Steve Leimberg's Income Tax Planning
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Subject: Stephen Liss & Section 199A - The Great Divide

“The Tax Cuts and Jobs Act added §199A to the tax code. It provides a deduction for the ‘combined qualified business income’ of the taxpayer. There is a lot to discuss about §199A, but this newsletter focuses on one way to help high income owners of services businesses qualify for the benefits of §199A even if they work in disfavored industries. In short, such business owners should consider dividing their business into two pieces so they can isolate the income Congress believes is akin to wages (not eligible for the §199A deduction) from income Congress believes is true business income (eligible for the §199A deduction).”

Stephen Liss provides members with his perspective on Section 199A.

Stephen Liss is a **Senior Wealth Strategist** and part of the **Advanced Planning Group** with **UBS Financial Services Inc,**[i] where he educates UBS clients on taxes, estate planning, and planned charitable giving. He is Vice-Chair of the Estate and Gift Tax Committee of the RPTE Section of the ABA. Stephen has previously published articles in Estate Planning, Trusts & Estates Magazine, the Journal of Taxation, and the Journal of International Taxation, among others. He received his JD from Georgetown University Law Center (cum laude) and his LLM from New York University.

Here is his commentary:

EXECUTIVE SUMMARY:

The Tax Cuts and Jobs Act added §199A to the tax code. It provides a deduction for the "combined qualified business income" of the taxpayer. There is a lot to discuss about §199A, but this newsletter focuses on one way to help high income owners of services businesses qualify for the benefits of §199A even if they work in disfavored industries. In short, such business owners should consider dividing their business into two pieces so

they can isolate the income Congress believes is akin to wages (not eligible for the §199A deduction) from income Congress believes is true business income (eligible for the §199A deduction).

COMMENT:

Slightly simplified, combined qualified business income (QBI) is 20% of (1) qualified REIT dividends, (2) qualified publicly traded partnership income, (3) qualified cooperative dividends, and (4) the income from a qualified trade or business.[ii] The fourth category excludes income earned from certain industries if the taxpayer is a high earner, and is also subject to a limitation based on (a) the W-2 income paid by the business and (b) the amount of depreciable property used by the business.[iii]

For taxpayers who earn less than the "threshold amount" ($157,500 for single filers and $315,000 for joint returns, adjusted for inflation going forward), any type of business taxed as a partnership, an S corporation, or a sole proprietorship is a qualified trade or business and the income generated from that business is eligible for a 20% deduction under §199A. For taxpayers who earn more than $207,500 ($415,000 for joint returns), a qualified trade or business does not include "a specified trade or business" or "the trade or business of performing services as an employee." As a result, those high earning taxpayers are denied the 20% deduction for income earned through such businesses. This limitation is phased in for those who earn between the two figures (i.e., $157,500 - $207,500 for single filers and $315,000 - $415,000 for joint returns).

A specified trade or business (STOB) includes 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. It also includes a business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[iv] Essentially a STOB is a business where Congress believes the income earned is akin to wage income and therefore should not benefit from a deduction that is intended for business income.

When you put all of this together, it means that many successful professionals do not benefit from the 20% deduction under §199A because

their industries were specifically excluded. Taxing those engaged in certain industries at a higher rate than those engaged in other industries is a new tax concept. For high earners who make a living through a STOB, one logical response to this new reality is to divide their business in two. One business will continue to be a STOB, while the other will be structured to avoid STOB classification. This division is intended to shift some profit to the business that is not a STOB, which will therefore qualify for the §199A deduction.

For example, imagine a law firm with 50 attorneys and $50 million of gross revenue. After paying all expenses, the 20 partners earn an average of $500,000, for a total profit of $10 million. The law practice is a STOB, so none of that income qualifies for the 20% deduction under §199A.

Now imagine the partners form a new entity called Law Firm Support LLC (LFS LLC). LFS LLC is owned by the 20 partners in exactly the same ratio as they own the law practice. Most of the employees of the law practice are shifted to LFS LLC, which enters into a series of contracts to provide (1) a full time receptionist, (2) IT support, (3) secretarial services, (4) marketing support, (5) secure file retention, and (6) property management.

None of the listed services run afoul of the STOB definition. For safety, we will assume the billing department will remain with the law practice since it could be argued that is a form of accounting.

The law practice will pay market rates for all of these services, which merely segregates the true profit earned from the practice of law from profit earned by providing ancillary services. As a result, in 2018, the law practice earns only $4 million, while LFS LLC earns $6 million. That $6 million of profit now qualifies for a $1.2 million deduction under §199A, saving the partners $444,000 based on a 37% top marginal rate.[v]

Will a business division like this work? A review of §199A does not reveal any requirement that various businesses be aggregated when determining whether income is from a STOB. On the contrary, for determining how much of a taxpayer's qualified business income is deductible it appears each business must be tested separately under §199A(b)(2).

The Secretary is authorized to "prescribe such regulations as are necessary to carry out the purposes of this section…"[vi] It's conceivable that the Secretary's authority is sufficient to create anti-abuse rules, but is dividing a business into its component parts abusive? So long as the fees

paid to a parallel business are consistent with prevailing market rates, I don't believe it is.

Historically there was no difference in the tax treatment of various industries, so for simplicity most businesses tended to aggregate all of their activities under a single entity. Returning to our law firm example, many attorneys lament that they cannot simply practice law, but are forced to run an IT department, a records department, a marketing department, etc. Those are in fact different businesses, and many smaller firms outsource those activities. Congress has determined that income from the practice of law (and numerous other professional industries) is akin to wage income, so it seems perfectly appropriate to determine just how much income was earned from the practice of law. The best way to do that is to operate the legal practice as a separate business and to account separately for the profit it earns. Said another way, Congress wants to provide a reduced tax rate to income earned from other businesses that may currently be concealed within a health, law, accounting, actuarial science, performing arts, consulting, etc. business, so dividing the activities of an existing business seems consistent with the purpose of §199A.

There will be some practical challenges to implementing this approach. For example, an insurance company may be required to treat these two businesses as distinct for purposes of evaluating the insurance pool and claims experience. That could result in a net increase in medical insurance premiums. There may be challenges associated with an existing 401(k) plan or other forms of deferred compensation. It may not be possible to have employees from both businesses participate in the same plan. If there are key managers who need to supervise both lines of business, the need for multiple employment contracts may lead to unanticipated complexity or confusion. In some instances, these issues will overwhelm the potential benefits of dividing a business, but in many cases the benefits will outweigh the burdens.

The Tax Cuts and Jobs Act represents a new series of challenges, but it also creates new ways we can help our clients. Dividing a STOB into its component parts seems to be an opportunity that falls into the latter category and is worth exploring further.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Stephen Liss

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[ii] §199A(a).

[iii] §199A(b).

[iv] §199A(d)(2).

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[v] This assumes, of course, that LFS LLC pays at least $2.4 million in wages or has sufficient basis so that the deduction will not be restricted under §199A(b)(2)(B).

[vi] §199A(f)(4).