



September 2018

## New IRS 199A Regulations Benefit Out-of-Favor Service Businesses

Clarity is worth its weight in gold.

The IRS issued 184 pages of regulations clarifying the new 20 percent Section 199A deduction. Based on the weight of those 184 pages, the value of this 199A clarity is about \$32,670.93.

The value to you will likely be more or less than the \$32,670.93, but count on it being worthwhile, for sure.

One big deal in the new regulations is a significant narrowing of the out-of-favor reputation and skill group. Other big deals are the clear definitions that apply to various professions.

The IRS did many businesses a huge favor with these new regulations. Let's dig in and find out who benefits.

### ***Why It Matters***

If you operate an out-of-favor business (known in the law as a "specified service trade or business") and your taxable income is more than \$207,500 (single) or \$415,000 (married), your Section 199A deduction is easy to compute. It's zero.

### ***Big Picture: Who Is Out of Favor?***

This out-of-favor specified service trade or business group includes any trade or business<sup>1</sup>

- involving the performance of services in the fields of health, law, consulting, athletics, financial services, and brokerage services; or
- where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; or
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that involves the performance of services that consist of investing and investment management trading or dealing in securities, partnership interests, or commodities. For this purpose, a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (Sections 475(c)(2) and 475(e)(2), respectively).

As you can see from the above, the tax code is a little vague on the requirements for who is and who is not in an out-of-favor specified service business.

But now, thanks to new IRS proposed Section 199A regulations, we have some real clarity. Below, we first go through the clarifications for each of the above three groups one by one.

## ***Group 1: Certain Professions***

**Health.** The out-of-favor specified health service business means a business where individuals render services as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar health care professionals who provide medical services directly to a patient.<sup>2</sup>

The health group does *not* include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.<sup>3</sup>

**Law.** An out-of-favor specified service business in the field of law is a business where individuals perform services in their capacities as lawyers, paralegals, legal arbitrators, mediators, and similar professionals.<sup>4</sup>

The law group does *not* include services that do not require skills unique to the field of law, such as printers, delivery services, or stenography services.<sup>5</sup>

**Accounting.** The performance of services in the field of accounting means the rendering of services by individuals as accountants, enrolled agents, return preparers, financial auditors, and other similar professionals performing services in their capacity as such.<sup>6</sup>

**Actuarial Science.** The actuarial group means businesses where individuals provide services as actuaries and other similar professionals performing services in their capacity as such.<sup>7</sup>

**Performing Arts.** The performance of services in the field of the performing arts means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such.<sup>8</sup>

The performing arts group does *not* include services that don't require skills unique to the creation of performing arts, such as the maintenance and operation of performing arts facilities and services by people who broadcast or disseminate video or audio of performing arts to the public.<sup>9</sup>

The regulations don't provide any clarity on the "behind the scenes" performing arts professions, such as producers, screenwriters, composers, and others.

**Consulting.** In the field of consulting, the out-of-favor specified service business includes providing professional advice and counsel to clients to assist clients in achieving goals and solving problems, including government lobbying.<sup>10</sup>

The consulting group does *not* include services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses or consulting services embedded in or ancillary to the sale of goods or performance of services on behalf of a trade or business that is otherwise not an out-of-favor business (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.<sup>11</sup>

**Athletics.** The performance of services in the field of athletics means the performance of services by individuals who participate in athletic competition, such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing.<sup>12</sup>

The athletics group does *not* include services that don't require skills unique to athletic competition, such as the maintenance and operation of athletic events facilities and services by people who broadcast or disseminate video or audio of athletic events to the public.<sup>13</sup>

**Financial Services.** The performance of services in the field of financial services means the provision of financial services to clients, including managing wealth; advising clients with respect to finances; developing retirement plans; developing wealth transition plans; providing advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in Title 11 or similar cases); raising financial capital by underwriting; or acting as a client's agent in the issuance of securities and similar services.<sup>14</sup>

The financial services group includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals performing services in their capacity as such.

**Brokerage services.** The performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities for a commission or fee.<sup>15</sup> This includes services provided by stockbrokers and other similar professionals.

The out-of-favor brokerage group does *not* include real estate agents or brokers or insurance agents or brokers.<sup>16</sup>

## ***Group 2: Primary Asset Is Reputation and/or Skill***

You likely worried about the reputation and/or skill of owners and/or employees as an out-of-favor specified service business. If you were worried, you joined a large group of worried businesses, because many businesses depend on reputation and/or skill for success.

For example, the National Association of Realtors believed real estate agents fell into this out-of-favor category.

Don't worry, be happy. The IRS has come to the rescue by regulating the draconian reputation and/or skill provision down to almost nothing. The reputation and/or skill out-of-favor specified service business includes you if you<sup>17</sup>

- receive fees, compensation, or other income for endorsing products or services;
- license or receive fees, compensation, or other income for the use of your image, likeness, name, signature, voice, trademark, or any other symbols associated with your identity; or
- receive fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

**Example 1.** Greg owns 100 percent of Corp, an S corporation that operates a bicycle sales and repair business. Corp has eight employees, including Greg. Half of the business net income is from sales of new and used bicycles and related goods, and the other half is from bicycle repair services performed by Greg and his other employees.

Corp's assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Greg and the other employees have worked in the bicycle business for many years and have acquired substantial skill and reputation in the field. Customers often consult with Greg and the other employees on the best bicycle for purchase.

Corp qualifies as an "in-favor business." It is not an out-of-favor specified service business.<sup>18</sup>

**Example 2.** Harry is a well-known chef and the sole owner of multiple restaurants, each of which is a single-member LLC—disregarded tax entities that are taxed as proprietorships.

Due to Harry's skill and reputation as a chef, he receives an endorsement fee of \$500,000 for the use of his name on a line of cooking utensils and cookware.

Harry's restaurant business is not an out-of-favor business, but his endorsement fee is an out-of-favor specified service business.<sup>19</sup>

### ***Group 3: Investing, Trading, Dealing***

**Investment and investment management services.** The performance of services that consist of investing and investment management refers to an out-of-favor specified trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments.<sup>20</sup>

The performance of services of investing and investment management does not include directly managing real property.

**Trading in Securities, Commodities, and Partnership Interests.** To determine whether you are in an out-of-favor trade or business, you must factor in all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether you trade for your own account, for the account of others, or any combination.<sup>21</sup>

The out-of-favor trading business does not include engaging in hedging transactions as part of a trade or business in manufacturing or farming.<sup>22</sup>

**Dealing in Securities, Commodities, and Partnership Interests.** You are an out-of-favor business dealer if you regularly purchase securities, commodities, and/or partnership interests from customers and sell to customers or regularly offer to enter into, assume, offset, assign, or otherwise terminate positions in these instruments with customers.<sup>23</sup>

The out-of-favor dealer category does not include originating loans.<sup>24</sup>

## ***Multiple Business Lines***

If you have multiple business lines and one of your business lines is in the out-of-favor specified service business, you may have a reduced Section 199A deduction.

The proposed regulations provide three important rules you need to know.

**De Minimis Rule.** If your business has \$25 million or less in gross receipts and less than 10 percent of its gross receipts are from services that would make it out-of-favor, then it is 100 percent not an out-of-favor business.<sup>25</sup> With gross receipts of more than \$25 million, reduce the 10 percent to 5 percent.<sup>26</sup>

**Example 3.** An auto repair store owner occasionally does outside consultations with other mechanics, all through his LLC. The gross receipts from the consultations are only 2 percent of the gross receipts of the entire business. Therefore, none of the business is an out-of-favor business.

**Property or Services Provided Rule.** Your property or services business is out of favor if it provides 80 percent or more of its property or services to an out-of-favor business if there is 50 percent or more common ownership of the businesses.<sup>27</sup>

Also, if your business provides less than 80 percent of its property or services to an out-of-favor business and there is 50 percent or more common ownership of the businesses, then that portion of the business providing property or services to the 50 percent or more commonly owned out-of-favor business is out of favor.<sup>28</sup>

**Incidental Rule.** If your business has (a) 50 percent or more common ownership with an out-of-favor business and (b) shared expenses with that out-of-favor business, then it is 100 percent out of favor if the gross receipts of the business represent 5 percent or less of the total gross receipts of the two businesses.<sup>29</sup>

**Example 4.** A dermatologist provides medical services and sells skin care products through his LLC. The gross receipts of the skin care product sales are less than 5 percent of the total gross receipts of the business. Therefore, the skin care product sales are incidental to the medical services and are out of favor along with the medical services.<sup>30</sup>

## Takeaways

When lawmakers enacted new tax code Section 199A, they put what you now know of as specified service businesses into an out-of-favor group that denies those individuals who own specified services businesses the 20 percent deduction if their taxable income exceeds \$207,500 (single) or \$415,000 (married).

The original statute with its owner and/or employee reputation or skill read broadly could have applied the out-of-favor specified service business designation to almost any business. Thank goodness the IRS and its new Section 199A regulations made good sense out of what could have been a huge mess.

Now, with the new IRS regulations, you can more easily identify which businesses are in favor and which are not. You even have clarity if you perform services in the fields of health, law, consulting, athletics, financial services, or brokerage services.

Make sure you read the “don’t worry, be happy” section above that details how the new regulations define an out-of-favor business based on the reputation or skill of one or more employees or owners.

If your business involves the performance of services that consist of investing and investment management trading or dealing in securities, partnership interests, or commodities, you should examine this section of the article to see whether you are in favor or out of favor.

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1 IRC Section 199A(d)(2).

2 Prop. Reg. Section 1.199A-5(b)(2)(ii).

3 Ibid.

4 Prop. Reg. Section 1.199A-5(b)(2)(iii).

- 5 Ibid.
  - 6 Prop. Reg. Section 1.199A-5(b)(2)(iv).
  - 7 Prop. Reg. Section 1.199A-5(b)(2)(v).
  - 8 Prop. Reg. Section 1.199A-5(b)(2)(vi).
  - 9 Ibid.
  - 10 Prop. Reg. Section 1.199A-5(b)(2)(vii).
  - 11 Ibid.
  - 12 Prop. Reg. Section 1.199A-5(b)(2)(viii).
  - 13 Ibid.
  - 14 Prop. Reg. Section 1.199A-5(b)(2)(ix).
  - 15 Prop. Reg. Section 1.199A-5(b)(2)(x).
  - 16 Ibid.
  - 17 Prop. Reg. Section 1.199A-5(b)(2)(xiv).
  - 18 Prop. Reg. Section 1.199A-5(b)(3), Ex. 7.
  - 19 Prop. Reg. Section 1.199A-5(b)(3), Ex. 8.
  - 20 Prop. Reg. Section 1.199A-5(b)(2)(xi).
  - 21 Prop. Reg. Section 1.199A-5(b)(2)(xii).
  - 22 Ibid.
  - 23 Prop. Reg. Section 1.199A-5(b)(2)(xiii).
  - 24 Prop. Reg. Section 1.199A-5(b)(2)(xiii)(A).
  - 25 Prop. Reg. Section 1.199A-5(c)(1).
  - 26 Ibid.
  - 27 Prop. Reg. Section 1.199A-5(c)(2)(i).
  - 28 Prop. Reg. Section 1.199A-5(c)(2)(ii).
  - 29 Prop. Reg. Section 1.199A-5(c)(3)(i).
  - 30 Prop. Reg. Section 1.199A-5(c)(3)(ii).
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