BRACEWELL

INSIGHTS

Proposed Regulations on the 20% Deduction for Qualified Business Income Provide Helpful Guidance for the Energy Industry

September 18, 2018

*By: **Elizabeth L. McGinley***

On August 8, 2018, the IRS and Treasury Department released proposed regulations (the Proposed Regulations) providing guidance on the deduction equal to 20% of an individual's qualified business income (QBI). As discussed ***here*** in greater detail, pursuant to Section 199A of the Internal Revenue Code (the Code), which was enacted by the Tax Cuts and Jobs Act (TCJA), QBI generally is domestic business income earned by individuals, either directly or indirectly through pass-through entities, including partnerships and entities treated as partnerships for federal income tax purposes, such as LLCs, and S-corporations. The QBI deduction, coupled with the reduction in the maximum individual federal income tax rate from 39.6% to 37%[1], represents a substantial reduction in the effective federal income tax rate applicable to an individual's non-corporate business income.

The purpose of the Proposed Regulations is to provide taxpayers with computational, definitional and anti-avoidance guidance regarding the QBI deduction. The Proposed Regulations provide helpful, practical guidance on a number of important topics with respect to which taxpayers and practitioners have sought clarification, including certain aspects of the QBI calculation and certain limitations on taxpayers' ability to claim the QBI deduction. The Proposed Regulations are subject to change before they are issued in final form, but individual taxpayers are likely to view the Proposed Regulations as a strong indication of the IRS's and the Treasury Department's approach to the final regulations and as reliable guidance for tax planning and estimation of their 2018 income tax liability.

The Proposed Regulations provide clarification on several technical aspects of the QBI calculation. As expected, the Proposed Regulations require that individuals must reduce positive QBI with net losses generated by other eligible businesses before applying the QBI deduction. Such a netting requirement will prevent taxpayers from segregating activities that produce losses, such as drilling activities with significant IDCs, from activities that earn taxable income and, standing alone, would permit a QBI deduction. In addition, the Proposed Regulations require that any net deficit in QBI for a taxable year must be carried forward and used to offset QBI for future years, which may prevent owners of energy companies with large project development costs yielding net losses from obtaining any benefit under the QBI deduction until a project's later years.

For purposes of calculating the QBI deduction, QBI includes items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business in the United States and included in determining taxable income for the year. QBI, however, does not include short-term or long-term capital gain or loss. The Proposed Regulation clarify that, to the extent Code Section 751 treats gain attributable to certain assets of a partnership, including unrealized receivables, which includes depreciation recapture, as ordinary income, such gain will qualify as QBI. Accordingly, if a partnership with significant investments in depreciable property sells such property at a gain, such gain, to the extent it does not exceed the depreciation taken with respect to such property, would be includable in QBI and therefore would increase the available QBI deduction.

Further, the Proposed Regulations clarify that, although a partner or owner's share of deductible losses of a pass-through entity generally reduces the tax basis in the partner or owner's equity, the QBI deduction has no effect on the tax basis of a partner's interest in the partnership or the tax basis of a shareholder's stock in an S-corporation.

The Proposed Regulations also provide guidance on two limitations on an individual's capacity to claim the QBI deduction, both of which apply if an individual's taxable income for a given year exceeds a statutory threshold (the Threshold). [2] The first limitation eliminates the QBI deduction for any specified service trade or business (SSTB). The Proposed Regulations confirm the categories of businesses that are classified as SSTBs, such as businesses involving the provision of medical, legal, accounting and consulting services,[3] and provide greater detail regarding services within these categories that will and will not be included as part of an SSTB. As expected, the Proposed Regulations do not add any new categories of SSTBs, such as oil field, transportation or similar services, that could impact the energy industry.

The Proposed Regulations also provide guidance with respect to the residual category of SSTBs, which was described under the TCJA as any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners (the Residual SSTB). Taxpayers in the energy industry were concerned that the Residual SSTB, if read broadly, could include nearly any business where an owner or employee had developed a professional reputation that contributed to the success of the business. The Proposed Regulations, however, limit this category to businesses where a person receives fees or other compensation for endorsing products or services, for the use the person's likeness, name or voice, or for appearing at an event or on radio, television or other media. The narrow scope of the Residual SSTB has put the energy industry at ease, since it appears unlikely that the IRS will use the Residual SSTB as a vehicle to draw most energy companies with prominent owners and operators into the SSTB definition.

Finally, the Proposed Regulations include a de minimis rule that would exclude from SSTBs larger businesses (those with more than $25 million in gross receipts in a taxable year) if less than 10% of its gross receipts are attributable to specified activities, and smaller businesses (those with $25 million or less in gross receipts in a taxable year) if less than 5% of gross receipts are attributable to specified activities.

The second limitation caps the QBI deduction at the greater of (1) 50% of the individual's allocable share of W-2 wages with respect to the trade or business (the W-2 Wage Limitation), or (2) the sum of 25% of the individual's allocable share of W-2 wages with respect to the trade or business, plus 2.5% of the individual's allocable share of the unadjusted tax basis immediately after acquisition (UBIA) of qualified property used in the trade or business (the W-2 Wage and UBIA Limitation). The Proposed Regulations provide much-anticipated guidance for determining a business's W-2 wages for purposes of the W-2 Wage Limitation and the W-2 Wage and UBIA Limitation. As expected, such portion of the Proposed Regulations was modeled after the rules for determining W-2 wages under former Code Section 199, which provided the deduction for domestic production activities and was repealed by the TCJA.

Taxpayers have been particularly pleased that, under the Proposed Regulations, an employer can include W-2 wages paid by another person or entity for purposes of calculating its W-2 wages, as long as the wages were paid to employees providing services to such employer. Accordingly, the common practice of creating a partnership subsidiary to employ individuals who are partners of the parent partnership to allow such individuals' compensation to be treated as W-2 wages, rather than guaranteed payments, should allow the parent partnership to include such subsidiary partnership wages for the W-2 Wage Limitation and the W-2 Wage and UBIA Limitation.

The Proposed Regulations also provide taxpayers the option, for purposes of calculating W-2 wages of a taxpayer and determining the UBIA of any qualified property held by a taxpayer, to aggregate multiple businesses that are conducted through different pass-through entities. Such aggregation must be elected at the individual taxpayer level, and generally is available for businesses that are under common control and are deemed to be functionally related under the Proposed Regulations. Such aggregation may permit individuals to use W-2 wages from one business to increase the W-2 Wage Limitation and the W-2 Wage and UBIA Limitation with respect to a related business with a greater amount of QBI but without significant W-2 wages and, similarly, to use UBIA attributable qualified property of one business to increase the W-2 Wage and UBIA Limitation of another business. Moreover, aggregation is expected to allow taxpayers to reduce the administrative burden of calculating the W-2 Wage Limitation and the W-2 Wage and UBIA Limitation on a business-by-business basis.

Finally, the Proposed Regulations clarify a critical aspect of the definition of qualified property for purposes of calculating the W-2 Wage and UBIA Limitation. For this purpose, qualified property generally means depreciable tangible property used in the trade or business for the production of QBI. The Proposed Regulations, however, provide that adjustments to the tax basis of partnership property arising when a taxpayer acquires an interest in a partnership, under Code Section 743(b) of the Code, or in connection with a distribution by the partnership, under Code Section 734(b), are not treated as qualified property and therefore would not increase a taxpayer's W-2 Wage and UBIA Limitation. As a result, rather than purchasing an interest in assets indirectly by acquiring a partnership interest, taxpayers may prefer to acquire and hold an undivided interest in such assets, and contribute the interest in such assets to a newly-formed partnership immediately after purchase. Prior to the TCJA, a taxpayer generally would have obtained the same tax basis adjustment under either acquisition structure, and therefore would have been largely indifferent as between the two structures from a tax perspective.

The Proposed Regulations are effective for taxable years ending after the date on which these regulations are finalized, although taxpayers are permitted to rely on the Proposed Regulations in their entirety until that date. Certain anti-abuse rules in the Proposed Regulations are proposed to apply to taxable years ending after December 22, 2017.

1 All income tax rates provided herein are exclusive of the Medicare tax on unearned income.

2 An individual will exceed the Threshold if the individual's taxable income for a given year is equal to or greater than (1) $315,000, with a phase-in of the limitation for taxable income up to $415,000, for married individuals filing jointly, or (2) $157,500, with a phase-in of the limitation for taxable income up to $207,500, for single individuals or married individuals filing separately.

3 Notably, the traditional banking business and services performed by real estate brokers, insurance brokers, engineers and architects are not SSTBs.