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Tax Reform Alert: Aggregation

The recently proposed 199A regulations provide additional guidance regarding the Section 199A deduction and the limits based on wages and qualified property. One of the key provisions of the proposed regulations allows for the aggregation of multiple trades or businesses that are part of a larger, integrated business in regard to QBI, wages, and qualified property. The following is a summary of the new aggregation regime, including what circumstances allow trades or businesses to be aggregated, specific rules for applying such aggregations, and the impact the choice to aggregate will have on the Section 199A deduction.

Background

Section 199A allows for a deduction equal to 20% of Qualified Business Income (QBI). For taxpayers with taxable income over $315,000 (married) or $157,500 (single), the 20% deduction is limited based on the taxpayer's share of the W-2 wages paid by the business and/or the taxpayer's share of the business's unadjusted basis of qualified property. The general rule requires the deduction to be determined separately for each business entity based on the taxpayer's share of QBI, W-2 wages, and qualified property. In recognition that it is not uncommon for a single trade or business to be operated across multiple entities, the IRS has provided the ability for commonly controlled trades or businesses to be aggregated for purposes of determining the deduction. That is, individuals will be able to combine QBI, W-2 wages, and qualified property for aggregated trades or businesses when applying the limits and determining the Section 199A deduction. Because aggregation maximizes the deduction for taxpayers whose deduction may be limited, taxpayers who are under the $315,000/$157,500 taxable income threshold will not benefit from aggregation.

New Aggregation Test

The 199A regulations propose a new aggregation regime, distinctly separate from the aggregation rules under the passive activity loss rules. The IRS has designed the following tests to determine whether a group of trades or businesses may be aggregated. All six of the following requirements must be met:

1. Each of the aggregated trades or businesses must in itself be a trade or business as defined in the regulations. Self-rental properties are given an exception and are treated as a trade or business for Section 199A– see our Rental Real Estate Tax Alert article for more information.
2. The same person or group of persons must directly or indirectly own a majority interest in each of the businesses to be aggregated.
3. This "common control" must exist for a majority of the year.

4. Aggregated trades or businesses must be reported on returns with the same taxable year. Practically, this means fiscal year entities and calendar year entities cannot be aggregated.
5. None of the aggregated trades or businesses can be a Specified Service Trade or Business (SSTB).
6. The aggregated businesses must be part of a larger, integrated trade or business. To establish this, <u>two out of three of the following requirements must be met:</u>
    a. The businesses provide products and services that are the same (for example, a restaurant and a food truck) or that are customarily provided together (for example, a gas station and a car wash).
    b. The businesses share facilities or significant centralized business elements such as common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
    c. The businesses are operated in coordination with, or reliance upon, one or more other businesses in the aggregated group (for example, supply chain interdependencies).

Common Control

One of the requirements for aggregated businesses is that the same person or group of persons must directly or indirectly own a majority interest in each of the businesses to be aggregated. Practically, this means owning 50% or more of shares in an S corporation or 50% or more of the capital or profits in a partnership. Family attribution rules apply and includes spouses, children, grandchildren, & parents of an individual.

However, a "group of persons" can still benefit. An example in the regulations illustrates four unrelated persons who each own 25% in two companies. Assuming the other requirements are met, ownership is not a problem even though no one individual owns 50% or more, because they are a "group of persons."

It should also be noted that the taxpayer does not have to own more than 50% directly. As long as someone else does, this requirement is met, meaning minority shareholders may still aggregate.

Rules of Application and Disclosure

Aggregation is determined at the individual level. Any number of businesses that meet these tests may be aggregated, and individuals may have multiple aggregations. This is not an all-or-nothing rule, and taxpayers are not required to aggregate any or all eligible businesses. Instead, taxpayers may "slice and dice" different entities however they choose, as long as all entities in an aggregation meet the tests above. Different owners may choose to aggregate or not aggregate the same business in different ways.

Once a taxpayer aggregates businesses for Section 199A, the election is generally irrevocable. An aggregated trade or business must be aggregated consistently in future tax years, and taxpayers will be required to report which entities are being grouped together each year. Newly created or acquired businesses can be added to existing aggregations, but businesses cannot be removed. Because of the permanency of an aggregation once elected, it is crucial that taxpayers consider the tax effect of aggregation, not just in the current year, but in the years to come. The only way the IRS will allow aggregated businesses to be disaggregated is when the facts and circumstances change such that any of the aggregated trades or businesses no longer meet the above requirements to be aggregated.

When to Aggregate

In most cases, aggregating businesses for Section 199A will not hurt the taxpayer. As stated earlier, the general rule is each business stands on its own when applying the wage and qualifying property limits and calculating the Section 199A deduction. This would place some taxpayers in unfavorable positions. For example, an individual owning one business with high income and low W-2 wages and another with low income and high wages would get a limited deduction (due to not enough wages) in the first case but does not benefit from having higher wages in the second case. Aggregating the two businesses combines the W-2 wages and QBI together, which maximize the individual's available deduction.

One rare situation where aggregation would reduce possible Section 199A deduction is an individual owning one business with QBI and only W-2 wages and the other business with QBI and only qualified property. Because the two businesses are taking advantage of two different prongs of the limitation when not aggregated, the individual would get less deduction if they were combined.

Summary

The aggregation rules generally have very positive implications for taxpayers who have a single business operated across multiple entities. Aggregating can allow these owners to maximize their available Section 199A deduction. Due to the irrevocable nature of the decision to aggregate, taxpayers should think carefully about which businesses to aggregate together. Please contact our office to discuss your specific situation.