

**199A**  
**PROPOSED REGULATIONS:**  
**A FIRST LOOK**

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**Presented by:**



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## **199A Proposed Regulations: A First Look**

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# COMMENT:

## **The proposed regulations are overwhelmingly tax-payer unfriendly, but planning is still possible.**

The authors believe that the Regulations proposed here are overwhelmingly taxpayer unfriendly, and that the decision to give automatic unconditional loopholes to C corporations, REIT's and publicly traded partnerships, while excluding a great many small and medium size taxpayers or requiring them to change how they do business to have better treatment, is repugnant to the tax system, fairness and the economy. As practical matter, the Regulations are intended to thwart two logical and reasonable methods of planning that practitioners had hoped to use for Section 199A purposes: (1) separating lines of income and (2) trusts.

One way practitioners had hoped to qualify at least some income from a Specified Service Trade or Business owned by a high income taxpayer was by separating out non-Specified Service Trade or Businesses that the trade or business had, which the owners could claim a Section 199A deduction on. This method is often called the "Crack-and-Pack method". For example, a related S corporation might provide management services for its own law office, as well as owning its own building, which could be separated out to a management company and rental activity that would be paid by the law firm at fair market value.

While the Regulations allow owners of non-Specified Service Trade or Businesses to aggregate some of their businesses to maximize a Section 199A deduction, they force certain Specified Service Trade or Businesses and their ancillary services to be aggregated and all considered to be Specified Service Trade or Businesses, even if the applicable services so labeled would clearly not be Specified Service Trade or Businesses if they were owned and operated by owners not related to the involved professionals. Specifically, a trade or business will be considered to be an extension of a Specified Service Trade or Business if it is 50% or more commonly controlled with a Specified Service Trade or Business and provides 80% or more of its property or services to that Specified Service Trade or Business.

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# COMMENT, continued

Further, if a trade or business provides less than 80% of its property or services to a Specified Service Trade or Business, but is 50% or more commonly controlled by the owners of a Specified Service Trade or Business, the income attributable to that separate business that services or sells products to the Specified Service Trade or Business will still be considered to be Specified Service Trade or Business income, and income that is not related to providing its property or services to the Specified Service Trade or Business will be eligible for the Section 199A deduction. Practitioners will therefore seek to avoid the common the control requirement of the Regulations wherever possible in order to qualify the maximum amount of income of ancillary companies for a Section 199A deduction. For example, three separate law firms might set up a management and billing company to service all three of them, with the separate owners each owning less than 50% of the management company and profits being divided based on percentage of ownership.

It is noteworthy that when a medical, legal or other professional practice cannot be owned by anyone other than licensed professionals under state law it may still save significant tax dollars to have a separate management company that is owned by trusts or lower bracket family members that can benefit from the Section 199A deduction even if the income is considered to be Specified Service Trade or Business Income if the final Regulations include these provisions and are enforceable.

## Treatment of income from charitable remainder trusts.

On a final note, the Regulations did not address the questions that exist for Charitable Remainder Trusts under Section 199A. In particular how income that is recognized by the trust but not taxed to beneficiaries until distributed will be treated for purposes of calculating the Section 199A deduction and if the deduction will be allowed for Charitable Remainder Trusts. The IRS did include a request for comment in these Regulations on how beneficiaries of these types of trust would be able to take a Section 199A deduction, which indicates a possibility that the Service may allow such a deduction.

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## Two Main Rules to Know

		Situation	Result	
1	Specified Service Trade or Business	A	Taxpayer's Taxable Income is under \$315,000 for Taxpayers married filing jointly, or \$157,500 for single filers	<b>No Limitation applies</b>
		B	Taxpayer's Taxable Income is between \$315,000-\$415,000 for Taxpayers married filing jointly or \$157,500-\$207,500 for single filers	Limitation is phased in by the amount Taxable Income exceeds threshold amount  Example – MFJ Taxable Income of \$365,000. Deduction is equal to 10% of QBI (50% ((365-315)/100) * 20% Deduction.
		C	Taxpayer's Taxable Income Exceeds \$415,000 for Taxpayers married filing jointly or \$207,500 for single filers	<b><u>No Deduction</u></b>
2	Wage and Qualified Property Test	A	Taxpayer's Taxable Income is under \$315,000 for Taxpayers married filing jointly, or \$157,500 for single filers	<b>No Limitation applies</b>
		B	Taxpayer's Taxable Income is between \$315,000-\$415,000 for Taxpayers married filing jointly or \$157,500-\$207,500 for single filers	Limitation is phased in by the amount Taxable Income exceeds threshold amount
		C	Taxpayer's Taxable Income Exceeds \$415,000 for Taxpayers married filing jointly or \$207,500 for single filers	Limitation applies unless 50% of Wages or 25% of Wages plus 2.5% of Qualified Property are met at the entity level

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199A Simplified

<p align="center">Low Earner (Less than \$157,500 single/\$315,000 Married)</p>		<p align="center">Higher Earner in Non-Specified Trade or Business (Over \$207,500 Single/ \$415,00 Married)</p>		<p align="center">High Earner in Specified Service Trade or Business (Over \$207,500 Single/ \$415,000 Married)</p>
<p>Any type of flow-through business eligible for deduction Including the specified service trades or businesses (i.e. Doctors, Lawyers, CPAs, CFPs, etc.)</p>		<p align="center">Wage and Qualified Property Test Applies.</p>		<p align="center">No Deduction Allowed for Specified Service Trade or Business</p>
<p align="center">Wages and Qualified Property Test does not apply.</p>	<p align="center"><b>Phase Out Zone</b></p>	<p>Taxpayers in this category must pay sufficient wages or own sufficient qualified property to avoid limitation on 20% deduction.</p>	<p align="center"><b>Phase Out Zone</b></p>	<p>Includes: Health, Law, Accounting, Actuarial Science, Performing Arts, Consulting, Athletics, Financial Services, Brokerage Services, Investing, trading, or dealing in securities or commodities, or any business where principal asset is the reputation or skill of one or more employees.</p>
<p align="center">Taxpayers in this category may consider converting C-Corp to S-Corp.</p>				<p align="center">Taxpayers in this category will want to separate out Non-Specified Service Trade or Business income into a separate entity and enter into arm's length arrangements with the Specified Service Trade or Business.</p>
				<p>Taxpayers may also consider gifting or selling portion of business to children or trust for children that are considered low earners.</p>

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\$157,500 (single filer)/  
\$315,000 (joint filer)

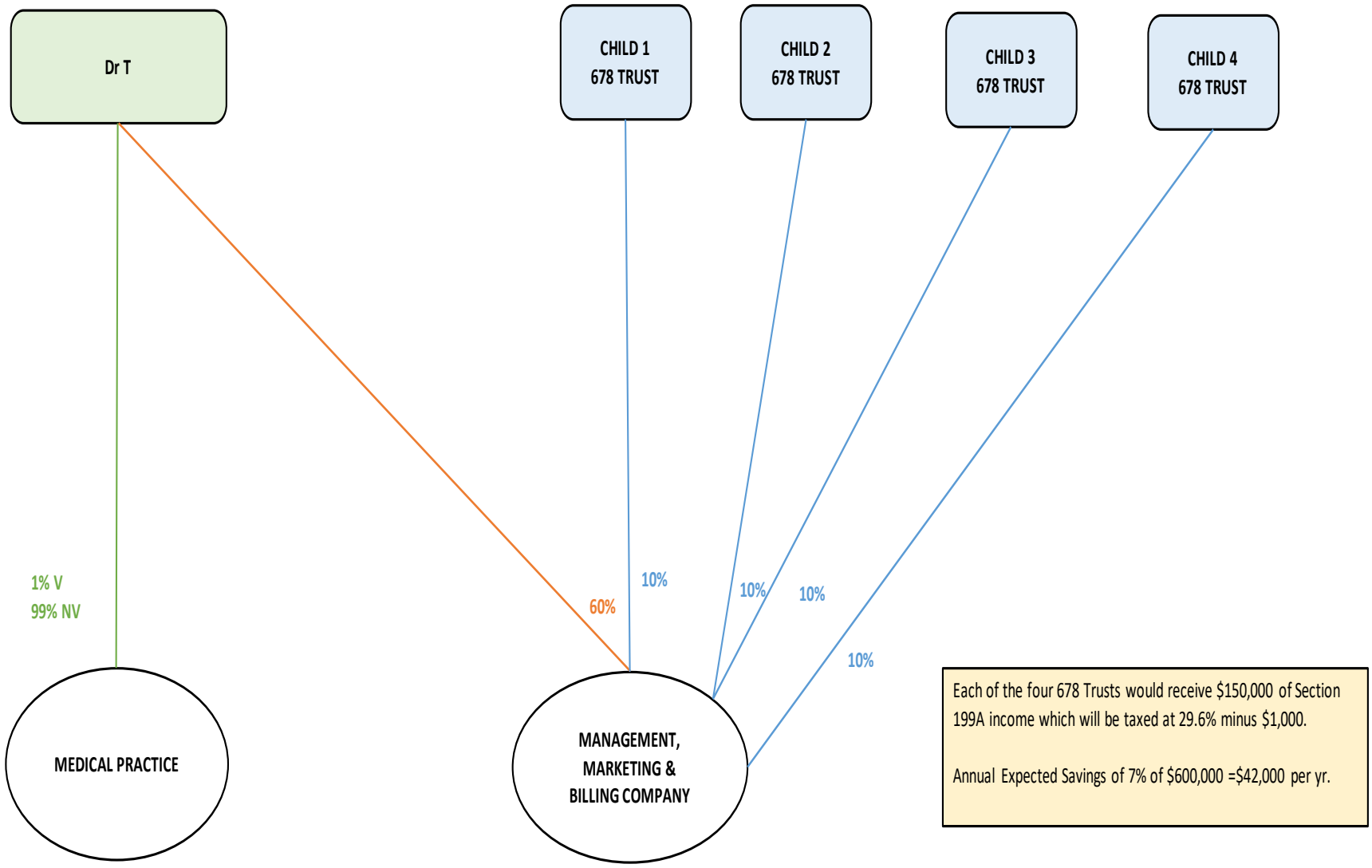
\$207,500 (single filer)/  
\$415,000 (joint filer)



Income (single/joint):	\$157,500/ \$315,000	\$170,000/ \$340,000	\$182,500/ \$365,000	\$195,000/ \$390,000	\$207,500/ \$415,000
Percent Phased-In/ Phased-Out (Amount Phased)	0%	25%	50%	75%	100%
Proportion of Wage/Property Test Applicable	0%	25%	50%	75%	100%
Maximum Section 199A Deduction Available for Specified Services (due to Phase-Out)	20%	15%	10%	5%	0%



<u>Issue/Factor</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>S Corporation</u>	<u>C Corporation</u>
Tax Rates	Owners are taxed at individual rates for salary and income of the company	Owners are taxed at individual rates for salary and income of the company	Owners are taxed at individual rates for salary and income of the company	Entity taxed for income at 21%; shareholders taxed for dividends and distributions
Double Taxation	Not subject	Not subject	Not subject	Dividends or distributions taxed separately
<u>Issue/Factor</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>S Corporation</u>	<u>C Corporation</u>
Availability of Section 199A deduction	Available (depending on limitations)	Available (depending on limitations)	Available (depending on limitations)	Cannot qualify for Section 199A
Accumulated Earnings	Taxed to owner as reported on their Form K-1, regardless of whether distributions are made	Taxed to owner as reported on their Form K-1, regardless of whether distributions are made	Taxed to owner as reported on their Form K-1, regardless of whether distributions are made	Taxed at 21% corporate rate; beware of accumulated earning tax issues
Guaranteed payments	N/A	Excluded from QBI; Not considered to be W-2 wages	N/A	N/A
Owner provides services (reasonable compensation issues)	Self-Employed (no W-2 wages); currently not subject to reasonable compensation	Self-Employed (no W-2 wages); currently not subject to reasonable compensation rules	W-2 Wages; excluded from QBI and subject to reasonable compensation rules	W-2 Wages; subject to reasonable compensation rules
Business is a Specified Service Trade or Business	Eligible if owner's taxable income is under lower-income thresholds; Limited if in between lower- and higher-income thresholds; Lost if taxable income is greater than higher-income thresholds	Eligible if owner's taxable income is under lower-income thresholds; Limited if in between lower- and higher-income thresholds; Lost if taxable income is greater than higher-income thresholds	Eligible if owner's taxable income is under lower-income thresholds; Limited if in between lower- and higher-income thresholds; Lost if taxable income is greater than higher-income thresholds	N/A
High Income earner as owner	May be limited if Wage/Property Hurdle is not met	May be limited if Wage/Property Hurdle is not met	May be limited if Wage/Property Hurdle is not met	N/A
Employees (W-2 Wages)	Consider impact on Wage/Property Limitation, adjust if necessary	Consider impact on Wage/Property Limitation, adjust if necessary	Consider impact on Wage/Property Limitation, adjust if necessary	N/A
<u>Issue/Factor</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>S Corporation</u>	<u>C Corporation</u>
Independent contractors	Hurts in application of Wage/Property Hurdle; Compensation not considered W-2 wages	Hurts in application of Wage/Property Hurdle; Compensation not considered W-2 wages	Hurts in application of Wage/Property Hurdle; Compensation not considered W-2 wages	N/A
Qualified property basis	Consider impact on Wage/Property Hurdle, adjust if necessary	Consider impact on Wage/Property Hurdle, adjust if necessary	Consider impact on Wage/Property Hurdle, adjust if necessary	N/A
State and local tax deductions	Deduction Limited	Deduction Limited	Deduction Limited	Fully Deductible
Medical expenses and plans deductions	N/A	N/A	N/A	Premiums and medical reimbursement plans are deductible

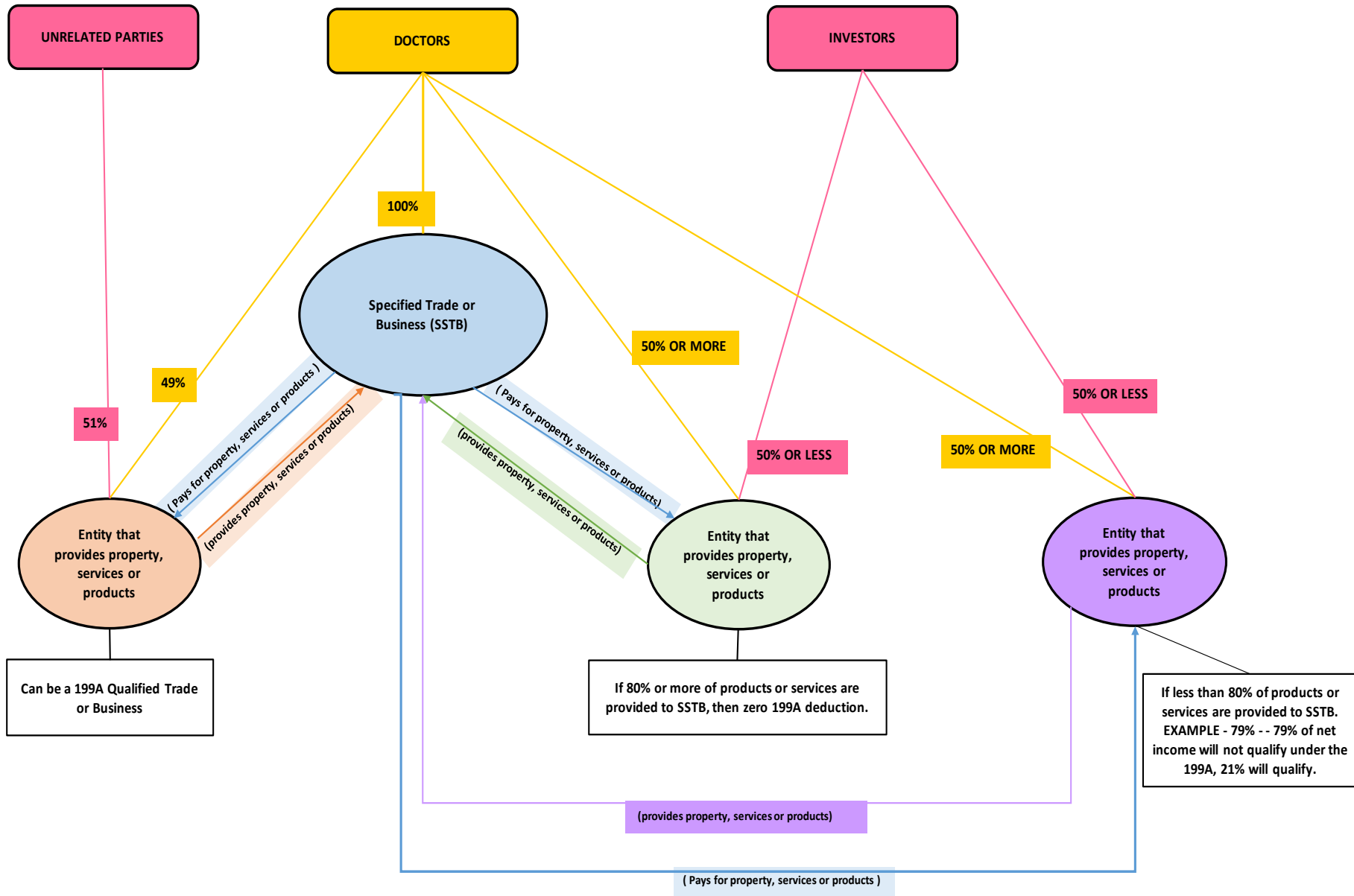


Each of the four 678 Trusts would receive \$150,000 of Section 199A income which will be taxed at 29.6% minus \$1,000.  
 Annual Expected Savings of 7% of \$600,000 = \$42,000 per yr.

Net Income \$1,500,000 (Per Year)



# SERVICE TRADE OR BUSINESS ILLUSTRATION CHART



# SPECIFIED SERVICE BUSINESS TEST

The deduction will not be available for “specified service businesses” if the taxpayer’s taxable income exceeds \$415,000 for MFJ or \$207,500 for single filers, and will be subject to phase outs if income exceeds \$315,000 for MFJ or \$157,000 for single filers.

Specified service businesses include any business where the principal asset is in one of the following:

1. Health
2. Law
3. Accounting
4. Actuarial science
5. Performing arts
6. Reputation or skill of commodities one or more employees
7. Consulting
8. Athletics
9. Financial Services
10. Brokerage Services
11. Investing, trading, or dealing in securities, partnership interest, or

It is noteworthy that the above service businesses are defined by reference to IRC Section 1202(e)(3), except unlike Section 1202(e)(3) there is a specific exclusion for engineers and architects. It is unclear, however, if engineers or architects can be brought back in under Section 6 above.

Section 1202 allows taxpayers to exclude up to 100% of the gain on the sale of qualified stock.

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# SPECIFIED SERVICE BUSINESS TEST

## Specified Service Trade or Business Under Section 199A (which also arise under Section 1202)

- Health
- Law
- Accounting
- Actuarial Science
- Performing Arts
- Consulting
- Athletics
- Financial Services
- Brokerage Services
- Investing Trading, or dealing in securities, commodities etc.
- Principal asset is reputation or skill of one or more employees.

## Businesses Not Limited Under Section 199A, but Limited Under Section 1202

- Engineering
- Architecture
- Any banking, insurance, financing, leasing, investing, or similar business.
- Any farming business (including the business of raising and harvesting trees).
- Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A (i.e. oil, gas, and mining businesses).
- Any business of operating a hotel, motel, restaurant, or similar business.

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Key excerpts from the August 13, 2018  
Article - “Proposed Regulations for 199A –  
The Good, The Bad, the Taxpayer –  
Unfriendly”

by Alan S. Gassman, Martin M. Shenkman, Brandon L.  
Ketron, Christopher J. Denicolo and Kenneth J. Crotty –

Published in the LISI Newsletter #152.

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## **The Regulations are comprised of seven sections, with six dedicated to Section 199A, and one dedicated to Section 643.**

They are as follows:

1. 199A-1 covers calculation rules of Section 199A, as well as definitional guidance on the standard of being engaged in a trade or business, and loss carry-over rules
2. 199A-2 covers the rules regarding the determination of W-2 wages and unadjusted basis immediately after acquisition of Qualified Property
3. 199A-3 provides guidance surrounding the terms and calculations regarding Qualified Business Income, Real Estate Investment Trust dividends, and qualified Publicly Traded Partnership income
4. 199A-4 covers the rules relating to aggregation non-Specified Service Trades or Businesses and Specified Service Trades or Businesses
5. 199A-5 covers definitional guidance of Specified Service Trades or Businesses
6. 199A-6 covers computational guidance for individuals who own or are beneficiaries of Relevant Pass-Through Entities, Publicly Traded Partnerships, trusts and estates
7. 643(f)-1 covers the treatment of multiple trusts, and possible aggregation thereof, when the trusts have significantly the same beneficiaries and the same grantors, namely that the IRS has the power to aggregate them into singular trusts

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## Statutory Authority for Treasury to issue regulations

It is important that practitioners remember that these are only proposed regulations and do not have the force of final regulations unless taxpayers choose to rely on them, and some of these regulations seem to exceed the authority granted by statute to the IRS.

For reference, we have included the subsections and text of the grants of authority on the next slides for viewers.

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Topic:	Code Section:	Specific Language:
<b>Short Taxable Years</b>	§ 199A(b)(5)	“The Secretary shall provide for the application of this subsection in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year.”
<b>Allocation of Items/Wages</b>	§ 199A(f)(4)(A)	“The Secretary shall prescribe such regulations ...for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate”
<b>Tiered Entity Situations</b>	§ 199A(f)(4)(B)	“The Secretary shall prescribe such regulations ...for the application of this section in the case of tiered entities.”
<b>Depreciable Periods / 1031 Exchanges</b>	§ 199A(h)	“The Secretary shall— (1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and (2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.
<b>Agricultural and Horticultural Cooperatives</b>	§ 199A(g)(3)(C) & § 199A(g)(6)	“Secretary shall prescribe rules for the proper allocation of items described in subparagraph (A) for purposes of determining qualified production activities income. Such rules shall provide for the proper allocation of items whether or not such items are directly allocable to domestic production gross receipts” & “The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this subsection, including regulations which prevent more than 1 taxpayer from being allowed a deduction under this subsection with respect to any activity described in paragraph (3)(D)(i). Such regulations shall be based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal)”

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<b>Tiered Entity Situations</b>	<b>§ 199A(f)(4)(B)</b>	<b>“The Secretary shall prescribe such regulations ... for the application of this section in the case of tiered entities.”</b>
<b>Depreciable Periods / 1031 Exchanges</b>	§ 199A(h)	<p>“The Secretary shall—</p> <p>(1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and</p> <p>(2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.</p>
<b>Agricultural and Horticultural Cooperatives</b>	§ 199A(g)(3)(C) & § 199A(g)(6)	<p>“Secretary shall prescribe rules for the proper allocation of items described in subparagraph (A) for purposes of determining qualified production activities income. Such rules shall provide for the proper allocation of items whether or not such items are directly allocable to domestic production gross receipts”</p> <p>&amp;</p> <p>“The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this subsection, including regulations which prevent more than 1 taxpayer from being allowed a deduction under this subsection with respect to any activity described in paragraph (3)(D)(i). Such regulations shall be based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal)”</p>

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**The IRS was given the authority to interpret the statute in a number of ways and to provide legislative regulations in a number of ways. However, time will tell what final binding Regulations may say, and whether many of these proposed provisions will be within the authority of the Treasury Department to issue these Regulations.**

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## **Guidance provided on definitions of specified service trades or businesses.**

The Regulations enumerate the categories of Specified Service Trades or Businesses, which are treated differently because income derived therefrom by high earner taxpayers (over \$157,500 for single filers, and \$315,000 for married filing joint filers) will be limited during the \$100,000 phase-out range (a \$50,000 phase out range applies for single filers) and not qualify for the deduction above that phase-out range. The Regulations give some useful examples of what functions are considered to be under these definitions and what functions are not, and the following chart illustrates all of the points made in the Regulations in this regard. While there are a few points of leniency, overall the tone of the Regulations is to broadly ensnare as much as possible under the Specified Service Trade or Business taint.

It is notable that the Regulations specifically state that banking, real estate brokerage services and liability and casualty insurance agencies are not Specified Service Trades or Businesses. However, investment banking, hedge funds management, lobbying and veterinary medicine are Specified Service Trades or Businesses.

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The following are the types of activities that are considered to be a Specified Service Trade or Business for the purposes of Section 199A:

ACTIVITY CHART		
	Includes	Does Not Include
<b>Health</b>	<p>The provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to the patient.</p>	<p>The provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, 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 research, testing and manufacture and/or sales of pharmaceuticals or medical devices. Payment processing is quite limited and would not appear to facilitate medical practices dividing off significant practice administrative activities as producing non-Specified Service Trade or Business revenue. Practitioners also need to read these very limited exclusions with consideration to the broad aggregation rules which further limit planning.</p>

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<b>Law</b>	The provision of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. Please note that in most states mediators do not need to be licensed lawyers.	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. Excluding delivery services is of no help and demonstrates the broad all-encompassing view the Regulations have taken of Specified Service Trades or Businesses. There is no discussion as to whether trustee and executor and executrix, title insurance and other services that do not require a law license are considered to be legal services.
<b>Accounting</b>	The provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals in their capacity as such.... accounting is not limited to services requiring state licensure as a certified public accountant (CPA)... which includes tax return and bookkeeping services, even though the provision of such services may not require the same education, training, or mastery of accounting principles as a CPA.	Payment processing and billing analysis. The inclusion of bookkeeping services, an activity that does not require the professional training or licensing of a CPA further illustrates the broad Specified Service Trade or Business view of the Regulations.
<b>Actuarial Science</b>	Is based on the ordinary meaning “actuarial science” and provides that the term “performance of services in the field of actuarial science” means the provision of services by actuaries and similar professionals in their capacity as such.	The provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

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<b>Performing Arts</b>	The 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 provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.  Does not include the performance of services that do not require skills unique to the creation of performing arts, such as maintenance and operation of equipment or facilities used in the performing arts.
<b>Consulting</b>	The provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems...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 other than advice and counsel. This determination is made based on all the facts and circumstances of a person's business.  Does not include the performance of services in the field of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is not otherwise an Specified Service Trade or Business (e.g., services provided by a building contractor) if there is no separate payment for the consulting services. This may require some businesses to modify their billing practice and incorporate fees for what would otherwise have been separately stated services into the product price.
<b>Athletics</b>	Is most similar to the field of performing arts.... provides that the term “performance of services in the field of athletics” means the performances 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.	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; the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

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<b>Financial Services</b>	Limits the definition of financial services to services typically performed by financial advisors and investment bankers and provides that the field of financial services includes 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 (including in Title 11 or similar cases), and raising financial capital by underwriting, or acting as the client's agent in the issuance of securities, and similar services... services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals.	Taking deposits or making loans. Please note that interest earned on notes owed by customers or on notes receivable resulting from the financed sale of products to customers will be included in 199A income, but that normal interest income earned on accounts owned by a trade or business will not.  Does not include insurance agents.
<b>Brokerage Services</b>	The performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities for a commission or fee. This includes services provided by stock brokers and other similar professionals.	Does not include services provided by real estate agents and brokers, or insurance agents and brokers
<b>Investment Management</b>	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.

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<b>Trading Services</b>	The performance of services that consist of trading means a trade or business of trading in securities, commodities, or partnership interests. 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.	A taxpayer who engages in hedging transactions as part of their business is not considered to be engaged in the trade or business of trading commodities.
<b>Dealing in Securities</b>	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 in securities with customers in the ordinary course of a trade or business.	A taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities.
<b>Dealing in Commodities</b>	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 in commodities with customers in the ordinary course of a trade or business.	A taxpayer who engages in hedging transactions as part of their business is not considered to be engaged in the trade or business of trading commodities.
<b>Where the Principal Asset of The Trade or Business is the Reputation or Skill of One or More Employees or Owners</b>	SEE DISCUSSION BELOW	

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Activity	Losers	Winners	Waiting to See (still lobbying)
Health	Physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to the patient.	The operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing and manufacture and/or sales of pharmaceuticals or medical devices	Recreational massage parlors
Law	Lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. Please note that in most states mediators do not need to be licensed lawyers.	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.	There is no discussion as to whether trustee and executor and executrix, title insurance and other services that do not require a law license are considered to be legal services.

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Accounting	<p>Accountants, enrolled agents, return preparers, financial auditors, and similar professionals.</p> <p>Tax return and bookkeeping services.</p> <p>Accounting is not limited to services requiring state licensure or the same education as a certified public accountant (CPA).</p>	Payment processing and billing analysis.	
Actuarial Science	<p>Is based on the ordinary meaning “actuarial science” and provides that the term “performance of services in the field of actuarial science” means the provision of services by actuaries and similar professionals in their capacity as such.</p>	<p>The provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.</p>	

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Performing Arts	The performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals.	<p>Broadcasters or individuals that disseminate video or audio of performing arts.</p> <p>Maintenance and operation of equipment or facilities used in the performing arts.</p>	
Consulting	<p>The provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems.</p> <p>Including lobbyists and other similar professionals.</p>	Does not include consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business (e.g., services provided by a building contractor) if there is no separate payment for the consulting services.	

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<p style="text-align: center;">Athletics</p>	<p>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.</p>	<p>Broadcasters or individuals that disseminate video or audio of athletics.</p> <p>Maintenance and operation of equipment or facilities used in athletics.</p>	
<p style="text-align: center;">Financial Services</p>	<p>Limits the definition of financial services to services typically performed by financial advisors and investment bankers and provides that the field of financial services includes 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 (including in Title 11 or similar cases), and raising financial capital by underwriting, or acting as the client's agent in the issuance of securities, and similar services... services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals.</p>	<p>Banks (i.e. taking deposits or making loans).</p> <p>Interest earned on notes owed by customers or on notes receivable resulting from the financed sale of products to customers.</p>	<p style="text-align: center;">Life Insurance Agents and Brokers</p> <p style="text-align: center;">Real Estate Appraisers, Art Appraisers, &amp; Business Appraisers for Gift and Estate Tax Purposes</p>

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<p>Brokerage Services</p>	<p>A person that arranges transactions between a buyer and a seller with respect to securities for a commission or fee.</p> <p>This includes services provided by stock brokers and other similar professionals.</p>	<p>Real estate agents and brokers, Ticket brokers, art brokers, car/boat brokers.</p> <p>Property and Casualty Insurance agents and brokers.</p>	<p>Life Insurance Agents and Brokers</p>
<p>Investment Management</p>	<p>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.</p>	<p>Does not include directly managing real property.</p>	

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Trading Services	A trade or business of trading in securities, commodities, or partnership interests, regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof.	Hedging transactions as part of normal business operations.	
Dealing in Securities	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 in securities with customers in the ordinary course of a trade or business.	A taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities. (i.e. banks)	
Dealing in Commodities	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 in commodities with customers in the ordinary course of a trade or business.	Hedging transactions as part of normal business operations.	

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<p>Where the Principal Asset of the Trade or Business is the Reputation or Skill of One or More Employees of Owners</p>	<p>Any individual that receives the following:</p> <p>(A) Fees or other compensation is received for endorsement of products or services;</p> <p>(B) License or fees are received for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated therewith; or</p> <p>(C) Compensation is received for appearing at an event or on radio, television, or other media.</p> <p>For the purposes of the above, compensation includes ownership in a business entity that is received in lieu of cash.</p>	<p>Any skilled individual or owner that does not receive income from one of the categories on the left.</p> <p>Engineers, architects, chefs, and other skill based services.</p> <p>(i.e. Jimmy Buffet and Margaritaville, Bobby Flay, Wolfgang Puck, Gordon Ramsey, etc.)</p>	
<p>In the Trade or Business of Being an Employee</p>	<p>Individual who was formerly treated as an employee for federal income tax purposes, and who is subsequently characterized as an independent contractor and provides services for the same individual or entity, will be presumed to be "in the trade or business of performing services as an employee."</p>	<p>Individuals that were not former employees.</p>	

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## **Guidance provided on definition of situation “where the principal asset of the trade or business is the reputation or skill of one or more owners” – Not as harsh as initially thought.**

The final category of a Specified Service Trade or Business involves a situation where the principal asset of the trade or business is the reputation or skill of one or more employees or owners. Many advisors were concerned with the potential breadth of this “catch all” provision. This was one of the few leniencies provided for in the Regulations.

Fortunately, under the Regulations, the Treasury choose to narrowly construe this category, and it will not apply unless one of the following exists:

- (A) Fees or other compensation is received for endorsement of products or services;
- (B) License or fees are received for the use of an individual’s image, likeness, name, signature, voice, trademark, or any other symbols associated therewith; or
- (C) Compensation is received for appearing at an event or on radio, television, or other media.

For the purposes of the above, compensation includes ownership in a business entity that is received in lieu of cash.

An example in the Regulations is that a famous chef may own a restaurant, and the income from the restaurant would qualify for the Section 199A deduction, but any income earned as a license fee for the use of his or her name to brand the restaurant or sell cookware would be considered as income from a Specified Service Trade or Business. What if instead of a pure license fee for the use of the chef’s name on the island-themed margarita cookware instead the chef received a share in the profits from the sales of cookware? Would that instead be characterized as non Specified Service Trade or Business income? Consideration should be given to how to structure license arrangements in light of this. It therefore appears that not all of Jimmy Buffet’s Section 199A deduction will get wasted away in Margaritaville.

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## **Small amount of specified service trade or business income will not taint a non-specified service trade or business.**

There is also a *de minimis* exception that applies when income from a Specified Service Trade or Business is less than 10% of gross receipts, if the entity has \$25,000,000 or less of annual receipts or 5% of gross receipts if annual receipts are greater than \$25,000,000.

For example, a consultant could join an engineering firm with less than \$25,000,000 in annual receipts, and qualify non-employment income for the exemption, if the consulting revenue is less than 10% of total revenue. A 5% threshold will apply if the engineering firm has more than \$25,000,000 a year of revenues.

## **Former employees presumed to be in the business of performing services as an employee.**

The Regulations state that an individual who was formerly treated as an employee for federal income tax purposes, and who is subsequently characterized as an independent contractor and provides services for the same individual or entity, will be presumed to continue to be an employee, or to be ineligible for the Section 199A deduction by reason of being “in the trade or business of performing services as an employee.” Thus, employee relationships will be viewed as “sticky” and not easy or safe to change or adapt.

For example where a lawyer employed by Law Firm 1 joins Law Firm 2, which provides services for Law Firm 1 on a contractor arrangement, and uses such lawyer to provide services under the contractor relationship. The lawyer is considered to be an employee of Law Firm 1, so her income from Law Firm 2 is considered to be ineligible to qualify for the Section 199A deduction unless she can prove that she is truly an independent contractor as to Law Firm 1.

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	Common Law Test Factor	Behavioral Control	Financial Control	Relationship of the Parties
1	Compliance with instructions	X		
2	Training	X		
3	Integration	X		
4	Services rendered personally	X		
5	Hiring, supervision, and paying assistants	X		
6	Set hours to work	X		
7	Full time required	X		
8	Doing work on employer's premises	X		X
9	Order or sequence test	X		
10	Oral or written reports	X		
11	Payment by the hour, week, or month		X	
12	Payment of business and/or traveling expenses		X	
13	Furnishing tools and materials		X	
14	Significant investment		X	
15	Realization of profit or loss		X	
16	Making services available to the general public		X	
17	Continuing relationship			X
18	Working for more than one firm at a time			X
19	Right to discharge			X
20	Right to terminate			X

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## **Amount of activity needed for real-estate leasing activities to qualify for Section 199A depends on whether property is rented to a related party or third party.**

The Regulations confirm that real estate leasing activities can qualify for the 20% deduction without regard to whether they are passive in nature, but only if the rental is between “commonly controlled” entities, which is defined as common ownership of 50% or more in each entity. The Regulations apply the Code Section 162 definition of a trade or business for non-commonly controlled rental activities, which can be problematic for passive landlords, lessors of non-real estate personal items, and licensors of intellectual property rights that are not active enough to qualify as a Section 162 trade or business.

The definition of “trade or business” under Section 162 of the Code, and its pre-1954 predecessor Section 23(a) of the Revenue Act of 1928, has been interpreted by court decisions and private letter rulings to require more than just the passive receipt of rent or license income to qualify. The law required a degree of activity or at least legal responsibility or risk, in order for a lease arrangement to be considered as a trade or business. This may come from the responsibility for maintenance, active tenant management or having the taxpayer active in pursuing, entering into, or selling positions in leases so that this is seen as a business of the taxpayer.

On the other hand, the Regulations give an example that seems primarily intended to provide other guidance besides the definition of trade or business where a taxpayer manages and leases vacant property to an airport and is found to qualify as a trade or business, so comments and updating of the Regulations before they become permanent may prove to allow triple net lease landlords with no other activities to qualify for the Section 199A deduction, but to be safe in the long run lease arrangements can be modified now to allow the landlord to be more active.

However, if and when these Regulations take effect, and the rental activity is commonly controlled with a Specified Service Trade or Business, the deduction all together may be disallowed altogether depending on the owners’ taxable income.

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## **Amount of activity needed for real-estate leasing activities to qualify for Section 199A depends on whether property is rented to a related party or third party, *continued***

Divisions and ambiguities in what qualifies as a trade or business is not a new phenomenon. Specifically, the question of whether single rentals can qualify to be a trade or business, including questions of what level of activity is required, will continue to be problems in the near future. A case law example that has been cited in many cases is the 1942 Tax Court decision in *Neill v. Commissioner* in which the court held that the mere collection of rent without other activity does not constitute a trade or business. The court likened the taxpayer's ownership in the property and collection of income therefrom to an individual holding stocks and bonds and earning income. In *Schwarcz v. Commissioner*, the Tax Court held that where a landlord manages and operates apartment buildings, whether individually or through his or her agent, this constitutes a trade or business. In *Elek v. Commissioner* and *Lagreide v. Commissioner*, the Tax Court held that ownership and renting of a single apartment building met the definition of trade or business under Section 23 of the pre-1954 Revenue Acts. The *Elek* Court also provided that having an agent actively manage and maintain rental property had no negative effects on the determination of the activity being a trade or business for the owner.

Additionally, in *Hendrickson v. Commissioner*, the Tax Court held that the passive investment in an oil gas well where the owner purchased part of an oil lease, and then simply collected income from the property, did not constitute a trade or business. The court analogized this to the treatment of rental properties under Section 162.

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## Proposed regulations prevent “crack & pack” planning.

The Regulations provide that entities that are set up to provide management, billing, wholesaling, or other services or products to a Specified Service Trade or Business will be considered to be an extension of that business, so that the special limitations that apply to Specified Service Trades or Businesses will apply to the separate entity as if it were a Specified Service Trade or Business if there is (1) at least 50% common ownership between them (after taking into account the Section 267(b) attribution rules) and (2) the ancillary trade or business provides 80% or more of its property/services to that Specified Service Trade or Business with which it is commonly controlled. These provisions are egregiously unfair to Specified Service Trade or Business and force different results than others not in Specified Service Trades or Businesses with identical real estate, leasing, licensing or similar non-Specified Service Trade or Business ventures. Why should an engineer who owns and operates the building where her business is have a better tax result from the building than her CPA, based upon equivalent facts? The harsh view of expanding the Specified Service Trade or Business definition to completely unrelated functions and activities is common in the Proposed Regulations and may well exceed the authority of the Treasury, with some notable exceptions, as described below.

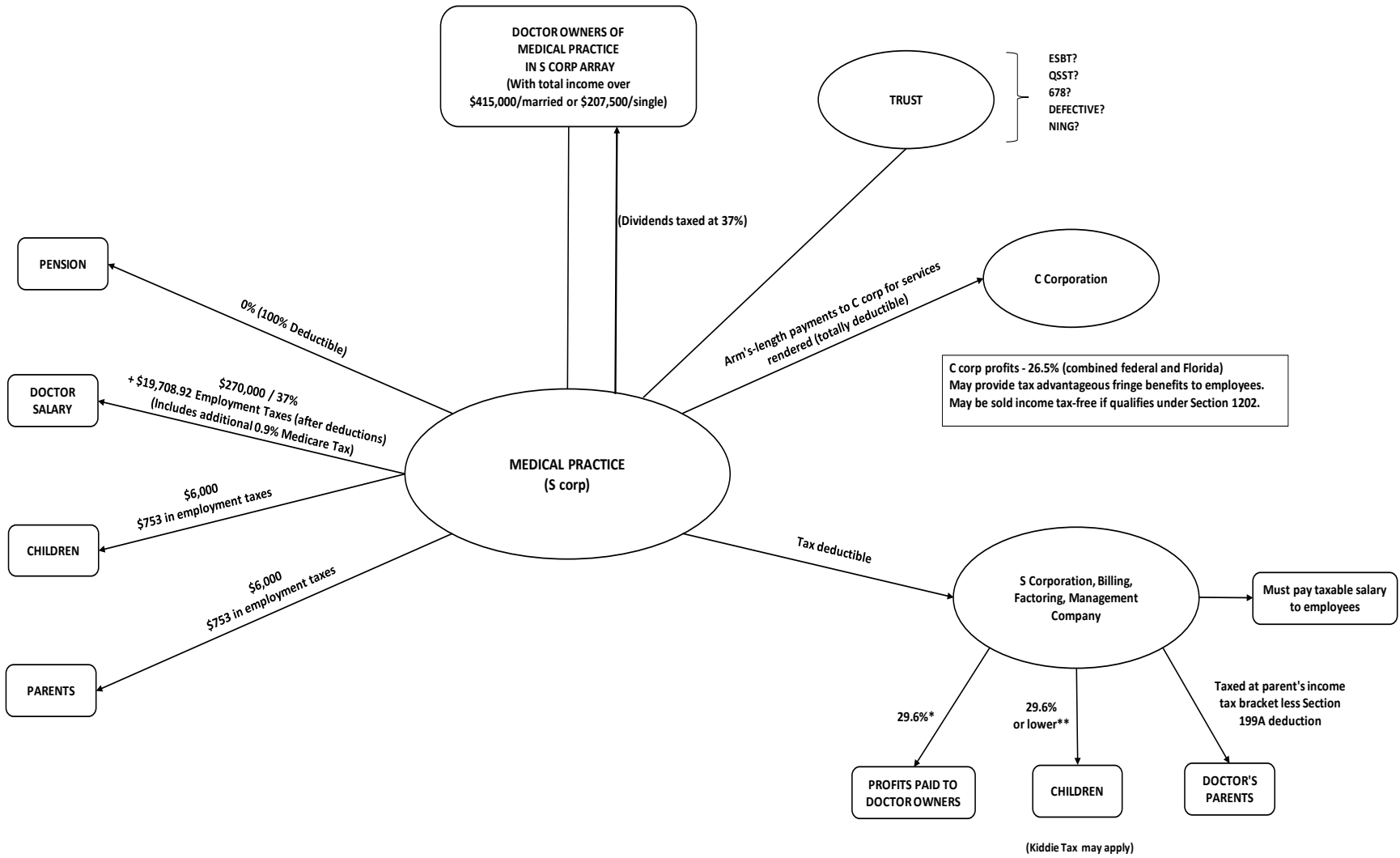
If the ancillary trade or business that is commonly controlled provides less than 80% of its property/services to a Specified Service Trade or Business, then only the portion of the ancillary trade or business that is attributable to the Specified Service Trade or Business will be considered Specified Service Trade or Business income.

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# FLOW THROUGH ENTITY TAXATION OPPORTUNITIES



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\* Assumes that 20% Section 199A Deduction Applies (37% \* 20% = 29.6%)  
 \*\* If Kiddie Tax applies income will be taxed at Trust tax rates and taxed at highest bracket if income exceeds \$12,700



## **ESBTs Qualify for the Section 199A deduction under the Proposed Regulations.**

The Regulations confirm that Electing Small Business Trusts (“ESBTs”), which are certain trusts that are eligible to hold S corporation stock, can qualify for the 199A deduction on S corporation income, even though the ESBT statute was not properly conformed by the 2017 Tax Act to allow this. This result is precisely what Congress stated was its intent so this was an anticipated correction that is hopefully within the power of the Treasury Department, if not confirmed by a statutory change to Section 1361. Remember the *Bobrow* case where a taxpayer followed the IRS Publication on IRA rollovers when rolling over from an IRA and was penalized when the Tax Court found that the taxpayer was not able to rely upon apparently erroneous instructions in the IRS Publication so that Mr. Bobrow had to pay taxes and penalties as a result. This should not be the case with taxpayers who rely upon the Regulations, which specifically state that they can be relied upon by taxpayers until withdrawn or replaced with final Regulations.

David Kirk has indicated that the \$157,500 income threshold may apply separately to S-Corporation income and non S-Corporation income under an ESBT, so that there would be two separate thresholds.

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## ESBTs Qualify for the Section 199A deduction under the Proposed Regulations, *continued*

ESBTs may only taken into account deductions that are specifically listed under Section 641(c)(2)(C). The language of the statute reads as follows:

(C)The only items of income, loss, deduction, or credit to be taken into account are the following:

- (i)The items required to be taken into account under section 1366.
- (ii)Any gain or loss from the disposition of stock in an S corporation.
- (iii)To the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).
- (iv)Any interest expense paid or accrued on indebtedness incurred to acquire stock in an S corporation.

No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

Since Section 199A is not described above, does this preclude the ESBT from taking the Section 199A deduction?

This appears to be an oversight by Congress, which was confirmed by the Proposed Regulations, however many believe that this will likely need to be corrected by amending 641(c) to include Section 199A, and cannot be corrected by Regulations.

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# ELECTING SMALL BUSINESS TRUST (“ESBT”)

A trust may be “disregarded,” “complex,” or a “simple” (pay all income) trust.

Grantor trusts are eligible S corporation shareholders without having to make an ESBT election. The ESBT election is for “belt and suspenders.”

An ESBT may have multiple beneficiaries, and mandatory distributions of income are not required.

If the trust is disregarded because the Grantor is alive and has retained certain rights, then the S corporation income will be taxed to the Grantor at the Grantor’s rates, notwithstanding the ESBT election.

After the death of the Grantor or if the Trust ceases to be a disregarded grantor trust before the death of the Grantor, the income associated with the S portion of the ESBT will be taxed at the highest trust rate of tax. Consider having the Trustee sell the S corporation stock to the beneficiary of the Trust for a note, so that the beneficiary receives the income at lower brackets, and uses the money to repay the note over time. The note could be secured by the stock.

## 199A Proposed Regulations: A First Look

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# ESBT, CONTINUED

If the Grantor is Living:	After the Grantor's Death:
If disregarded (Grantor Trust) - Income is taxed at Grantor's individual income bracket	S-Corporation income taxed a highest bracket
If Complex: <ol style="list-style-type: none"> <li>1. S-Corporation income is taxed at highest income tax bracket</li> <li>2. Other income taxed at beneficiary's bracket if distributed; if not income is taxed at compressed trust brackets</li> </ol>	Other income taxed at beneficiary's bracket if distributed; if not income is taxed at compressed trust brackets

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## ESBT, CONTINUED

The new 2018 tax law allows non-resident aliens to be beneficiaries of ESBTs, and thus indirect owners of S corporations for the first time in tax history.

Under the new 2018 tax law, the charitable deduction associated with the portion of an ESBT holding S corporation stock has also been changed.

ESBTs had been able to deduct charitable contributions up to the Trust's income without a limitation based on the Trust's adjusted gross income. There also had been no carryforward for charitable contributions that were made in excess of the Trust's income.

Under the new law, the charitable contribution deduction for the portion of an ESBT holding S corporation stock is determined based on the rules that apply to individuals. This is an important item to consider if a non-grantor trust will own S corporation stock and will also provide for dispositions to charity.

As a result, the adjusted gross income percentage limitations and the carryforward rules that are applicable to individuals will now apply to the portion of an ESBT holding S corporation stock.

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## The income threshold for trusts and estates is measured at the trust or estate level.

For trusts and trust beneficiaries, it is important to note that the \$157,500 threshold is measured at the trust level without taking into account any distribution deduction for “Distributable Net Income” (DNI) distributed to beneficiaries.

Specifically, subsection 1.199A-6(d)(3)(iii) states that:

For purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of a trust or estate is determined before taking into account any distribution deduction under sections 651 or 661.

For example, if A was to establish a trust that owns a portion of a flow-through entity for the benefit of B, the trust can accept \$157,500 of taxable income without being subject to any limitations of Section 199A. If the trust made a distribution to B of \$50,000 and retained \$157,500 for the taxable year, the trust would be considered to have \$207,500 in taxable income for the year, and would be subject to the wage/Qualified Property limitation of Section 199A.

As a result, the trust in the above example cannot distribute amounts in excess of \$157,500 to one or more trust beneficiaries and take a distribution deduction to remain under the \$157,500 threshold.

If the trust exceeds the \$157,500 threshold, then the trust and trust beneficiaries must each satisfy the wage/Qualified Property test, with wages and Qualified Property being allocated among the trust and the trust beneficiaries in proportion to DNI distributed to the beneficiaries or retained by the trust. For example, if the trust has \$257,500 of income and distributes \$100,000 of income to a trust beneficiary, then the trust exceeds the \$157,500 threshold and wages and qualified property would be allocated 61% ( $\$157,500 / \$257,500$ ) to the trust and 39% ( $\$100,000 / \$257,500$ ) to the beneficiary.

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# TRUST TAX RATES

Ordinary Taxable Income	Ordinary Income Tax Rate	Capital Gain Income	Capital Gain Tax Rate
\$0 – \$2,550	10%	\$0 – \$2,600	0%
\$2,551 – \$9,150	24%	\$2,661 – \$12,700	15%
\$9,151 – \$12,500	35%	\$12,701 +	20%
\$12,501 +	37%		

The 3.8% Net Investment Income Tax begins to apply at the \$12,501+ level.

Kiddie Tax uses trust tax rates for children under age 18 and children aged 19 to 24 if he or she is a full-time student with unearned income over a certain threshold.

Complex Trust taxation - \$3,010.91 on the first \$12,500 of undistributed income and 37% in excess thereof. A 37% taxpayer can save \$1,614 by shifting \$12,500 of income to a Complex Trust.

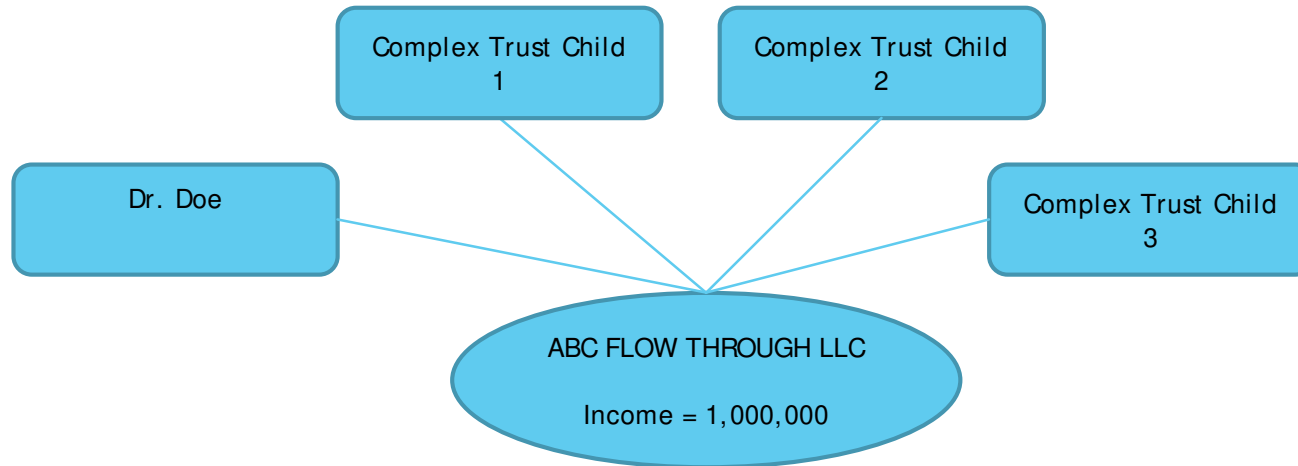
\$100,000 of income would be taxed at a 35.39% average tax rate.

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# Will multiple trusts be respected under section 199A?



Beware of Section 643(f) which reads as follows:

For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

- (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
- (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.

For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

As of the date of the presentation, no final regulations have been passed under Section 643(f), therefore one argument is that this section simply does not apply.

## 199A Proposed Regulations: A First Look

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## Will multiple trusts be respected under section 199A? – *continued*

Many taxpayers will establish trusts for children or others that are separately taxed and can own interests in S corporations and partnerships, and qualify for the deduction under situations where the parents would not qualify because of their income levels or other factors. The Regulations specifically state that “Trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A” under the title “Anti-Abuse Rule for Creation of Multiple Trusts to Avoid Exceeding the Threshold Amount.” This is controversial and appears to exceed the scope of the statute.

Furthermore, the authors are not certain what it means to “not respect” a trust. Does this mean that the IRS will simply ignore the trust? Will they aggregate these trusts, or substitute the beneficiaries or the grantor as the taxpayer, in lieu of the trust itself?

A much grander concern is where the IRS is given the ability to issue such a broad power to itself. The apparent authority for this statement in the Regulations would be the following language under Code Section 199A(f)(4), (“Anti-Abuse Rules”), which is the only subsection of 199A to grant the Secretary authority to issue anti-abuse rules and does not in the opinion of the authors authorize such a discriminatory provision:

If Aretha Franklin knew about these regulations, she might have said “R-E-S-P-E-C-T , what the hell are you going to do to my trust and me?” Aretha Franklin’s hit song “Respect” was recorded in February 14, 1967 in New York’s Atlantic Studios, and the song won Franklin two Grammy awards.

The Secretary shall prescribe such Regulations as are necessary to carry out the purposes of this section, including Regulations:

(a) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and

(b) for the application of this section in the case of tiered entities.

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## Will multiple trusts be respected under section 199A? *continued*

Nowhere under Section 199A is the Secretary given the authority to issue regulations regarding the treatment of trusts, nor is the Secretary given the ability to treat discriminatorily or to “disrespect” (for lack of a better term) within a specific class of taxpayers eligible under the statute.

The more reasonable authority for this power seems to be under Section 643, which provides for the aggregation of multiple trusts if there are not significant non-tax differences between the trusts and the trusts have substantially the same grantors and beneficiaries. The authors believe it is likely that the IRS could be (in a rather disingenuous and deceptive way) stating that trusts established for the primary purpose of qualifying for Section 199A will not be considered to have significant non-tax purposes under Section 643. If this is true, it drastically reduces the threat the Regulations pose to trust planning under Section 199A

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## Regulations issued under section 643(f).

In 1989, Section 643(f) was enacted to provide that Regulations could be issued to allow the IRS to treat two or more trusts as a single trust if they (1) were formed by substantially the same grantor, (2) had substantially the same primary beneficiaries, and (3) were formed for the principal purpose of avoiding income taxes. Regulations were never issued, and some commentators (writing in LISI and elsewhere) pointed out that the IRS could not assert the multiple trust provision of the Code without having Regulations issued. It appears that the Regulations specifically intend to address this point by including provisions under 643(f). However, the Regulations as proposed appear excessive and to exceed the scope of the statute. More particularly, they appear to ignore the requirement of the statute that all three conditions must be met before trusts can be aggregated or ignored.

The Regulations under Section 199A were connected to new Regulations under Section 643, and the Section 643 Regulations state that a principal purpose will be presumed if it results in a significant income tax benefit, unless there are significant non-tax purposes that could not have been achieved without the creation of the separate trust.

What is not clear is how the Regulations will handle trusts established solely for the purpose of qualifying for Section 199A, and this subsection does not give any examples of how this applies. As discussed above, the authors believe the text of subsection 1.199A-6(d)(3)(v), which provides that trusts “formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A. See also Section 1.643(f)-1 of the regulations,” if taken literally would overstep the IRS’s grant of authority.

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## Regulations issued under section 643(f), *continued*

However, the Regulations for Section 643, do give an example for the consolidation of trusts, a condensed version is as follows:

A flow-through business owner decides to set up trusts for family members for the explicit reason of avoiding the wage/Qualified Property limitations of Section 199A, and the owner is not engaged in a Specified Service Trade or Business for the purposes of this example. He establishes three trusts with following beneficiaries: Trust 1 for the owner's sister, B, and the owner's brothers, C and D; Trust 2 the owner's other sister, E, and for C and D; and Trust 3 for E.

The result is that the trusts would be aggregated and treated as a single trust. However, a key fact specified in this example is that the owner would not have created or funded the trusts but for his desire to qualify for the Section 199A deduction.

If the IRS intends to disregard trusts that are formed to take the Section 199A deduction, it seems that the IRS would want to completely invalidate the trusts altogether, as the aggregated trust is still established only for qualifying the owners for the Section 199A deduction, and even when aggregated the trust helps the owner avoid the wage/Qualified Property limitations because it is still lowering the owner's taxable income. This gives credence to the view that the IRS only meant to ignore trusts to the extent of its power under Section 643, or put simply, that establishing a trust for the purposes of Section 199A is not a "significant non-tax purpose" under Section 643.

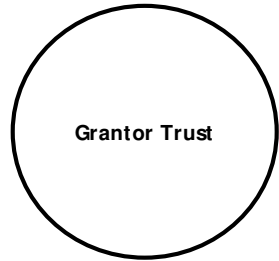
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### 199A Proposed Regulations: A First Look

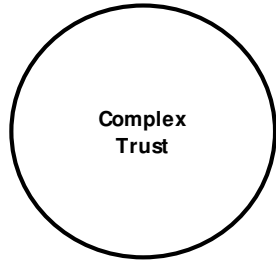
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# BASIC INCOME TAX OPERATION OF EACH TYPE OF TRUST



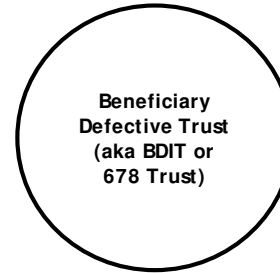
Grantor treated as the owner for federal income tax purposes.



1. Taxed as a separate entity to the extent that income is not distributed
2. "Distributable Net Income" paid out can carry the income to lower bracket taxpayers
3. The trust has an effective tax rate of 24.1% on the first \$12,500 of income and 37% above that.
4. Distributions made within 65 days of the next tax year can be considered to have been made in the previous tax year.
5. Distributions made to charity can carry income to the charity to in effect give a tax deduction without a 60% adjusted gross income limitation or itemized deduction considerations.
6. 3.8% Medicare tax begins to apply at \$12,500+ of AGI.
7. Unlike a C Corporation - No tax upon liquidation of the trust.
8. Can shield Trustee and Beneficiaries from operational liability similar to a corporation depending upon state law.



1. Can be owner of an S-Corporation.
2. Can allow a non-resident alien beneficiary to effectively be a member of an S-Corporation.
3. S-Corporation income taxed at the highest rate bracket, regardless of whether income is distributed to beneficiaries.
4. ESBTs may have multiple beneficiaries, and mandatory distributions of income are not required.
5. Distributions made to charity will be subject to the same rules that apply to individuals.
6. 3.8% Medicare tax begins to apply at \$12,500+ of AGI.



Beneficiary treated as owner for federal income tax purposes.



1. Can be owner of an S-Corporation.
2. Can have only one named beneficiary.
3. Must pay all "fiduciary accounting income" to trust beneficiary each year.
4. All S-Corporation K-1 income taxed to beneficiary of trust.

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# USES OF ESBTS, QSSTS, BDITS, NINGS, AND OTHER COMPLEX TRUSTS

## SALTY SLATS

- Might these clients be able to structure completed gift (unlike the ING trusts), non-grantor (like the ING trusts) trusts to achieve multiple goals use temporary exemptions, access assets, and save SALT?
- Trust may distribute income to the client/settlor's spouse, or accumulate for future distribution to the settlor's spouse, all subject to the required consent of adverse party, and not be characterized as a grantor trust. IRC Sec. 672(a).
- An adverse party is a person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power. This might include trust beneficiaries, such as an adult child (Consideration must be given, of course, to whether an adverse party consenting to the gift would be making a gift.). 2514 default remainder beneficiary is an adverse party. ING strategy provides concepts.

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# USES OF ESBTS, QSSTS, BDITS, NINGS, AND OTHER COMPLEX TRUSTS

## SALTY SLATS – Drafting Tips

- Start with a form for a BDT.
- Trust should intentionally omit the swap power and other powers that might make it grantor as to the settlor.
- Delete the Crummey power included to make the trust grantor as to the beneficiary.
- Add requirement for approval or provide veto to non-adverse party on distributions to spouse.
- Form in trust friendly jurisdiction.

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# NING, DING & SIMILAR THINGS

State income taxes just got 5.27% more expensive for 37% tax bracket high earners.

## Example:

California – 13.3% x 60.4% was a 8.03% incremental cost. Now this is a flat 13.3%.

13.3% - 8.03% is a 5.27% increase!

A Californian with \$100,000 of interest income will therefore pay an additional \$5,720 in taxes (assuming the taxpayer is in the 37% bracket), consisting of \$37,000 in federal taxes and \$13,300 in CA state taxes.

This is an effective tax rate of 50.3%.

A Californian with \$100,000 of qualified dividend and capital gains income would pay an additional \$3,165 in taxes, consisting of \$23,800 in federal taxes and \$13,300 in CA state taxes. This is an effective capital gains rate of 37.1%

A NING or DING or other thing allows avoidance of this extra tax.

The cost of establishing a NING or DING is no longer tax deductible as an itemized deduction.

The NING or DING offers:

- Asset protection
- Can benefit charity to in effect have a 100% charitable deduction under Code Section 642(c) (except as to an ESBT, which is limited to the same charitable deduction thresholds that apply to individuals)
- Can spray income to lower bracket family members

A downside: Not accessible to Grantor without consent of a control committee. Committee members may be sued for breach of fiduciary duty even though they are not fiduciaries – Should the client find adequate comfort in that thought?

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## **Grantor trust treated as owned by the grantor for income tax purposes, and Section 678 trust are treated as owned by the beneficiary for income tax purposes.**

The Regulations provide that trusts which are treated as owned by an individual under the grantor trust rules will cause the grantor or applicable income tax owner of the trust to be considered to be the owner of trade or business interests held by the trust. This means that a grantor could establish a trust considered as owned by a named beneficiary pursuant to Section 678, and the individual beneficiary will be considered to be the owner of the Section 199A interest without application of the anti-abuse rules above that would apply to a non-grantor (“complex”) trust.

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## Consider the “Beneficiary Defective Trust” (678 Trust)

If a beneficiary of a trust is given the power to withdraw all contributions made to the trust, then the beneficiary is treated as the owner of the trust for federal income purposes under IRC Section 678(a)(1).

In the traditional BDT (BDIT) the parent may create a BDT for a wealthy child with a \$5,000 initial gift, so that the child could sell assets to the trust without triggering capital gain because the BDT would be grantor as to the child. A good plan, but how can this be spun for the Act?

Further, if the beneficiary's power lapses or if the beneficiary releases such power, and if the beneficiary otherwise has a grantor trust power (i.e., a power described in IRC Sections 671 through 677), then the beneficiary will nevertheless be treated as the owner of the trust for federal income purposes under IRC Section 678(a)(2).

The beneficiary's withdrawal power can lapse or the beneficiary can release his or her withdrawal power each year to the extent of the greater of \$5,000 or 5% of the value of the trust's assets without the beneficiary being considered to have made a gift to the trust for federal gift tax purposes.

Therefore, the beneficiary's withdrawal power could be expected to lapse or be completely released prior to the beneficiary's death, which would cause the trust assets to not be included in the gross estate of the beneficiary upon his or her death, notwithstanding that the beneficiary is treated as the owner of the trust for federal income tax purposes (and could therefore enter into an installment sale with the trust without recognizing income taxes related to the sale).

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## 678 Trust

**(a)General rule** A [person](#) other than the grantor shall be treated as the owner of any [portion](#) of a trust with respect to which:**(1)**such [person](#) has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

**(2)** such [person](#) has previously partially released or otherwise modified such a power and after the release or [modification](#) retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

**(b)Exception where grantor is taxable** Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the [trust](#) or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

**(c)Obligations of support** Subsection (a) shall not apply to a power which enables such [person](#), in the capacity of [trustee](#) or cotrustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the [taxable year](#), such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

**(d)Effect of renunciation or disclaimer** Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

**(e)Cross reference** For provision under which [beneficiary](#) of trust is treated as owner of the portion of the trust which consists of stock in an S corporation, see section 1361(d).



## 678 TRUST EXAMPLE

Father places \$100,000 of S corp stock into a Trust.

Son has 60 days to withdraw all of the contribution, and the Trust is then held for son's health, education and maintenance in an Asset Protection Trust ("APT") jurisdiction.

Trust income will be taxed to son, and the son will be considered to be the owner of the trust for federal estate tax purposes on the son's death.

Son may later release/disclaim all rights, assuming that this is not prevented by a spendthrift clause, but will still be considered to be the owner of the Trust for income tax purposes during his lifetime.

### **199A Proposed Regulations: A First Look**

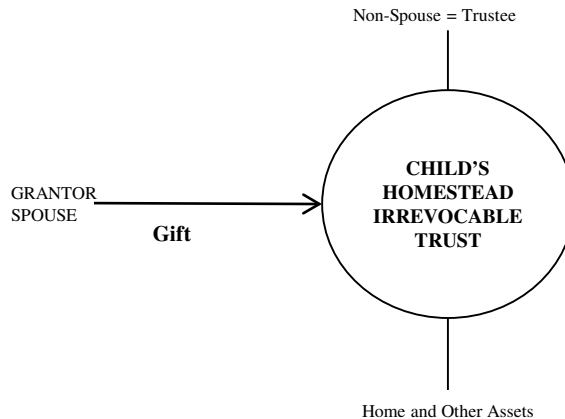
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# CHILD'S 678 HOMESTEAD IRREVOCABLE TRUST

A trust that can own a home used by a child to benefit the spouse and descendants;

- can qualify for the State Homestead Exemption and 3% cap
- can be considered as owned by the Child for income tax purposes to qualify for the \$250,000 income tax exemption on sale
- can be controlled by the Trustee and used for the benefit of various family members
- will insulate family members from liabilities associated with ownership of the home



Trust assets can be applied for the health, education, maintenance and support of the spouse and children.

One or more children may reside in the house to qualify for the Florida Tax Homestead Exemption.

For income tax purposes, the Trust can be considered as owned by the child who lives in the house so that the house can be sold income tax free to the extent of up to \$250,000 in appreciation.

The Trust will not be subject to creditor claims of any family member unless (1) the transfer to the Trust by the Grantor Spouse is a "fraudulent transfer," or (2) the child has a right to withdraw more than the gift tax exclusion amount in any calendar year.

NOTE – The Trust must be appropriately drafted, funded, and administered to achieve the above results.

## 199A Proposed Regulations: A First Look

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# 642(c) Trust Charitable Deduction

In order to receive a charitable deduction, the following requirements of Section 642(c) must be met:

1. The distribution must be made from gross income
2. The distribution must be made pursuant to the terms of the governing instrument.

If the above requirements are met, the trust is entitled to a charitable deduction without being subject to the percentage of gross income limitations that apply to individuals.

As a result, charitably inclined individuals may want to consider making charitable contributions from pre-existing complex trusts (if the terms of the trust allows for this) or complex trusts that are created to plan for Section 199A so that the deduction is not limited and/or possibly lost as a result of the taxpayer no longer itemizing deductions.

Planners should also consider specifically including in trust instruments that the trustee is authorized to make distributions to one or more charitable organizations so that this option is available.

As discussed in Slide 50, the charitable deduction for ESBTs is determined under the rules applicable to individual taxpayers (Section 170) and not under the rules of Section 642(c).

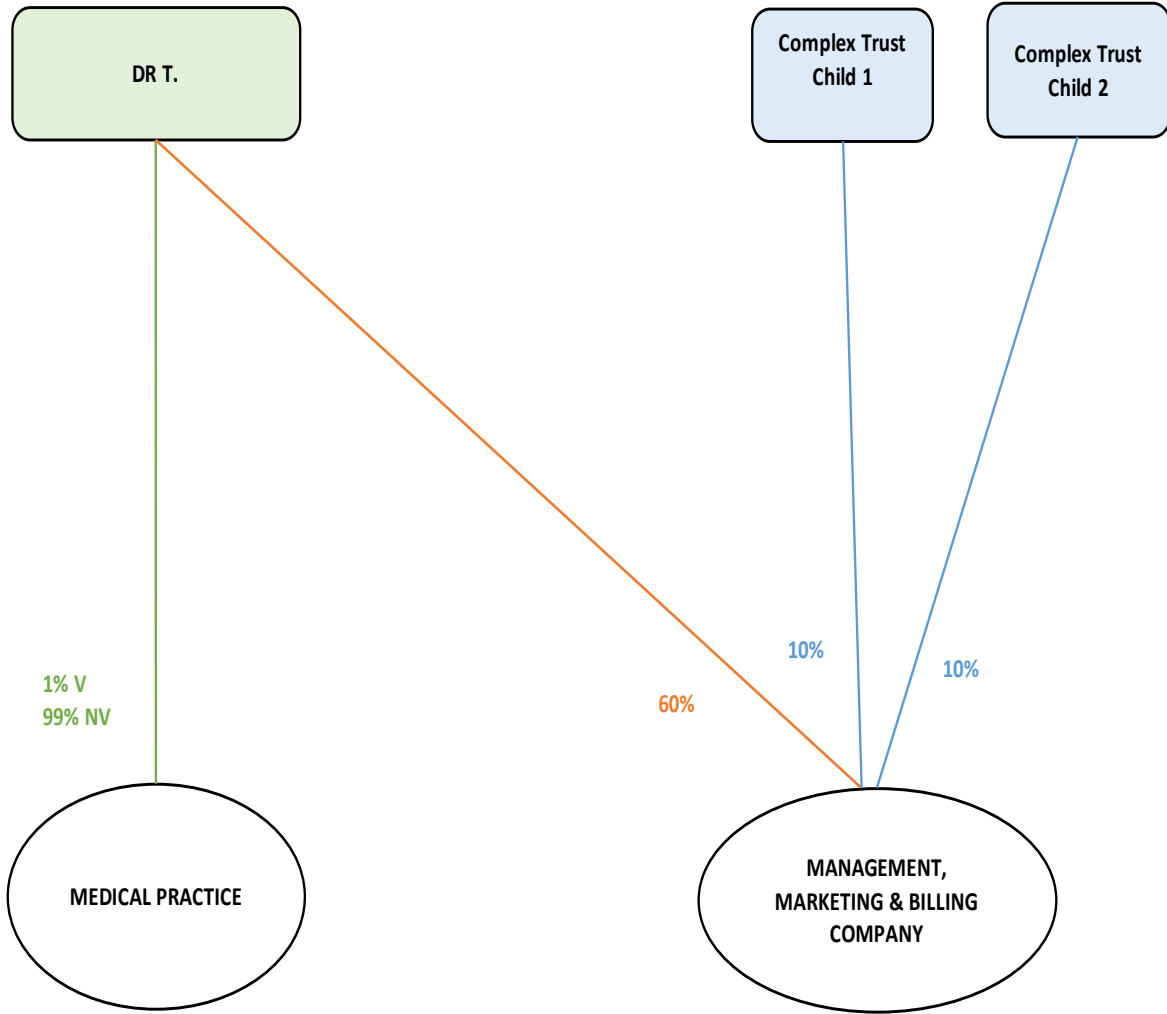
See also Larry Katzenstein's LISI Charitable Planning Newsletter #275 (February 13, 2018) which discusses the recent 10<sup>th</sup> Circuit opinion of *Green v. U.S.* which held that unrealized gain on appreciated trust property is not considered gross income and the charitable deduction was limited to the trust's basis in the property to the extent that such property was purchased from the gross income of the trust.

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# Consider Giving Trust Protectors Ability to Convert Complex Trusts into 678 Trusts



Trust Protector could have power to convert Complex Trust into 678 Trust by giving beneficiary the power to withdraw assets and one other Grantor Trust Power such as the power to substitute assets of equal value.

Net Income \$1,500,000 (Per Year)

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## **Wages paid by employee leasing, PEOs and common paymasters will account for new wage and qualified property test.**

The Regulations state that wages paid to “common law employees and officers” of a trade or business will be treated as having come from the actual employer, notwithstanding whether the payment is made by an employee leasing or other organization, including certified professional employer organizations under Section 7705, statutory employers under Section 1401(d)(1), and agents under Section 3504. This would include common paymaster and employee leasing scenarios.

The Regulations further specify that wages can be considered as paid as long as they are timely recorded in an appropriate manner within sixty days after the end of the applicable calendar year in which they are paid, with a possible extension of an additional sixty days when needed to correct wage reporting returns.

The Regulations make clear that wages are to be allocated to the trade or business that actually employed the individual, as opposed to being considered as paid by an affiliated company that might be acting as a common paymaster but did not actually use the employee in that business.

## **The vast majority of advisors are not aware that Section 199A allows certain pension plan contributions, health insurance costs, and other items of compensation to be included in the calculation of wages.**

The IRS released IRS Notice 2018-64 that contains a proposed revenue procedure that provides further guidance on the calculation of W-2 wages for purposes of Section 199A.

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Which employees, below, can be paid W-2 wages by the business structures listed on the right?	Sole Proprietorship	Partnership	S Corporation
Owners/employees with ownership interest	No	No	Yes
Non-owner employees	Yes	Yes	Yes
Spouses (with no ownership interest)	Yes	Yes	Yes
Independent contractors	No	No	No

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<u>Income:</u>	<u>Employed</u>			<u>Independent Contractor</u>
	<u>Employer (Deductible)</u>	<u>Employee</u>	<u>Combined</u>	<u>Self Employed*</u>
\$100,000	(63% x 7.65%) = 4.82% <b>Cumulative Cost:</b> <b>\$4,820</b>	7.65% <b>Cumulative Cost:</b> <b>\$7,650</b>	12.47% <b>Cumulative Total:</b> <b>\$12,470</b>	12.47% <b>Cumulative Total:</b> <b>\$12,470</b>
\$128,400	(63% x 7.65%) = 4.82% <b>Cumulative Cost:</b> <b>\$6,189</b>	7.65% <b>Cumulative Cost:</b> <b>\$9,823</b>	12.47% <b>Cumulative Total:</b> <b>\$16,012</b>	12.47% <b>Cumulative Total:</b> <b>\$16,012</b>
\$200,000	(63% x 1.45%) = 0.914% <b>Cumulative Cost:</b> <b>\$6,843</b>	1.45% <b>Cumulative Cost:</b> <b>\$10,861</b>	2.34% <b>Cumulative Total:</b> <b>\$17,684</b>	2.34% <b>Cumulative Total:</b> <b>\$17,684</b>
\$250,000	(63% x 1.45%) = 0.914% <b>Cumulative Cost:</b> <b>\$7,300</b>	1.45% <b>Cumulative Cost:</b> <b>\$11,586</b>	2.34% <b>Cumulative Total:</b> <b>\$18,856</b>	2.34% <b>Cumulative Total:</b> <b>\$18,856</b>

\*Self-employed taxpayers act as employer and employee, and can deduct one-half of their employment tax against their income tax.

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**The Regulations further provide that wages will be tracked separately for any short years that result from the change of ownership of a trade or business by tracking the actual wages paid in each portion of the year, as opposed to prorating them.**

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## **Anti-abuse rule related to purchase of qualified property within 60 days of the end of the taxable year.**

The Regulations also disallow including Qualified Property under the 2.5% test if it is purchased within 60 days of the end of the taxable year and disposed of within 120 days, if the trade or business does not use the property for at least 45 days prior to disposition, unless the principal purpose of the acquisition and disposition was for other than increasing the Section 199A deduction.

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## **Treatments of improvements of qualified property under section 199A.**

Improvements to Qualified Property are treated as a separate Qualified Property, with its own basis. Therefore, if a taxpayer buys a new air-conditioning system for a building in year 1, it would constitute Qualified Property through year 10, and then if the taxpayer adds additional components to the system in year 3, the cost of the additional components can be considered as Qualified Property until year 13. The recordkeeping impositions of the new Regulations and other rules under the statute, will be quite difficult and costly for many taxpayers.

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Type of Property	Depreciable Period	Depreciable Period For 199A Purposes
Non-residential Real Property (post-1986)	39 Years	39 Years
Office Furniture (Desks, files, safes, etc.)	7 Years	10 Years
Automobiles and Taxis	5 Years	10 Years
Light General Purpose Trucks	5 Years	10 Years
Information Systems (Computers, card readers, printers, etc.)	5 Years	10 Years

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## **Basis of qualified property contributed to an S corporation equals depreciated value of the property on the date of the transfer to the S corporation.**

It is surprising that the Regulations provide that Qualified Property that is contributed tax-free to an S corporation will have its basis for the 2.5% calculation based upon the depreciated basis of the property on the date of the transfer to the S corporation, instead of original cost. This will punish taxpayers who wish to convert their Schedule E or C trades or businesses into S corporations.

Inconsistently, the Regulations require that the depreciation and ten year time limit will still be based upon when the property was originally acquired and placed in service by the contributing shareholder.

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## Regulations address Qualified Property acquired in like kind exchange.

The Regulations provide that property that has been received in a like kind tax-free exchange will be considered as acquired when the property that it is replacing was acquired, and will be considered to have the basis of the property that it is replacing. Advisors familiar with the Section 1031 like kind exchange rules know that it was cut back to apply only to real estate and buildings and other fixed improvements thereto, and that the older property traded away is called the “relinquished property”, and that the new property acquired is called the “replacement property”. The holding period and basis of the relinquished property is what applies under Section 199A when applying this to the 2.5% Qualified Property hurdle. If the replacement property has excess basis (that is basis in excess of the cost of the relinquished property), then such excess is treated as placed in service when the replacement property is acquired.

Taxpayers that have previously made elections under Code Section 168(f)(1) to exclude property from standard depreciation methods (depreciation based upon MACRS tables) and use an alternative method, such as depreciation based upon units of production, can make a new election under Treas. Reg. 1.168(i)-6(i)(1) to bring the replacement property back under standard deprecation methods (MACRS) in a like kind exchange, in which event the basis in the replacement property would be treated as placed in service in the year the replacement property is acquired.

It is noteworthy that non-recognition provisions under Section 1031 are mandatory, and taxpayers do not have the option to elect out of Section 1031 to treat the transaction as a sale and purchase of replacement property in order to obtain a new stepped up basis in the replacement property. However, nothing prevents a taxpayer from structuring a transaction so that the exchange will not qualify as a Section 1031 exchange by exchanging non-like kind property or not meeting the applicable timing requirements. Although the failure to meet the like kind requirements will cause any gain on the transaction to be recognized, the replacement property will have a basis equal to the purchase price and a new holding period will apply for purposes of the Section 199A Qualified Property calculation. This may also be beneficial in situations where the taxpayer has an expiring loss carryforward that could be used to offset the gain on the exchange and result in a new basis for the replacement property.

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## Application of step up in basis upon death under section 199A.

If property is inherited and immediately placed in service by the heir, the basis in the property will generally be its fair market value at the time of the decedent's death, but the Regulations do not mention whether this resets the property's depreciation period for the purposes of Section 199A. This applies even if there is personal or other use of the property, not directly related to the applicable trade or business.

Property owned by a partnership will not receive a step-up in basis upon the death of a partner or sale of a partnership interest, as the Regulations state that basis adjustments under Sections 734(b) and 743(b) (when a 754 election is in effect for the partnership) will not be taken into account in determining the entity's unadjusted basis Qualified Property. Although further analysis is necessary, at first blush it appears that if a partnership owning appreciated property is liquidated prior to the death of a partner or the sale of a partnership interest, then the property may benefit from a full basis step-up upon the partner's death or the sale of the partnership interest, which would not occur if the property were still held in the partnership, even if a 754 election was in place. Because many taxpayers will not benefit from discounts these entities afford for estate tax purposes while exemptions are high, it may be advantageous to liquidate entities before a partner's death or before the sale of a partnership interest in some instances.

This could allow for various planning techniques where the partnership distributes the property to its partners before the death of a partner or a combined sale of the partnership interest and the appreciated property. Some practitioners have indicated that the partnership should hold the property until after the death of a partner or sale of the partnership interest, and distribute the property immediately thereafter. This apparently would allow the appreciated property to receive a basis increase due to Section 1014 and the Section 754 election, and the heir can place the property back into the partnership with an increased basis for the purposes of Section 199A. It is unclear whether the step-up in basis from Section 1014 is accompanied by a new depreciable period under the statute.

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## **Allocation of wages and qualified property among multiple trades or businesses.**

When an entity conducts multiple trades or businesses, as determined under Code Section 162, wages and Qualified Property must be allocated among the trades or businesses using reasonable allocation methods, which include gross income or direct tracing methods. While there appears to be some flexibility in these rules there does not appear to be an offset for the harsh treatment intended for Specified Service Trades or Businesses. The Regulations provide that taxpayers may make an election to aggregate businesses, which is discussed in more detail below, and provides details on the netting of losses and profits on various businesses.

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## **Election to aggregate multiple trades and businesses for purposes of wage and qualified property testing under section 199A.**

The Regulations do not use the Section 469 passive loss rules for grouping trades or businesses, but instead the Regulations explain that Section 469 dealt with the level of taxpayer involvement in a particular endeavor and that this not the paradigm under 199A. The Regulations also explain that the substantial existing body of law under Section 162 is what was used instead as the reference. Further, the Regulations create a new method of aggregation of trades or businesses so that taxpayers can combine multiple trades or businesses for the purposes of applying the wage and Qualified Property limitations and maximizing the deduction. In order to be aggregated, the businesses must meet the following requirements:

- a. The same person or group of persons directly or indirectly own 50% or more of each trade or business; (although minority owners may aggregate if 50% or more test is met by other owners – Each owner makes separate decision on what to aggregate)
- b. For purposes of determining ownership under this subsection, ownership by spouses, as well as children, grandchildren, and parents, can be attributed to each other;
- c. The ownership existed for a majority of the tax year;
- d. The items must be reported on returns within the same taxable year;
- e. None of the businesses must be a Specified Service Trade or Business; and

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## Election to aggregate multiple trades and businesses for purposes of wage and qualified property testing under section 199A, *continued*

- f. The aggregated trades or business must also satisfy at least two of the following factors:
- i. The trade or businesses provide products or services that are the same or customarily offered together;
  - ii. The trade or businesses share facilities or significant centralized business elements such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and
  - iii. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chains interdependencies).

A series of fourteen well-written examples beginning at Section 1.199A-4(d) demonstrate that a taxpayer owning less than 50% of multiple entities when another taxpayer owns more than 50% of each entity, and elects to aggregate the minority interests therein, if the other rules are satisfied.

Aggregation will allow wages and Qualified Property to be considered as paid for all of the entities, so that the deduction can be taken for an entity that has little or no wages or Qualified Property if another entity has sufficient wages and Qualified Property for both its own income and the income of affiliates. The examples point out that losses from an entity that could be aggregated must be netted against the aggregate profits of other applicable entities, if any aggregation occurs.

One example indicates that ownership of a sailboat racing team and a marina by separate companies would not be aggregated, but that ownership of a trucking company that delivers lumber and other supplies in one company, operation of a lumber yard in another company, and operation of a construction business that presumably uses lumber and other supplies, can be aggregated.

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## **Election to aggregate multiple trades and businesses for purposes of wage and qualified property testing under section 199A, *continued***

Once a taxpayer chooses to aggregate two or more trades or businesses, they must be consistently reported and aggregated for all subsequent taxable years, unless there is a change in facts and circumstance so that a taxpayer's prior aggregation no longer qualifies for aggregation. The implications of all of this to professional advisers can be daunting. In some instances, modeling the various options may be the only way to determine what the actual impact of various decisions might be. Practitioners should be cautious about providing conclusions to clients with specificity without the opportunity to perform the appropriate analysis. The costs of the level of detailed analysis that might be necessary in many instances will be a concern for many clients. It will be easy to make mistakes in advising on this law, which raises the stakes by lowering the substantial understatement threshold to 5% of the tax required to be reported for the year (essentially what the IRS says you should have paid), in lieu of the normal 10% threshold that applies. There is no explanation as to why taking a Section 199A deduction would cause this unfair tripwire standard that will apply to many innocent taxpayers who may not even know that they are eligible for the deduction and may not even claim the deduction or reduce tax liability as the result of it.

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## **Decrease of substantial understatement – penalty threshold if Section 199A deduction is taken.**

If the Section 199A deduction is taken, then the threshold for substantial understatement of tax is reduced from 10% to 5%. Many people incorrectly believe that tax penalties are only exacted on those who show bad intent or negligence, but this is not the case. There are eight enumerated ways for the IRS to impose accuracy-related penalties, and while negligence is one of these reasons, the IRS only needs to demonstrate that the taxpayer substantially underpaid their taxes in order to impose a sanction on the taxpayer under Section 6662 which provides an additional tax of 20% of the underpayment. There is a reasonable cause exception where no penalty will apply if the taxpayer can show there was reasonable cause for the understatement and that the taxpayer acted in good faith.

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## **Reasonable compensation not expanded beyond its traditional concept.**

The Regulations state that the term “reasonable compensation,” which is not includable in Qualified Business Income under Section 199A, refers to the traditional concept that applies to S corporations paying their employee/owners a wage. In other words, profits or K-1 income from partnerships and disregarded entities could not be re-characterized as money earned for personal services rendered, and thus are not eligible for the 199A deduction.

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## **The Regulations provide that losses that were built up through December 31, 2017 will not reduce Qualified Business Income.**

Almost uniformly, the Regulations provide that S corporations, trusts, estates and partnerships that are not on a calendar year basis for 2017 and 2018 will be considered to have all items of income and deduction occur for Section 199A calculation purposes for the period ending in 2018. The Regulations appear to contemplate that the income and deductions that such entities will have for the fiscal year beginning in 2018 will be counted in 2019 when the subsequent fiscal year ends, but this is not specifically mentioned so it is not clear what becomes of income and deductions for fiscal years that begin in 2018 and will end in 2019.

Where Internal Revenue Code provisions block and delay the recognition of losses, such as under the passive loss rules under Section 469, and the S corporation rules that limit losses to the basis of stock, the losses that are released after 2017 will only reduce qualified business income to the extent accumulated after 2017.

Net operating losses that are unrelated to a given trade or business will not cause a reduction in the Section 199A deduction for unrelated trades or business, but this does not apply to net operating losses attributable to a relevant trade or business that are disallowed under IRC Section 461(1).

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# CONCLUSION:

## **Don't panic, these are only proposed regulations.**

Conscientious advisors will need to carefully study the Regulations and analysis thereof, in order to best advise clients on how to proceed with their planning. It is quite probable that significant aspects of these Regulations will not be finalized, given possible lack of authority and political and fairness issues that are sure to be loudly voiced by many interest groups.

Most importantly of all, remember that these Regulations are only proposed, and do not have the force of law, and therefore may not necessarily reflect what the IRS's position will be if and when final Regulations are ever promulgated. There will be inevitable errors made by those of us who draw conclusions about the Regulations early in the process. Concerned tax advisors and practitioners should send comments to the IRS during the public commenting period.

The Regulations provide that a public hearing is scheduled to discuss the Regulations on October 16, 2018 at 10:00 a.m., and comments may be sent to Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044, or hand delivered at the Courier's Desk of the Internal Revenue Service Offices at 1111 Constitution Avenue NW, Washington, D.C. 20224, or via the federal eRulemaking which can be found here.

We welcome questions, comments and suggestions with respect to this big job of applying the law to the situations of taxpayers to make the best of a complicated but fascinating law that advisors can use to help their clients save significant taxes.

The Regulations mention that an estimated 10,000,000 taxpayers will be impacted by this tax provision, and that over 25 million hours will be spent complying with this one code provision. Let's make sure that the tax savings will be maximized to make all of this worthwhile!

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199A

**PROPOSED REGULATIONS:  
A FIRST LOOK**

Tuesday, August 28, 2018

3:00 p.m. EST

Presented by:

**Thank you!**



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