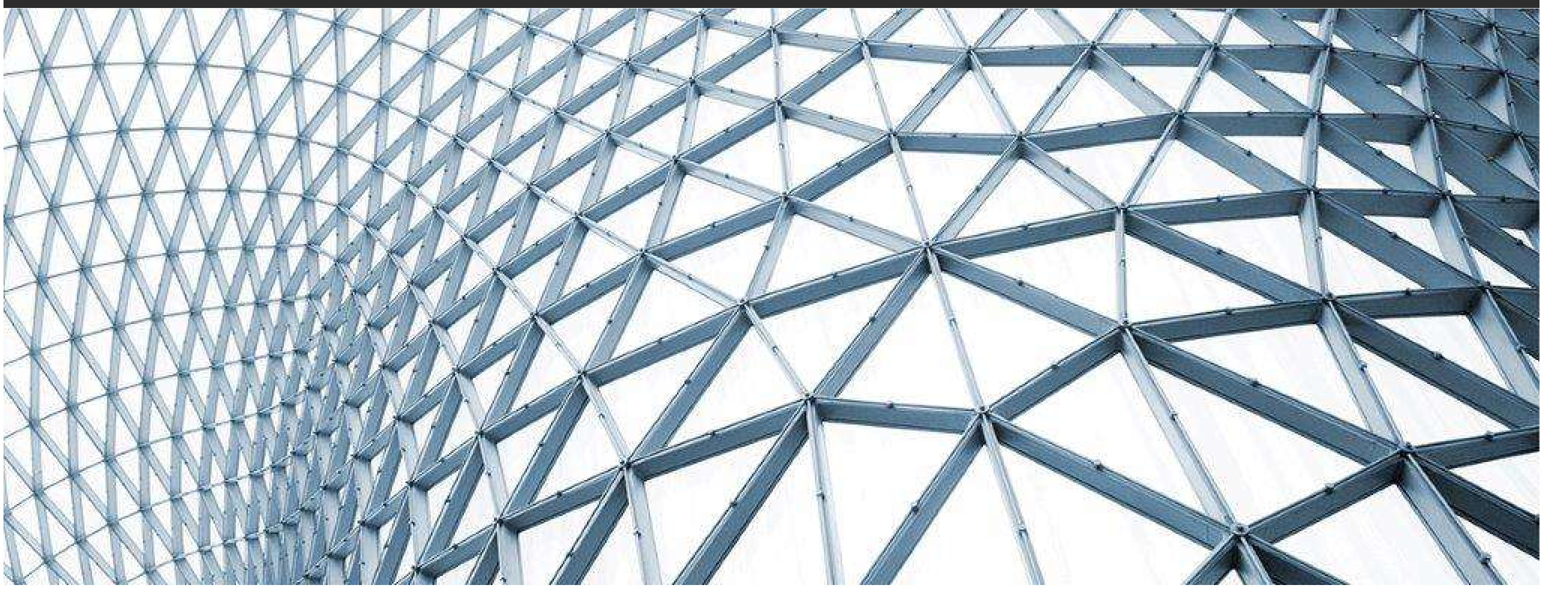
Rules Clarifying Small Business Tax Break – the Good, the Bad and the Unanswered



One of the most talked about components of the Tax Cuts and Jobs Act passed by Congress last year is a 20 percent deduction for operating profits earned by certain sole proprietors and pass-through entities (LLCs, partnerships, S corporations and REITs).

By Marvin Kirsner | October 2, 2018 | Daily Business Review

One of the most talked about components of the Tax Cuts and Jobs Act passed by Congress last year is a 20-percent deduction for operating profits earned by certain sole proprietors and pass-through entities (LLCs, partnerships, S corporations and REITs). This new provision of the tax code, which sets these limitations out in Code Section 199A, is very complex and has numerous limitations. As a result, many professional types of businesses (referred to in this article as "specified services trade or business" or SSTB) will not be able to get the benefit of the 20-percent deduction. Also, for business owners with total income over a certain threshold— $157,500 for a single filer or $315,000 for a married couple filing jointly—the deduction is limited or not allowed at all depending on certain factors, including the type of business and whether the business pays enough in payroll or has adequate depreciable property. Code Section 199A, as enacted by Congress, left many unanswered questions for the Treasury Department to resolve through regulations. The initial round of proposed regulations was published on Aug. 8, 2018. As discussed below, there are both favorable and unfavorable provisions for taxpayers, but the current draft of the proposed regulations don't answer all of the issues raised by the statute.

First, the good news.

Skill and reputation of an Individual: The law says that the 20-percent deduction is not available to a business if its principal asset is the reputation or skill of an employee or owner. This raises the question of how broadly this limitation would be applied. For example, would a restaurant operated by a well-known chef or an architecture firm with a renowned architect be eligible for this tax break? The proposed regulations take a taxpayer friendly view of this "reputation or skill" limitation, stating that the limitation would apply only in cases where the employee or owner with the reputation or skill is paid compensation to endorse a product or service or is paid a royalty for use of her image or likeness.

Employee leasing: One important limitation on using this break is that a business must pay a certain amount of W-2 wages (and/or own depreciable assets) in order to get the full benefit of the 20-percent deduction. This raised the question of whether a business that leases its employees through an employee leasing company will be treated as paying W-2 wages itself in order to satisfy this requirement. The proposed regulations say that amounts paid to an employee through an arrangement with an employee leasing company which is a certified professional employer organization will be treated as W-2 wages paid by the business. Consequently, there would be no difference to a business between paying W-2 wages directly to its employees, or using a certified professional employer organization (an employee leasing company which passes certain requirements and posts a bond to secure payment of payroll taxes withheld from employees) to provide employees and administer payroll functions, a major relief to businesses who use certified professional employer organizations for their human resources. needs.

Narrow definition of financial services business: The statute provides that a financial service business is not eligible for the benefit of the 20-percent deduction. However, the proposed regulations define "financial services" narrowly, limiting financial services to managing wealth, advising clients with respect to finances, developing retirement plans, investment banking services, and valuation services. The commentary to the regulations says that this restriction applies primarily to securities brokers, and that insurance brokers and real estate brokers are not providing a financial service, allowing this tax benefit for insurance businesses and realtors (although real estate brokers might have difficulty satisfying the W-2 wage requirement because real estate agents are statutorily classified as independent contractors—not employees—under the tax code, so payments to a real estate agent would not satisfy the W-2 requirement). Furthermore, the commentary states that a bank is not a financial services business, a big win for community banks which are structured as subchapter S corporations.

Now the bad news.

Tax advisers had hoped that a SSTB might be able to spin off nonservice business components of its business into a separate entity, where the SSTB would be eligible for the tax deduction. For example, a law firm might spin off its administrative services such as billing and information technology into a related entity, and charge the law firm company a fee for these services, with the idea of shifting income from the law business (a SSTB not eligible for the 20-percent deduction) to the administrative services company (which would not be a SSTB). Unfortunately, the regulations say that if a business provides services to a SSTB, and both are 50 percent commonly owned, then the income from the service business would be treated as income from a SSTB, thereby eliminating the hoped-for tax benefit from splitting up the business.

Furthermore, if a SSTB has a separate line of businesses which would otherwise qualify for the 20-percent deduction, the separate line must account for more than 5 percent of the total revenue in order to be treated as a separate business eligible for this tax break. For example, if a dermatology practice sells a line of skin care products, the revenue from the sale of the skin products line must be more than 5 percent of the total revenue of the business in order to be treated as a separate business eligible for this tax benefit.

Finally, the proposed regulations do not address an important issue for real estate and equipment leasing businesses, as follows: In order to be eligible for the 20-percent deduction, the underlying activity must be a "trade or business." So the question is, do real estate and equipment leasing businesses that lease their properties on a triple-net basis constitute a "trade or business" for which the 20-percent deduction is available? There is some authority in situations involving net leased properties owned by foreign taxpayers that suggest that such activities are investments, and not trades or businesses. However, the regulations do not address this question. Hopefully, additional guidance will be published to give clarity regarding this open issue.

These proposed regulations are subject to additional changes.

About the Author:

Marvin Kirsner *is a shareholder in the Boca Raton office of Greenberg Traurig, where his practice focus includes internet tax and electronic commerce tax issues, multistate tax issues and federal, state and local tax controversies. The contributor wants to make known this article is presented for informational purposes only and it is not intended to be construed or used as general legal advice nor as a solicitation of any type.*

Marvin Kirsner
kirsnerm@gtlaw.com