ADVISING CLIENTS UNDER SECTION 199A—A REVOLUTIONARY NEW FIELD OF TAX AND LEGAL PRACTICE

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I. INTRODUCTION

A. The Enactment of Section 199A

The Tax Cuts Act and Jobs Act of 2017 (the “TCJA”) was signed into law on December 22, 2017, and it became effective on January 1, 2018. Because of problems in Section 199A(g) as originally enacted, Congress substantially amended the provisions of that subsection of Section 199A. These amendments became law on March 23, 2018, but were retroactively effective to January 1, 2018.

As readers will know, for owners of domestic businesses, the two most important TCJA provisions are:

- Amended Internal Revenue Code (“IRC”) section 11, which reduced the maximum federal income tax for C corporations from 35 percent in the highest bracket to a flat 21 percent; and
- New IRC Section 199A, which, among other things, provides the owners of pass-through businesses with a deduction (a “pass-through deduction”) of at least 20 percent from their net business income.¹

This article provides a detailed introduction to Section 199A for tax lawyers who have not yet had occasion to study the section. In this article, “Section 199A practice” means federal tax practice and state-law legal practice under Section 199A itself and the closely related practice, described below, under section 11 and Subchapter C.

B. The Tasks That Tax Lawyers Must Be Competent to Perform for Their Clients under Section 199A

There are four principal tasks that, to the extent of their competence, tax lawyers must perform for their clients under Section 199A:

- First, they must advise their clients who are owners of pass-through businesses whether their federal income tax savings are likely to be greater under Section 199A or under Subchapter C, and, if the latter is the case, they must assist them in converting the federal tax regimen of their businesses to Subchapter C or forming a new Subchapter C entity for their business. The performance of this task will require their making at least basic computations of the federal income tax savings their clients will realize both under Section 199A and under Subchapter C.²
- Second, if they determine that the best option for their pass-through business clients is to obtain pass-through deductions under Section 199A, they must determine whether the personal, tax and business arrangements of these clients will provide them with the maximum pass-through deductions available to them under the section, and, if they will not, they must advise them how to restructure these arrangements to achieve this goal.
- Third, to the extent of their business organization law competence, they must assist their clients in creating new state-law business entities and implementing other state-law non-tax arrangements required by their new federal tax arrangements. These new legal arrangements will often involve
the formation of single-member or multi-member LLCs and the negotiating and drafting of operating agreements among the members of these LLCs.³

• Fourth, they must advise their clients who are shareholders of C corporations whether, in order to maximize their TCJA federal income tax savings, their businesses should continue as C corporations or whether, instead, the owners should conduct their business under a pass-through regimen. In addition, to the extent of their competence, they should assist their Subchapter C clients with any necessary restructuring of their personal, tax or legal arrangements to maximize Section 199A pass-through deductions. It is possible that in order to obtain Section 199A federal income tax savings, many millions of shareholders of closely held C corporations must create new entities with pass-through federal tax regimens to conduct their businesses.

This article provides introductory guidelines for performing all of the above four tasks.⁴

C. Section 199A Practice as a Major New Area of Legal and Tax Practice; the Knowledge and Practice Skills Tax Lawyers Must Possess in Order to Be Competent Under Section 199A

It is too early to attempt a comprehensive definition of the tax and legal knowledge and the specific practice skills that tax lawyers will have to possess in order to provide competent advice and service to their clients under Section 199A. However, even now it is clear that any competent representation of Section 199A clients by tax lawyers will make radical professional demands on these lawyers.

In other words, because of the vast number of potential clients who will need its services (see discussion below), the unique length, complexity and difficulty of Section 199A itself, the radically new relationship between pass-through federal tax regimens and Subchapter C effected by the enactment of S1, and the great complexity of the personal, tax and legal restructuring that many owners of pass-through business owners and C corporations must implement in order to maximize their federal income tax savings under Section 199A, the new type of tax and legal practice made necessary by the enactment of Section 199A and the amendment of section 11 can only be described as revolutionary.⁵

To illustrate: In order to be able to represent Section 199A clients competently:

• Obviously, these lawyers must have a comprehensive knowledge of the provisions of Section 199A.⁶

• They must also have a comprehensive knowledge of TCJA Sections 11011(a) through (d), which contain several provisions critically relevant to practice under Section 199A.⁷

• They must have a comprehensive knowledge of the U.S. Treasury Department Entity Classification Regulations under Treas. Regs., 26 CFR 301.7701 et seq., since these regulations govern the validity and indeed the very possibility of any federal tax regimen conversion of pass-through businesses and C corporations necessary in order to take account of Section 199A and the above amendment of section 11.

• To handle tax choice of entity issues under Section 199A, they must have a thorough comparative knowledge of the federal income taxation of businesses and their owners under the four major federal tax regimens—i.e., sole proprietor taxation and Subchapters C, K and S.

• They must have a solid basic knowledge of the IRC in general, since many IRC provisions besides those mentioned above may be relevant in addressing issues under Section 199A.

• If they are to handle changes in the legal arrangements of their Section 199A or Subchapter C clients that are necessary in order to implement federal tax regimen conversions, they must have a thorough comparative knowledge of the state-law rules of business organization law governing LLCs, state-law business corporations and the other major types of state-law business entities and arrangements.⁸

• They must be skilled in planning, negotiating and forming business entities and, above all, in forming single-member and multi-member LLCs needed by their Section 199A clients and in drafting appropriate operating agreements for these clients.⁹

II. SECTION 199A—THE BASICS

Set forth below are the major points that tax lawyers must understand about Section 199A as a basis for providing clients with competent Section 199A advice.
and services. The points about the section set forth below and elsewhere in this article assume that the relevant businesses are existing businesses. However, these points also apply to business start-ups.

**A. General Perspectives**

1. IRS filing statistics indicate that there are currently about 25 million individuals in the United States who own and operate sole proprietorships, about 20 million shareholders of S corporations, about 30 million partners of entities taxable as partnerships, and many millions of shareholders of closely held C corporations, for a total of, incredibly, more than 75 million business owners. Thus, the federal income tax impact of Section 199A on owners of closely held American businesses will be immense.

2. Under the TCJA, Section 199A is scheduled to expire on December 31, 2025. However, because of the many tens of millions of pass-through business owners who will be affected by the section’s expiration, I believe it is likely that Congress will extend it indefinitely.

3. There is no useful legislative history of Section 199A. However, it is clear that the principal intent of Congress in enacting the section was to preserve the roughly 10 percent federal income tax rate advantage of pass-through businesses over C corporations as in effect before the enactment of the TCJA. In addition, the terms themselves of the section clearly imply that the section’s intent is to encourage and support business start-ups, the hiring of employees, and sales and purchases of business assets. These intentions are evident, for example, in the greater availability of pass-through deductions under the section for pass-through businesses that pay significant wages to their employees and that own and use substantial business assets than for those that do not.

4. Section 199A does not define the term “pass-through business” for purposes of the section. However, under Section 199A, as elsewhere under the IRC, it is evident that pass-through businesses comprise sole proprietorships, S corporations and multi-owner entities, such as most multi-member LLCs, that are taxable as partnerships under the Entity Classification Regulations.

5. Section 199A provides not only pass-through deductions but also certain special deductions under Section 199A(g) for farmers, horticulturalists (i.e., growers of orchard and garden trees and plants), farm cooperatives, horticultural cooperatives, and investors in real estate investment trusts and publicly traded partnerships. However, for most clients of tax lawyers, the pass-through deductions provided by Section 199A are by far the most important deductions. A discussion of the above additional deductions is beyond the scope of this article.

6. Statutory authority for all of the various deductions provided to taxpayers under Section 199A is provided in general terms in the stem of Section 199A. This provision of Section 199A also provides that for any taxable year, the combined deductions of a taxpayer under the section may not exceed 20 percent of the taxpayer’s taxable income less net capital gain. Section 199A(a) provides as follows:

   199A(a) ALLOWANCE OF DEDUCTION.— In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the lesser of—

   199A(a)(1) the combined qualified business income amount of the taxpayer, or

   199A(a)(2) an amount equal to 20 percent of the excess (if any) of—

   199A(a)(2)(A) the taxable income of the taxpayer for the taxable year, over

   199A(a)(2)(B) the net capital gain (as defined in section 1(h)) of the taxpayer for such taxable year.

7. The Section 199A(a) term “combined qualified business income amount of the taxpayer” is defined as follows in Section 199A(b)(1):

   199A(b)(1) IN GENERAL.— The term “combined qualified business income amount” means, with respect to any taxable year, an amount equal to—

   199A(b)(1)(A) the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus
199A(b)(1)(B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

**B. Qualified Trades or Businesses vs. Specified Service Trades or Businesses**

1. As noted above, under Section 199A, there are two types of pass-through businesses—"qualified trades or businesses," as defined in Section 199A(d)(1), and "specified service trades or businesses" ("SSBs"), as defined in Section 199A(d)(2). As explained below, the classification of a pass-through business as a qualified trade or business or as an SSB may heavily affect the pass-through deductions available to its owners.

2. SSBs include all of the classic professions except architecture and engineering. They also include investment professionals and businesses for which, under the Section 199A "principal asset" test, the principal asset is the reputation or skill of one or more of their employees or owners. Qualified trades or businesses include all other types of businesses except the business of providing employment services. Thus, under Section 199A, no employee of a third-party employer can receive a pass-through deduction.

3. The professions defined as SSBs under section 1203(a)(3)(e) as amended and incorporated in Section 199A under Section 199A(d)(2)(A) comprise, in alphabetical order:
   a. Accounting,
   b. Actuarial science,
   c. Athletics,
   d. Brokerage services,
   e. Consulting,
   f. Financial services,
   g. Health,
   h. Law,
   i. Performing arts.

4. While the full definition and scope of several of the above professions is not entirely clear, the regulations under section 448, and especially Regs. § 1.448-1T(e)(4), are useful in construing their definition, and on definitional issues under Section 199A(d)(2), one can reasonably expect that the IRS will view these regulations as authoritative.\(^\text{12}\)

5. Section 199A(d)(2)(B) identifies an additional six types of trades or businesses as SSBs. These are:
   a. Investing,
   b. Investment management,
   c. Trading,
   d. Dealing in securities (as defined in section 475(c)(2)),
   e. Dealing in partnership interests, and
   f. Dealing in commodities (as defined in section 475(e)(2)).

6. The tax economist Martin Sullivan has commented in a recent Tax Notes article that in the absence of an IRS definition, the meaning of the Section 199A principal asset rule referred to above is "anybody's guess."\(^\text{13}\) However, in my view, the rule should be construed narrowly to include only service businesses that do not buy, sell or otherwise deal in physical or intellectual property or, broadly speaking, in "things." See generally, Cunningham, "Defining the Principal Asset Rule for the Pass-through Deduction," Tax Notes, Vol. 160, Number 1, page 83 (July 2, 2018).

**C. What is a Trade or Business Under Section 199A?**

The owners of neither qualified trades or businesses nor SSBs can obtain pass-through deductions unless their businesses are "trades or businesses" within the meaning of Section 199A. In general, a business is a Section 199A trade or business if its owners or their employees devote regular, continuous and substantial time to the business and if they operate it for a bona fide profit motive. See generally, Commissioner v. Groetzinger, 480 U.S. 23 (1987); Crile v. Comm’r, T.C. Memo. 201 (2014); Schwartzman and Brandstetter, “New Sec. 1411 Brings Difficulty Defining Real Estate ‘Trade or Business,’” The Tax Advisor, May 2013;\(^\text{14}\) Niemann, “Commissioner v. Groetzinger: The Supreme Court Takes a ‘Common Sense’ Approach to the Trade or Business Requirement,” 33 St. Louis U.L.J. 257 (1988); Boyle, “What is a Trade or Business?” 39 Tax Lawyer 737 (1986).\(^\text{15}\)