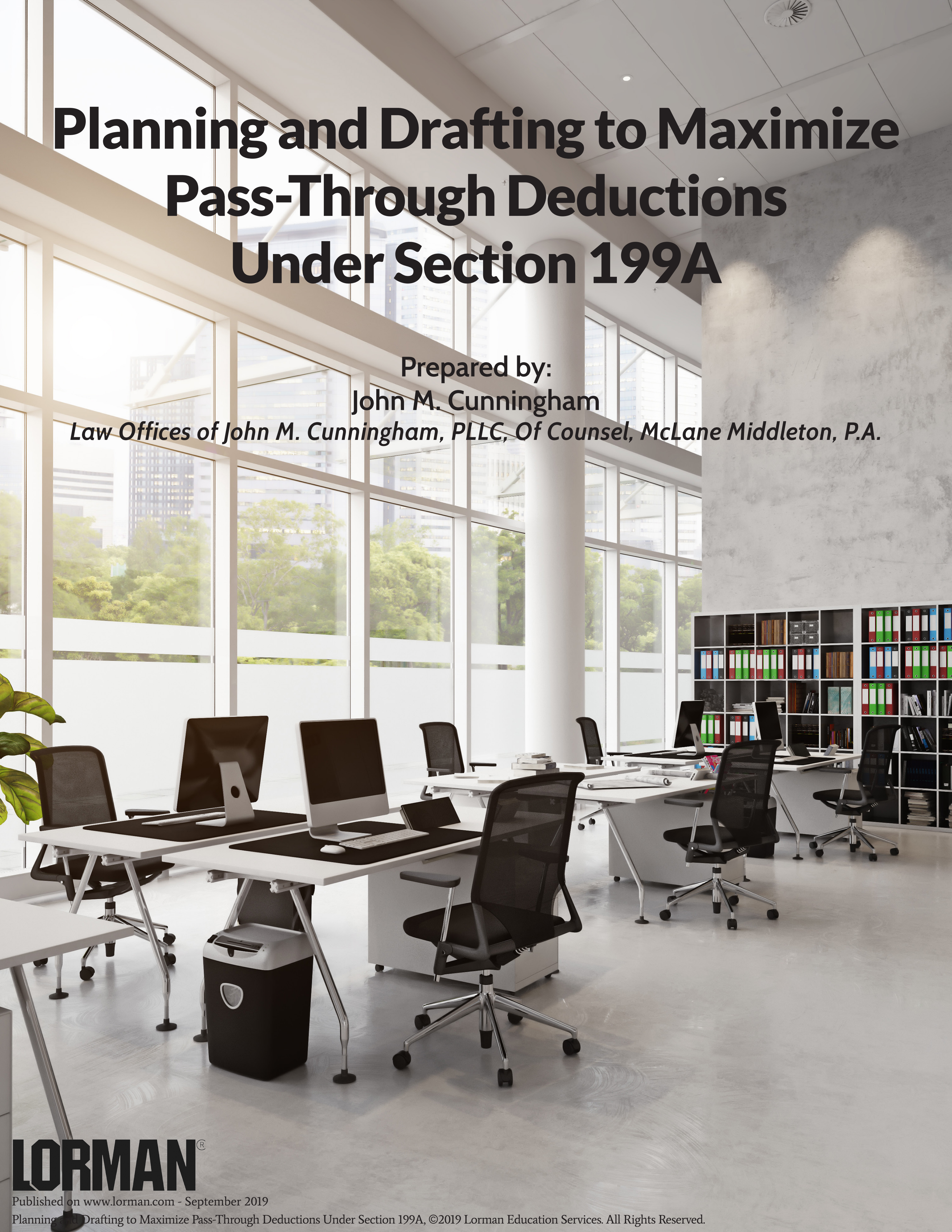

Planning and Drafting to Maximize Pass-Through Deductions Under Section 199A

Prepared by:
John M. Cunningham
Law Offices of John M. Cunningham, PLLC, Of Counsel, McLane Middleton, P.A.

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PLANNING AND DRAFTING TO MAXIMIZE PASS-THROUGH DEDUCTIONS UNDER SECTION 199A

A. THE ORIGIN OF SECTION 199A; ITS EXTRAORDINARY COMPLEXITY

1) Section 199A provides the owners of closely-held businesses with federal income tax "pass-through deductions" of up to 20% of their net business income.

2) It also provides certain special deductions to farmers, horticulturalists and their cooperatives and to persons investing in real estate investment trusts and publicly traded partnerships. Section 199A became effective on January 1, 2018.

3) On January 1, 2018, Congress reduced the top federal income tax rate for C corporations from 37% to a flat rate of 21%. The purpose of section 199A is to preserve the same roughly 10% federal income tax rate advantage of pass-through businesses over C corporations.

4) Section 199A and the Proposed Regulations thereunder are among the most complex provisions and regulations under the Tax Cuts and Jobs Act of 2017. Furthermore, maximizing section 199A pass-through deductions for business start-ups by properly structuring them and for existing businesses by properly restructuring them imposes a very substantial additional level of section 199A complexity.

B. SECTION 199A BECAME EFFECTIVE ON JANUARY 1, 2018. ITS TERMS REQUIRE ITS EXPIRATION ON DECEMBER 31, 2025.

However, a failure by Congress to extend section 199A would trigger immense outcries by affected business owners. Thus, I think an indefinite extension is likely.

C. THE SECTION 199A(A) INCOME CAPS ON PASS-THROUGH DEDUCTIONS.

Under Section 199A(a), there is cap on section 199A deductions of the lesser of 20% of a taxpayer's taxable income and 20% of the taxpayer's "combined qualified business income amount" (consisting of qualified business income and income from REITs and publicly traded partnerships).

D. PASS-THROUGH DEDUCTIONS—THEIR IMMENSE IMPORTANCE FOR TENS OF MILLIONS OF PASS-THROUGH BUSINESS OWNERS

Pass-through deductions are available to at least 50 million business owners, including not only owners of pass-through businesses (sole proprietorships, S corporations and entities taxable as partnerships) but also to many millions of C corporation shareholders if they convert their federal tax regimen to a pass-through regimen—which most of them should do.

E. PASS-THROUGH DEDUCTIONS—THRESHOLD AMOUNTS, PHASE-IN RANGES AND TAXABLE INCOME

The concepts of "threshold amount," "phase-in range" and taxable income are central under section 199A.

F. THE "FOUR SITUATIONS" OF SECTION 199A TAXPAYERS AND THE SECTION 199A RULES DETERMINING THEIR PASS-THROUGH DEDUCTIONS

Section 199A practitioners must be aware of these four situations and the rules that govern them for owners of both qualified trades or businesses and specified service trades or businesses.

1) Taxpayer's taxable income doesn't exceed his or her threshold amount. Deduction is under Section 199A(b)(3)(A).
2) Taxpayer's taxable income does exceed threshold amount but is within phase-in range and Section 199A(b)(2)(A) deduction exceeds Section 199A(b)(2)(B) deduction. Deduction is under Section 199A(b)(3)(B)(i) through (iii).
3) Taxpayer's taxable income does exceed threshold amount but is within phase-in range and Section 199A(b)(2)(B) deduction exceeds Section 199A(b)(2)(A) deduction. Deduction is under Section 199A(b)(2).
4) Taxpayer's taxable income exceeds his or her phase-in range. Deduction is under Section 199A(b)(2).

G. THE "TRADE OR BUSINESS" PROBLEM WITH REAL ESTATE RENTAL LLCS

The basic problem is the *Groetzinger* requirement of "regular and continuous activity."

H. THE SPECIAL TRADE OR BUSINESS RULE UNDER PROPOSED § 1.199A—1(B)(13)

Proposed § 1.199A—1(b)(13) is extremely beneficial in situations in which the owners of operating companies also own their business real property in a holding company. Basically, proposed § 1.199A-1(b)(13) overrides *Groetzinger* in this situation.

I. DRAFTING TO ADDRESS SECTION 199A

Special provisions must be included in LLC agreements to maximize section 199A pass-through deductions.

PLANNING AND DRAFTING TO ADDRESS THE BBA PARTNERSHIP AUDIT RULES

A. THE PARTNERSHIP AUDIT RULES, WHICH ARE SET FORTH IN THE BIPARTISAN BUDGET ACT OF 2015, BECAME EFFECTIVE ON JANUARY 1, 2018; THEY ARE HARSH

In essence, they provide that partners can't participate in partnership audits and that partnership tax underpayments must be paid by the partnership itself not the partners (with certain exceptions).

B. THE LEGISLATIVE INTENT OF THE BBA PARTNERSHIP AUDIT RULES

The intent is to prevent federal income tax abuses by large diverse investment with members in multiple jurisdictions..

C. THE BBA PARTNERSHIP AUDIT RULES DON'T APPLY TO ELIGIBLE PARTNERSHIPS" THAT ELECT OUT OF THE RULES IN EACH OF THEIR FEDERAL TAX RETURNS

Partnerships that have 100 or fewer partners, whose members are individuals, estates of deceased individuals, C or S corporation and in which no partners are, among other things, trusts, partnerships or single-member LLCs are eligible to elect out of the partnership audit rules by so filing in their annual tax returns.

D. For eligible partnerships, drafting partnership audit provisions is fairly easy; for ineligible partnerships, it is a complex task. My book contains model provisions for both.

A discussion of the above provisions would require much time and the addressing of many technicalities and is thus beyond the scope of this webinar.

THREE OFTEN IMPORTANT LLC AGREEMENT PARTNERSHIP TAX PROVISIONS WHICH ARE TECHNICAL AND NON-INTUITIVE BUT OF WHICH NON-TAX LAWYERS SHOULD HAVE AT LEAST A BASIC UNDERSTANDING

A. Section 704(c)(1)(A)

IRC section 704(c)(1)(A) provides in effect that if a partner contributes property to an LLC whose fair market value at the time of contribution is either less or more than its tax basis, then, if, after the contribution, the partnership disposes of the property, the "built-in" gain or loss in the property must be allocated to the contributor. The purpose of the section is to ensure tax fairness and prevent tax abuses.

B. Minimum gain chargebacks

Minimum gain chargebacks are special allocations to members in situations in which their multi-member LLC taxable as a partnership owes a non-recourse debt to a lender—such as a mortgage debt to a bank. In this situation, the LLC must allocate interest deductions and other deductions relating to the loan to the members even though the IRS recognizes that the deductions don't represent real economic losses to the members. However, the governing regulations require that as the loan is paid down, these deductions must be offset by allocations to the members. A link that provides a brief but useful explanation of minimum gain chargebacks is http://www.korntax.com/articles/once-and-for-all-what-is-a-%E2%80%9Cminimum-gain-chargeback%E2%80%9D.

C. Targeted capital accounts

In a targeted capital account arrangement, the LLC agreement of a multi-member LLC taxable as a partnership provides for cash distributions to the members based on capital account liquidations rather than on a straight-up partnership allocation structure or convention contractual special allocations. The purpose of targeted capital account arrangements is, in essence, to provide guaranteed annual cash distributions to the members even if these distributions are inconsistent with current financial results. These arrangements are very commonly used in sophisticated, high-stakes multi-member LLC deals, but the IRS has never ruled on whether they are consistent with generally applicable Internal Revenue Code and regulatory requirements. For a detailed introduction to targeted capital accounts, see the Tax Adviser article entitled "Targeted Capital Accounts," available online at https://www.thetaxadviser.com/issues/2011/oct/clinic-story-11.html.