

MASSACHUSETTS SOCIETY OF CERTIFIED PUBLIC ACCOUNTS
INTERNAL REVENUE CODE SECTION 199A
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I. INTRODUCTION

1) My background.

- a) I’m a lawyer licensed to practice law in New Hampshire and Massachusetts. I’m of counsel to the New Hampshire-based law firm of McLane Middleton, P.A. The McLane firm has Massachusetts offices in Woburn and Boston.
- b) My practice is focused on LLC law and tax, on advising clients about section 199A and on restructuring their business and personal arrangements when necessary to enable them to maximize their pass-through deductions.
- c) I’m the principal author of *Drafting Limited Liability Company Operating Agreements*, an LLC formbook and practice manual for lawyers and accountants. I’m also the author of *Maximizing Pass-Through Deductions Under IRC Section 199A*, a handbook on legal and tax practice under section 199A. Both books are published by Wolters Kluwer, an international publisher of professional information.

2) The section 199A pass-through business—overview. As you know, section 199A provides an annual federal income tax pass-through deduction to taxpayers (whom I’ll refer to here as “qualified taxpayers”) who are owners of non-professional pass-through businesses. The Section 199A deduction (which I’ll refer to here as “the pass-through deduction”) can be up to 20% of qualified taxpayers’ shares of the “qualified business income” of their businesses. Qualified business income means, in general, net business income. By its terms, section 199A will expire at the end of 2025. Qualified taxpayers include sole proprietors, shareholders of entities taxable as S corporation, and partners of entities, such as multi-member LLCs, that are taxable as partnerships.

3) However, in certain circumstances, pass-through deductions are limited in the case of the owners of 13 types of businesses, referred to in Section 199A as “specified service trades or

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businesses,” or are excluded altogether. The 13 types of specified service trades or businesses are listed in the attached Exhibit A. Let’s take a minute to look at the exhibit.

- a) A word about a client of mine in California who has an Exhibit B issue. I think she is not a consultant. She told me she is a consultant for medical malpractice lawyers, and her CPA has not been claiming the pass-through deduction on her 1040’s. .

II. WILL SECTION 199A SURVIVE DURING THE BIDEN PRESIDENCY?

The first question I want to address today is whether President Biden is likely to repeal or limit section 199A or whether, at the very least, he will allow it to expire in 2025. This is obviously a key question for clients who need restructuring to obtain pass-through businesses, since this restructuring can be extensive and costly. As you know, President Biden intends to increase the top federal income tax rate for C corporations from 21 percent to 25 percent. In connection with this increase, he may also repeal or limit section 199A, since section 199A was enacted to provide pass-through business owners with tax parity when President Trump decreased the C corporation top rate of 27% to a flat rate of 21%.

- 1) The answer to the above question is unclear, and, to my knowledge, President Biden’s website and other sources do not clearly answer it. However:
 - a) There are indications in President Biden’s website and in other sources that he will *not* repeal section 199A in 2021 or thereafter and that he or his successor as president will extend it indefinitely beyond 2025.
 - b) However, these sources indicate that he will limit its availability to taxpayers whose taxable income for the relevant taxable year is \$400,000 or less.
 - c) In addition, IRS sources suggest that approximately 17 million business owners claimed the deduction for their 2019 taxable years, and it is probable that a significantly greater number of taxpayers will claim it for their 2020 taxable year. Furthermore, because of the devastating impact of the Covid pandemic on millions of pass-through businesses, the pass-through deduction has undoubtedly been of great economic importance to many pass-through business owners; and the pandemic is likely to create major economic difficulties for many of these owners for at least the next couple of years.
 - d) For all these reasons, it seems unlikely that President Biden will repeal the pass-through deduction for at least these years and perhaps indefinitely.

III. SECTION 199A COMPUTATION RULES

- 1) Exhibit B. A number of tax scholars have described section 199A as “overwhelmingly complex.” I want to take a minute to refresh your memory about the rules in section 199A for computing pass-through deduction. There are seven such rules, scattered through the section. They are summarized in Exhibit B. Let’s spend a few minutes going through that exhibit. With respect to the application of the section to higher-income pass-through business owners, section 199A can be overwhelming complex. However, as we’ll see in reviewing Exhibit B, for to most pass-through business owners whose income is at or under their section 199A threshold amount, the application of section 199A is relatively simple.
- 2) Rev. Proc. 2020-45, Section 3.27. As you may know, Rev. Proc. 2020-45, Section 3.27 provides that for 2021, the section 199A threshold amounts are as follows:

- a) \$329,800 for married filing joint returns;
- b) \$164,925 for married filing separate returns; and
- c) \$164,900 for all other returns.

IV. THE AVAILABILITY OF PASS-THROUGH DEDUCTIONS TO QUALIFIED TAXPAYERS WHO OWN REAL PROPERTY AND RENT IT TO TENANTS AS A PART-TIME BUSINESS

- 1) The section 199A problem of Part-time real estate landlords. There are at least a few million qualified taxpayers nationwide, and probably many tens of thousands taxpayers in Massachusetts, perhaps including some of you, who, in addition to their full-time jobs or in connection with their retirement, own parcels of residential or commercial real property that they rent to tenants as a part-time business. If these qualified taxpayers have good tenants, they may have to devote only a few hours a year to these businesses.
- 2) The “considerable time” trade or business requirement. However, under the section 199A regulations, the pass-through deduction is available only to “trades or businesses” within the meaning of IRC section 162, and certain federal tax authorities state that a business is a section 199A trade or business only if its owners devote “considerable” or “substantial” time to it.
- 3) Rev. Proc. 2019-Rev. Proc. 2019-38. Furthermore, Rev. Proc. 2019-38 provides a section 199A trade or business safe harbor to owners of real estate rental enterprises only if they, their employees, their agents and their independent contractors (referred to here collectively as the “owners”) devote at least 250 hours a year to these businesses and meet various stringent record-keeping and filing requirements.
- 4) The section 199A trade or business “profitability” test for part-time landlords. However, in my view, these taxpayers should be able to qualify for the pass-through deduction on their net real estate rental income as long as they devote enough time to their real estate rental business to reasonably insure its profitability. I’ve set forth detailed arguments in favor of this “profitability rule” in an article entitled “Advising Owners of Rental Real Estate Enterprises on How to Address the Code Section 199A ‘Trade or Business’ Issue” in the November 2020 issue of *Taxes, the Tax Magazine*.

V. SECTION 199A RESTRUCTURING ISSUES

- 1) Principal section 199A role. The principal role of CPAs under section 199A is to compute the amount of the claims for pass-through deductions claim that can be made by their federal tax return clients who are qualified taxpayers and to claim those amounts for them in their returns.
- 2) What should you do, e.g., for tax return clients who are C corporation shareholders? However, on the basis of the relevant tax return background information, it should be apparent to tax preparers that, in order to obtain or maximize their pass-through deductions, at least a few of their tax preparation clients must do substantial restructuring of their personal or business arrangements. For example:
 - a) C corporation owners. Business owners whose businesses are taxable as C corporations cannot qualify for the pass-through deduction. In order to qualify for it, many of these

owners should consider converting their businesses to pass-through businesses. And this restructuring may require, in some cases, statutory conversions of the owners' state-law business corporations to LLCs or other relatively complex procedures.

- b) LLC owners who receive guaranteed payments. If the operating agreements of business owners who are partners of multi-member LLCs taxable as partnerships provide significant income to these owners in the form of guaranteed payments, these owners, in order to maximize their qualified business income, should consider amending these agreements to provide that their income is in the form of distributions, since this action will increase their LLC's qualified business income. Indeed, some of these owners should consider amending these agreements retroactively under section 761(c).
- 3) Tax return preparer section 199A malpractice issues. If the need of their tax preparation clients to restructure their business or personal arrangements to obtain or maximize their pass-through deductions is or should be obvious to tax preparers, but these tax preparers fail to so advise their tax preparation clients, might these tax preparers be liable for malpractice claims—for example, in the amount of the pass-through deduction claims their clients could have made but did not, plus interest and CPA fees? The law on this question is unclear, but certain state case law suggests that the answer is yes.

VI. THE SUBCHAPTER S “REASONABLE COMPENSATION” ISSUE AND SECTION 199A

- 1) Under section 199A(b)(3)(B) and other section 199A provisions, qualified taxpayers whose taxable income exceeds their threshold amount and who, as is often the case, not only own their businesses but also work for them, should often be structured as S corporations so that, in order to maximize their pass-through deductions, these shareholder-employees can use their own compensation as well as that of third-party employees to increase the W-2 wages they will need under sections 199A(b)(2) (B)(i) or (ii).
- 2) The Subchapter S reasonable compensation rule. As every federal tax professional knows, shareholders of S corporations who are also employees of their corporations must pay themselves “reasonable compensation” for their employment services.
- 3) Reasonable compensation flexibility. As every federal tax professional also knows, under the relevant Subchapter S reasonable compensation tax authorities, S corporation shareholders often have broad flexibility as to the amount of compensation they can pay themselves without risking a negative IRS reasonable compensation audit. This flexibility can also involve substantial complexity.
- 4) However, determining this compensation for purposes of sections 199A(b)(2) (B)(i) or (ii) will often substantially increase this complexity. This is because, among other considerations, while particular S corporation shareholder-employees may want to *maximize* their compensation for purposes of those section 199A provisions, they may also want to *minimize* them for FICA avoidance purposes and sometimes for other purposes, such as state tax purposes.
- 5) And if these shareholders want to maximize their contributions to qualified plans, determining the optimal amount of the reasonable compensation they pay themselves may become yet more complicated.

- 6) In my experience, there will often be no readily apparent algebraic formula to make the above determination. Rather, the computation can be made only on the basis of trial and error.

EXHIBIT A

THE THIRTEEN TYPES OF SPECIFIED SERVICE TRADES OR BUSINESSES

The 13 types of specified service trades or businesses under section 199A are listed below in alphabetical order. The specified service trades or businesses listed below that primarily involve financial services and dealing in securities are shaded.

- 1) Accounting
- 2) Actuarial science
- 3) Athletics
- 4) Brokerage services
- 5) Consulting
- 6) Dealing in securities
- 7) Financial services
- 8) Health
- 9) Investing and investment management
- 10) Law
- 11) Performing arts
- 12) Businesses whose primary asset is the reputation or skill of one or more of its employees or owners
- 13) Trading in securities

Exhibit B

THE RULES UNDER SECTION 199A FOR COMPUTING PASS-THROUGH DEDUCTIONS FOR THE SEVEN RELEVANT CATEGORIES OF QUALIFIED TAXPAYERS UNDER THAT SECTION

CATEGORY	DEFINITION	COMPUTATION RULE
Category 1	Category 1 consists of owners of qualified trades or businesses <i>and</i> specified service trades or businesses whose taxable income does not exceed their threshold amount.	Under section 199A(b)(3)(A), the pass-through deduction of Category 1 taxpayers is their section 199A(b)(2)(A) pass-through deduction—i.e., 20% of their qualified business income.
Category 2	Category 2 consists of owners of qualified trades or businesses whose taxable income is within their phase-in range and whose section 199A(b)(2)(A) pass-through deductions exceed their section 199A(b)(2)(B) pass-through deductions.	Under section 199A(b)(3)(B), the pass-through deduction of Category 2 owners is their section 199A(b)(2)(A) deduction as reduced under sections 199A(b)(3)(B)(i) through (iii) (which hinges on a ratio between their taxable income and their threshold amount).
Category 3	Category 3 consists of owners of specified service trades or businesses whose taxable income is within their phase-in range and whose section 199A(b)(2)(A) pass-through deductions exceed their section 199A(b)(2)(B) pass-through deductions.	Under section 199A(b)(3)(B) and section 199A(d)(3)(B), the pass-through deduction of Category 3 owners is their section 199A(b)(2)(A) pass-through deduction as reduced under sections 199A(b)(3)(B)(i) through (iii) and under section 199A(d)(3)(B).
Category 4	Category 4 consists of owners of qualified trades or businesses whose taxable income is within their phase-in range and whose section 199A(b)(2)(B) pass-through deductions exceed their section 199A(b)(2)(A) pass-through deductions.	Section 199A does not expressly provide a computation rule for Category 4 taxpayers. However, the final regulations under section 199A provide that the governing rule is Section 199A(b)(2)—the lesser of their Section 199A(b)(2)(B)(i) pass-through deduction (50% of W-2 wages) and their Section 199A(b)(2)(B)(ii) pass-through deduction (25% of W-2 wages and 2.5 percent of their “unadjusted based of qualified property “immediately after acquisition (their “UBIA”). See Regs., § 1.199A-1(d)(iv)(B) (last sentence). The goal here is to compute the Section 199A(b)(2) deduction so that (i) and (ii) are as close to each other as possible.
Category 5	Category 5 consists of owners of specified service trades or businesses whose taxable income is within their phase-in range and whose section 199A(b)(2)(B) pass-through deductions exceed their section 199A(b)(2)(A) pass-through deductions	Section 199A does not expressly provide a computation rule for Category 5 taxpayers. However, the final regulations under section 199A provide that the governing rule is Section 199A(b)(2). See regs. citation above. But for Category 5 taxpayers, their Section 199A(b)(2) deduction must be reduced under section 199A(d)(3)(B).
Category 6	Category 6 consists of owners of qualified trades or businesses whose taxable income exceeds their phase-in range.	The pass-through deductions of Category 6 taxpayers are their pass-through deductions under section 199A(b)(2).
Category 7	Category 7 consists of owners of specified service trades or businesses whose taxable income exceeds their phase-in range.	No pass-through deduction is allowable to Category 7 taxpayers.