)(B). Finally, the IRS concluded that the taxpayer's payments of other unpaid payable expenses and accounts payable related to the production of the accounts receivable outstanding on the effective date of the S election, if paid at any time during the recognition period, would qualify as built-in loss items under IRC Section 1374(d)(5)(B).[84]

[j] Acceleration of Accounts Receivable.

Alternatively, in order to avoid forced double taxation on its receivables, a service corporation converting from C to S corporation status may choose to accelerate its receivables income and recognize such income prior to conversion to S corporation status. In this manner, the corporation may be able to defer (possibly indefinitely) shareholder-level tax on its receivables until the earnings and profits generated by the collection of such receivables are distributed to the corporation's shareholders. The recognition of receivables income by a corporation prior to its conversion to S corporation status will have the added benefit of decreasing its overall NUBIG. The pre-conversion recognition of receivables income may be achieved in at least three ways.

1) First, the corporation may simply assign and sell its accounts receivable prior to its conversion to S corporation status to a third party.

2) Second, the corporation may sell its accounts receivable to its shareholder-employees prior to its conversion to S corporation status. Additionally, in each of the first two alternatives, the sale of the receivables could be combined with the payment of a bonus in an amount equal to the sales proceeds in order to avoid payment of a corporate level tax on the corporation's sale of its receivables.

3) Finally, the corporation could, in order to avoid a pre-conversion C corporation tax on the sale of its accounts receivable, simply "bonus" its accounts receivable to its shareholder-employees. The pre-conversion recognition of receivables income by a service corporation, when combined with the payment of a corresponding bonus to its shareholder-employees, should also limit any attempts by the IRS to recharacterize payments to the corporation's shareholder-employees as dividend distributions under unreasonable compensation arguments to the corporation's last tax year as a C corporation.

---

84 It is interesting to note that Priv Ltr Rul 200925005 did not specifically state that any type of special bonus had to be accrued prior to the last day of the corporation's last tax year as a C corporation or require any written evidence of such accrual in the corporate minutes or other documentation. Rather, the IRS simply concluded that the payment of salary and wages to the shareholder-employees of the corporation which related to the production of the accounts receivable on the effective date of the S election would qualify as built-in loss items if paid in the first two and one-half months of the recognition period. To be certain, the authors would recommend that such bonus be accrued prior to the last tax year as a C corporation and evidenced at least in the Board of Director minutes of the corporation.

[k] Examples. The examples set forth below examine tax planning alternatives available with respect to the accounts receivable of a cash-basis service corporation converting to S corporation status.

Example (1): *No Planning*. Doctors R Us, a professional corporation using the cash receipts and disbursements method of accounting, has taxable income (pre-salary and bonus to its four shareholder-employees) of $1,000,000. The corporation is planning to pay total salaries and bonuses to its four shareholder-employees of $1,000,000, resulting in taxable income to the corporation of zero. The corporation also has $200,000 of accounts receivable as of December 31, 2018, which will be collected and give rise to income in 2019. The corporation desires to elect S corporation status effective January 1, 2019. If the corporation takes no action to affirmatively plan for its receivables and has no other built-in gain or built-in loss items, it potentially will be subject to a tax of $42,000 under IRC Section 1374 on the collection of the $200,000 of receivables in 2019 (21% of $200,000). The $200,000 of income recognized on the collection of the receivables, reduced under IRC Section 1366(f)(2) by the $42,000 corporate level tax imposed under IRC Section 1374, will pass through to, and be taken into account by, the individual shareholder-employees of the corporation under IRC Section 1366 in 2019. Consequently, assuming a maximum marginal tax rate of 37% for individuals, the shareholder-employees will be subject to a tax of $58,460 (37% of $158,000). The aggregate tax paid by both the corporation and the individual shareholders of the corporation on the $200,000 of receivables will therefore be $100,460 ($42,000 corporate level tax under IRC Section 1374 plus $58,460 tax imposed on the individual shareholder-employees), resulting in an aggregate tax rate of approximately 50.23%

Example (2): *Accrual of Bonus*. Now assume that the corporation accrues an additional bonus to its four shareholder-employees in 2018 of $200,000, an amount equal to its receivables. Under IRC Section 1374(d)(1), the corporation should avoid application of the built-in gains tax altogether because its NUBIG will be zero (even if the accrued bonus does not constitute a built-in deduction item under IRC Section 1374(d)(5) because of the limitations of IRC Section 267(a)(2) and/or IRC Section 404(a)(5)). As such, when the receivables are collected by the corporation in 2018, they will be subject to a single level of tax at the shareholder level of $74,000 (37% of $200,000). If the accrued bonus is paid within the first two-and one-half (2-1/2) months of the corporation's first taxable year as an S corporation, it will constitute a built-in deduction item that will offset the built-in income item dollar for dollar, again resulting in a single level of tax at the shareholder level of $74,000 (assuming no deduction under section 199A). This same result should also occur if the accounts receivable themselves (rather than cash) are bonused out to the shareholder-employees in 2018.

Example (3): *Sale of Receivables to Third Party.* Now assume that instead of accruing a bonus in 2018, the corporation sells the receivables to a third party (for their face value). Also assume that the corporation continues its policy of reducing its taxable income to zero except for the $200,000 recognized on the sale of its receivables. In this situation, the corporation will be subject to a tax of $42,000 on the sale of its receivables to the third party (21% of $200,000). In turn, the earnings and profits of the corporation will be increased by $158,000, the difference between the $200,000 received on the sale of the receivables and the $42,000 of taxes paid with respect to the sale of the receivables. The shareholder-employees will not, however, be taxed on the $158,000 of earnings and profits until such earnings and profits are distributed to them.

Although the corporate level tax of $42,000 is accelerated and recognized in 2018 rather than in 2019, any tax payable at the shareholder level may be deferred for a number of years and, in fact, may never be recognized by the shareholders if the distributions made by the corporation never exceed its accumulated adjustments account following its conversion to S corporation status.

Example (4): *Sale of Receivables to Third Party and Payment of Bonus.* Assume the same facts as in Example 3, above, except that in addition to selling the receivables to a third party, the corporation distributes the additional $200,000 collected on the sale of its receivables to its four shareholder-employees as an additional bonus, thus reducing the corporation's taxable income to zero. The corporation will not be subject to the built-in gains tax imposed under IRC Section 1374 since it will no longer own any receivables, and additionally will not be subject to any tax in 2018 since it will have no taxable income. The shareholders will be subject, however, to a tax of $74,000 in 2019, determined by multiplying the additional $200,000 bonus by the highest marginal individual income tax rate of 37% (assuming no deduction is available under Section 199A .

The sole difference between this example and the straight accrual of a bonus alternative found in Example 2, above, is that the tax of $74,000 is paid in 2018 in this case whereas the tax of $74,000 is paid in 2019 in the case of a bonus accrued in 2018. This method has an additional advantage of not exposing the corporation to an unreasonable compensation argument beyond its last tax year as a C corporation since it will not be subject to IRC Section 1374, and as such, will have no reason to pay high amounts of compensation to its shareholder-employees in order to zero out its income.

Example (5): *Sale of Receivables to Shareholder-Employees.* Assume the same facts as in Example 4, above, except that the corporation sells the receivables to its shareholder-employees for $200,000. Assuming that the shareholder-employees have $200,000 to pay the corporation for the receivables (or will execute promissory notes to the corporation for the receivables), the corporation will recognize a corporate level tax of $42,000 in 2018.

As the shareholder-employees collect the receivables in 2019, they will recognize no gain since they will have a cost basis in the receivables under IRC Section 1012 equal to $200,000. Again, until some future point in time when the earnings and profits of $158,000 ($200,000 of sales proceeds minus $42,000 of tax) is distributed to such shareholder-employees, any shareholder level tax will be deferred. This is the same result as achieved in Example 3, above, where the receivables were sold to a third party. Since it may be impossible for a corporation to find a third party willing to buy its receivables, it may be forced to sell the receivables to its shareholders if it desires to dispose of its receivables prior to its conversion to S corporation status.

Example (6): *Sale of Receivables to Shareholder-Employees and Payment of Bonus.* Assume the same facts as in Example 5, above, where the corporation sold the receivables to its shareholder-employees, but assume as in Example 4, above, that the corporation accrues an additional bonus of $200,000 to its shareholder-employees. In actuality, the only money that will change hands on the sale of the receivables will be withholding taxes since the shareholders will be receiving a bonus equal to the amount which they are paying for the receivables of the corporation (less applicable withholding taxes).

Just as in Example 4, above, if this strategy is successful, the receivables will be subject to a single level of tax at the shareholder level equal to $74,000 (37% of $200,000) in 2018. As the receivables are collected by the shareholders in 2019, they will recognize no income since they will have a cost basis in the receivables under IRC Section 1012 of $200,000.

Example (7): *Bonus of Receivables.* Assume the same facts as in Example 6, above, except that the corporation simply distributes the $200,000 of receivables proportionately to the shareholder-employees generating the receivables as a bonus. Under the assignment of income doctrine, the corporation should recognize $200,000 of income on the distribution of its receivables to its shareholder-employees, but will receive a corresponding compensation deduction for the $200,000 bonus paid to them. The shareholders will therefore recognize $200,000 of income in 2018, and be subject to a tax of $74,000 (37% of $200,000).

Once again, the shareholder-employees will have a IRC Section 1012 tax-cost basis in the receivables, and as such, will recognize no income in 2019 when they collect the receivables.

[l] Summary of Accounts Receivable Planning Alternatives.

These examples demonstrate that the accrual of a bonus in an amount equal to the receivables of a cash-basis service corporation in its final C year, produces the lowest amount of tax and the greatest amount of deferral on the entire amount of tax due (provided the corporation has no other built-in gain items). Alternatively, the sale of the corporation's receivables prior to its conversion to S corporation status will accelerate the corporate level tax due on the receivables, but may result in an indefinite deferral of the shareholder level tax on the earnings and profits generated by the sale of the receivables. The sale of receivables in a cash-basis service corporation's last C year with a corresponding bonus in the amount of its receivables or the bonus of its receivables will result in a single level of tax and a one year acceleration of income in comparison to the bonus accrual alternative. The alternatives involving the sale or bonus of the cash-basis service corporation's receivables in its last C year also have the added benefit of limiting any unreasonable compensation arguments to its last year as a C corporation, rather than exposing the corporation to such an argument in years following its conversion to S corporation status when the corporation may be subject to the built-in gains tax imposed under IRC Section 1374.

Consequently, the tax practitioner must analyze the specific facts and circumstances of each situation, including the total compensation package otherwise being paid to the shareholder-employees of the corporation in its last year as a C corporation, in order to determine the optimal planning alternative regarding the cash-basis service corporation's receivables. In no event, however, should the cash-basis service corporation merely convert to S corporation status without engaging in any planning to minimize the built-in gains tax which will be imposed under IRC Section 1374 on such corporation's receivables.

Conclusion. As discussed above, the rules applicable to the 20% of QBI Deduction for pass-throughs and sole proprietorships are complex and should be carefully considered in the selection of the type of entity to use, as well as whether employees versus independent contractors should be used in the business and whether employees can be in a separate management company. Until guidance is issued by the IRS on the many open issues under Section 199A, practitioners and taxpayers should proceed with caution.

Also, a great deal of thought should be given before a business decides to convert from a pass-through entity to a C corporation due to the difficulty in getting out of “C” corporation status, and the “toll charges” imposed on converting from “C” corporation status, especially the built-in gains tax imposed under Section 1374 discussed in detail above.

Unless you have a crystal ball predicting future changes in tax laws, revenues, payroll, equipment purchases and the timing of the sale of the business, it may be very hard to recommend that a business convert to “C” corporation status. However, there will certainly be some situations in which a C corporation will make sense. Obviously, one of the biggest factors as to whether a “C” corporation makes sense at all is how much of the earnings are expected to be distributed to the shareholders. If one frequently take profits out of one’s business or the business will be sold in the foreseeable future, it makes the most sense to stay a pass-through entity or sole proprietorship. Conversely, if the owners are reinvesting most of the earnings of the business (back into non-deductible expenditures), cannot take advantage of the Section 199A deduction and/or are not planning on selling their business in the foreseeable future, a “C” corporation may be the better vehicle to conduct the business. Concepts of the time value of money also come into play in making this determination.