

# Guaranteed Payments Under IRC 199A Regulations: Year-End Strategies to Maximize QBI Benefits

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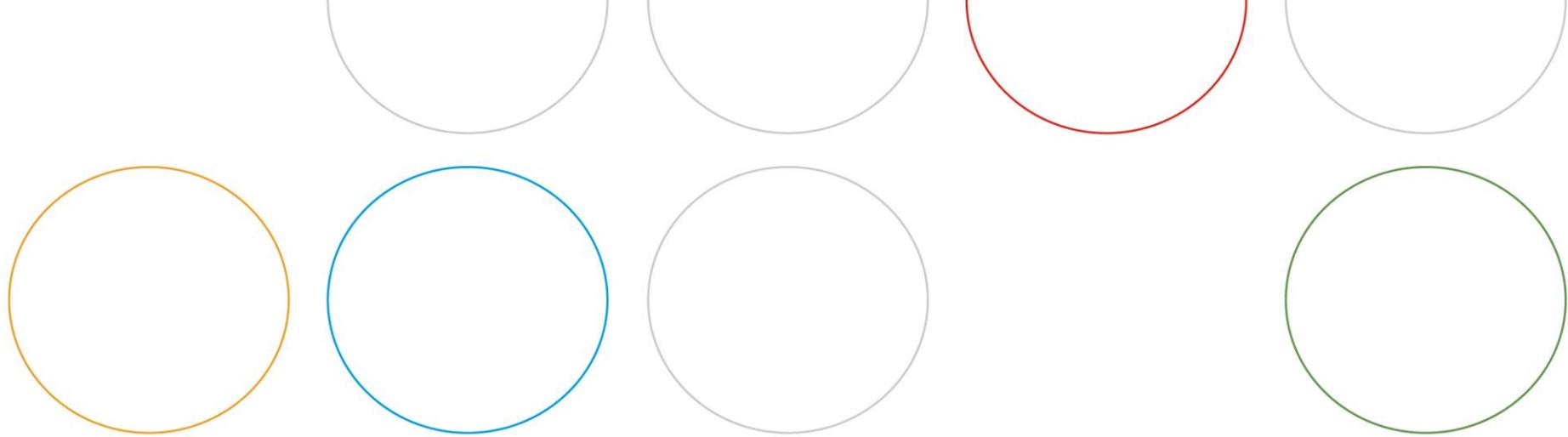
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# Guaranteed Payments Under IRC 199A Regulations: Year-End Strategies to Maximize QBI Benefits

Restructuring Section 707 Payments to Partners Through Priority Allocations, Using Lower  
Tier Partnerships

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# Topics Covered

- Overview of Section 199A and proposed regulations
- Structure of Section 707 payments
  - 707(a) provisions
  - 707(c) payments for services provided outside the scope of the role as a member
  - Tax treatment before enactment of 707(c)
- QBI W-2 wage limitations under Section 199A
- Proposed regulations and IRS position on the treatment of guaranteed payments for QBI calculation purposes
- Using priority allocations to compensate partners for capital or services outside the scope of his role as a partner
- Using lower-tier partnerships to pay W-2 wages to partner instead of guaranteed payments

# Passthrough Deduction - Overview

- “Passthrough” deduction for noncorporate taxpayers in Section 199A
  - 20% of combined qualified business income amount
  - 20% of qualified cooperative dividends
- Effective rate = 29.6% (i.e., 80% of 37%)
- Combined Qualified Business Income
  - Income from each qualified trade or business of the taxpayer (“QBI”)
  - Qualified REIT dividends
  - Qualified PTP income
- Noncorporate Taxpayers
  - Individuals
  - Trusts
  - Estates
- Sunset Provision
  - Deduction will not apply to tax years beginning after December 31, 2025



# Qualified Trade or Business

- Any trade or business other than:
  - A “specified service trade or business,” or
  - The trade or business of performing services as an employee.
- Specified Service Trade or Business
  - Performance of services described in Section 1202(e)(3)(A) (as modified under Section 199A):
    - Health, law, **engineering, architecture**, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. (See Proposed Regs for details).
  - Performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.
- Taxpayers with net income less than \$157,500 (or \$315,000 for joint filers) can take passthrough deduction even for specified service trades or businesses, with a phase-out for the passthrough deduction for specified service trades or businesses applying to taxpayers with net income between such threshold and \$207,500 (or \$415,000 for joint filers).
  - This limitation is applicable only to the QBI component of calculating the passthrough deduction.

# Specified Service Trade or Business – Principal Asset Test

- “. . . any trade or business where the **principal asset** of such trade or business is the **reputation or skill** of one or more of its employees or owners.”
- Though many commentators questioned the broad scope of this provision in Section 199A, regulations proposed thereunder have limited the scope significantly:
- The term any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners means any trade or business that consists of any of the following (or any combination thereof):
  - A trade or business in which a person receives fees, compensation, or other income for endorsing products or services,
  - A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, or
  - Receiving fees, compensation, or other income (including partnership interests or S Corp stock) for appearing at an event or on radio, television, or another media format.

# Qualified Business Income

- Net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business, that are:
  - Included or allowed in determining the taxpayer's taxable income, and
  - Effectively connected with the conduct of a trade or business within the United States.
- Excluded:
  - Most types of investment income:
    - Capital gain or loss
    - Dividends or dividend equivalents
    - Interest income (other than interest properly allocable to a trade or business)
    - Gain or loss from commodities and foreign currency transactions
    - Income from notional principal contracts
    - Annuity income
  - **"Reasonable compensation" and Section 707(a) and (c) payments.**

# Exclusion for Reasonable Compensation and Section 707 (a) and (c) Payments

- Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business.
  - Limited to S corporations, and applies even if the S Corporation fails to pay such reasonable compensation.
- Guaranteed payment described in Section 707(c) paid to a partner for services rendered with respect to the trade or business.
- Any payment described in Section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or a relevant passthrough entity, is not taken into account as QBI. However, the partnership's deduction for such payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.
  - To the extent an upper-tier relevant passthrough entity receives a Section 707(a) payment, that income should **not** constitute QBI to the partners of the upper-tier entity.

# REIT Dividends; PTP Income

- Qualified REIT dividend:
  - Any REIT dividend other than the portion that constitutes:
    - Capital gain dividend, or
    - Qualified dividend income.
- Qualified publicly traded partnership income:
  - Net amount of taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (generally, income that is not investment income) from a publicly traded partnership, plus
  - Any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain not treated as gain from the sale or exchange of a capital asset.

# Cap Based on Taxable Income

- Deduction is capped at 20% of the excess of the taxpayer's taxable income for the year over the taxpayer's net capital gain for the year.
- Applies to deduction for qualified business income, REIT dividends, and PTP income.

# Determined at Partner/Shareholder Level

- Partner or shareholder takes into account its allocable share of the partnership or S corporation's qualified items of income, gain, deduction, and loss.
- Partner or shareholder also takes into account its allocable share of the partnership or S corporation's W-2 wages and unadjusted basis in qualified property.
  - Allocable share of W-2 wages determined in the same manner as allocable share of wage expenses.
  - Allocable share of unadjusted basis in qualified property determined in same manner as allocable share of depreciation.
- For S corporation shareholders, an allocable share is the shareholder's pro rata share of an item.

# Taxable Income Computation; Loss Carryover

- Passthrough deduction allowed as a deduction reducing taxable income, not in computing adjusted gross income.
  - Thus, Section 199A does not affect limitations based on AGI.
- Deduction is available to both non-itemizers and itemizers.
- Loss Carryover
  - If the taxpayer's net amount of qualified income, gain, deduction, and loss with respect to its qualified trades or businesses for any taxable year is less than zero, such amount shall be treated as a loss from a qualified business in the succeeding taxable year.

# Guaranteed Payments: Overview

- General Rule of Section 707(a): if a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction is treated as occurring between the partnership and one who is not a partner.
- Section 707(c) recognizes two types of “guaranteed payments”:
  - (1) guaranteed payments for services, and
  - (2) guaranteed payments for the use of capital.
- Payments are “guaranteed” if they are first priority distributions and will be made even if they create a net loss for the partnership.
- Guaranteed payments that are not contingent are deemed to fall within the scope of Section 707(a).

# When Guaranteed Payments Are Used?

- Partners in a partnership are typically paid in two different ways:
  - Distributive share of partnership income or
  - Some minimum payment guaranteed to be made to each owner
- Partners who contribute capital to the partnership can receive preferred interest, which can be structured in different ways
  - If dependent on profits, such as a fixed % of partnership net income = allocations under section 704(b) when recognized and as distributions under section 731 when paid
  - If determined without regard to income of the partnership and are payable in all events = guaranteed payments under section 707(c) (if paid to a person acting in his capacity as a partner, rather than a third party, in which case they would fall under section 707(a))

# Tax Treatment of Payments for Services Prior to Enactment of Section 707(c)

- Before enactment of Section 707(c), courts had held that a partner could not be an employee of his own partnership.
- Compensation to a partner for services was treated as part of distributive share of partnership profits
  - If there was sufficient underlying partnership income to cover amounts paid as compensation—partner included the entire amount in income.
  - If partnership profits were insufficient to cover compensation payments, the amounts were treated as a return of capital.
  - If the recipient did not have sufficient basis to absorb the payment, the excess was treated as funded by the other partners, was taxable to the recipient, and entitled the other partners to deductions.
- Congress found that differing treatment to be “unrealistic and unnecessarily complicated,” which led to enactment of Section 707(c).

# Legislative History of Section 707(c)

- Confusing legislative history, but both the House and the Senate version provided that guaranteed payments should not be considered a distributive share
  - Unclear if the intent was for the rule to apply for all purposes of the Code or only for purposes of income inclusion and deduction
  - Significant uncertainty in the statute
  - Senate version of the provision was adopted, which is substantially similar to the current version of Section 707(c):
    - “To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of Section 61(a) (relating to gross income) and Section 162(a) (relating to trade or business expenses).”

# Tax Treatment of Guaranteed Payments To the Partnership and the Partner

- Tax treatment of guaranteed payments to the partner:
  - payments are ordinary income (question is whether payments for the use of capital should be treated as interest income)
  - partner is not considered an employee of the partnership for purposes of withholding taxes, FICA, deferred compensation plans and other employment tax provisions
  - must be included in taxable income for partner's tax year in which the partnership's tax year ended (and in which the partnership deducted such payments as paid or accrued according to its method of accounting)
- Tax treatment of guaranteed payments to the partnership:
  - payments are either deductible under Section 162 as ordinary or necessary business expenses or capitalized under Section 263

# What Is a Guaranteed Payment: IRS' and Court's View

- Section 707(c) has clear wording, but practical questions raise issues
  - Example: Partner A is entitled to 10% of partnership income but with a minimum distribution of \$10,000. If a partnership's income is \$100,000 for the year, the entire distribution is not a guaranteed payment. If a partnership's income is \$50,000 for the year, \$5,000 is a distributive share and \$5,000 is a guaranteed payment
- When is the payment made “without regard to the income of the partnership?”
  - Rev. Rul. 81-300: IRS broadly concluded that “guaranteed payments should not be limited to fixed amounts. A payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all facts and circumstances, the payment is compensation rather than a share of partnership profits.”
  - Court's view: In *Pratt v. Commissioner USTC*, 64 TC 203 (1975) the court considered whether payments based on gross rentals should be considered as payments based on income. The court concluded that since the payments were tied in some way to partnership income, they could not be considered guaranteed payments.

# Guaranteed Payments for Services and for Use of Capital

- Many partnerships structure “salary-equivalent” payments to partners as guaranteed payments, because partners cannot be employees of the partnership
- Payments for use of capital can also be structured as either guaranteed payments or priority allocation
- Guaranteed payments are severely disfavored in the QBI deduction context:
  - explicitly and completely excluded from QBI under Section 199A(c)(4)(B)
  - do not “count” for purposes of the limit because the IRS’s position is that compensation paid by a partnership to any of its partners can never be classified as W-2 wages.

# Guaranteed Payments vs. Net Income Allocations

- Guaranteed payments can be structured as net income allocations
  - Taxable to the service partners as ordinary income, subject to self-employment tax
  - Although not deductible, reduces ordinary income allocable to other partners
  - Unlike guaranteed payments, net income allocations could be eligible for 199A deduction
- Example:
  - A, B and C are partners in a services partnership, generating \$300,000 of income a year
    - A, B and C are each entitled to \$100,000 guaranteed payment = no 199A deduction
    - A, B and C are each entitled to 1/3 of the partnership's income and the partnership generates \$300,000 of net profits = 20% deduction can be available and each partner would pay tax only on \$80,000

# Treatment of Guaranteed Payments for Use of Capital Under Proposed Regulations

- August 16, 2018, the IRS published Proposed Regulations under Section 199A (“Proposed Regulations”)
- Guaranteed payment to a partner for use of capital is not QBI
  - If capital used by the partnership is cash, guaranteed payment is akin to interest payment
    - However, if the partnership made interest payments to a partner and the interest was allocable to the trade or business—could qualify as QBI
    - No similar ability to treat guaranteed payment as allocable to the trade or business
  - If capital contributed by the partner and used by the partnership is an asset other than cash (e.g., real estate), guaranteed payment could be akin to rental payments
    - Still not QBI
    - No policy reason why all guaranteed payments are excluded from QBI
- Deduction attributable to a guaranteed payment may reduce QBI of the partnership

# Treatment of Guaranteed Payments For Services Under Proposed Regulations

- Section 199A itself provided that guaranteed payments for services  $\neq$  QBI, not allowing for different interpretation in the Proposed Regulations
- However, treatment of such payments as not QBI is not mandated and gave IRS and Treasury authority to determine if payments are QBI
- Proposed Regulations provide that all guaranteed payments for services are not QBI
- Guaranteed payments do not “count” for purposes of the wage limitation because the IRS’s position is that compensation paid by a partnership to any of its partners can never be classified as W-2 wages.

# QBI W-2 wage limitations under Section 199A

- Form W-2 Wages are only necessary for *higher income taxpayers* in order to obtain the Section 199A 20% deduction
- Therefore, taxpayers with less than \$157,501 (single) or 315,001 (joint), on tax return do not need any W-2 wages to get the 20% deduction

<b>Total Taxable Income</b> (e.g. similar to Line 43 of 2016 Form 1040)	<b>Not exceeding threshold</b> Single: \$157,500 Joint: \$315,000	<b>Threshold plus Phase Out/In</b> Single: \$157,501-\$207,500 Joint: \$315,001-\$415,000	<b>Over Threshold</b> Single: \$207,501 Joint: \$415,001
Specified Service trade or business (e.g. accounting, law, consulting)	Full 20% Deduction No W-2 Limit applied	20% Deduction subject to phase-out, W-2 Limit phased in	No 20% Deduction at all permitted, so W-2 Limit irrelevant
Non-specified Service trade or business (e.g. rental)	Full 20% Deduction No W-2 Limit applied	20% Deduction subject to phase-in of W-2 Limit	20% Deduction permitted but fully subject to W-2 Limit

# Cap Based on Wages and Qualified Property

- Deductible amount for each qualified trade or business limited to the greater of:
  - 50% of the W-2 wages with respect to the qualified trade or business, or
  - The sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.
- W-2 Wages
  - Only includes wages properly allocable to qualified business income.
  - Must be properly included in a return filed with the Social Security Administration on or before the 60<sup>th</sup> day after the due date (including extensions) for such return.
- Qualified Property
  - Tangible property subject to depreciation under Section 167 that is (i) held by, and available for use in the qualified trade or business at the close of the taxable year, (ii) used at any point during the taxable year in the production of qualified business income, and (iii) the depreciable period for which has not ended before the close of the taxable year.
- ***Cap does not apply to REIT dividends or PTP income.***

# QBI W-2 wage limitations under Section 199A (cont'd)

- W-2 Wages must relate to the trade or business, including *aggregated* trade or business
- I.R.C. § 162 for determining whether a trade or business exists for purposes of I.R.C. § 199A.
- The Preamble to the Proposed Regulations acknowledges that it is common for what are thought of as single trades or businesses to be operated across multiple entities for various legal, economic or other non-tax reasons – thus aggregation is allowed but not required
- Specifically, for aggregation to apply, an individual must satisfy several requirements described in Prop. Reg. §1.199A-4(b)(1)(i)-(v), which reflect common ownership and indicia of a relatedness between the aggregated trades or businesses. Moreover, for taxpayers that choose to aggregate trades or businesses, the Proposed Regulations would require consistency in aggregation in subsequent years and include individual reporting/disclosure requirements
- Multiple owners need not aggregate in the same manner.

# QBI W-2 wage limitations under Section 199A (cont'd)

- Notice 2018-64 Provides Methods for Determining Wages – none are automatically available:
  1. *Unmodified box method.* Under the unmodified box method, W-2 wages are calculated by taking, without modification, the lesser of Box 1 and Box 5
  2. *Modified Box 1 method.* Under the Modified Box 1 method, the taxpayer makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the taxpayer. W-2 wages under this method are Box 1 of all Forms W-2, subtract amounts which are not wages for Federal income tax withholding purposes, eg supplemental unemployment compensation benefits; and add the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.
  3. *Tracking wages method.* Under the tracking wages method, the taxpayer actually tracks total wages subject to Federal income tax withholding and adds to the amount obtained after paragraph .03(B) of this section the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

# QBI W-2 wage limitations under Section 199A (cont'd)

- Other Form W-2 Guidance:
  - Proposed Regulations provide guidance on how to allocate Form W-2 wages to multiple owners – common sense approach
  - Form W-2 wages are remuneration paid only to common law employees including officers, but not statutory employees or independent contractors
  - Form W-2 wages must actually be reported to the SS administration, but the reporting can be that of a third party payor or PEO





# Guaranteed Payments Under IRC §199A:

## Priority Allocations and Lower-Tier Partnership Wages

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**December 3, 2018**

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# Terminology

- For brevity and because of the relative popularity of limited liability companies, these slides will often refer to LLCs, but such term should be understood to include general partnerships, limited partnerships, LLPs, LLLPs, and other entities that are taxed as partnerships for federal income tax purposes.
- Similarly, references to operating agreements also include partnership agreements, and references to members also include partners.

# Overview

- Using Priority Allocations
- Using Lower-Tier Partnerships to Pay W-2 Wages

# Stakes

- Under the §199A regulations, guaranteed payments pose several problems:
  - they are not treated as QBI;
  - they reduce a partnership's overall QBI; and
  - they are not treated as W-2 wages that could be used to increase the overall §199A deduction amount.
- We first consider whether a guaranteed payment can be restructured as an allocation and then consider whether a guaranteed payment can be restructured as a W-2 wage payment from a lower-tier entity.

# Priority Allocations

# Guaranteed Payments

- As noted, the §199A regulations taint all guaranteed payments.
- A “guaranteed payment” is a tax term first set out in IRC §707(c) and more fully defined in the regulations.
- Treas. Reg. §1.707-1(c): “Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership.”

# Guaranteed Payments

- In brief, a guaranteed payment is a payment by the partnership that is made without regard to the income of the partnership.
- Example 1: Newco agrees to pay its managing member \$1,000 a week. This is probably a guaranteed payment because it is an obligation that arises regardless of the partnership's income.
- Example 2: Newco agrees to pay its managing member the first \$1,000 of that week's profits. This is probably not a guaranteed payment because it depends on whether the LLC has profits.

# Guaranteed Payments

There are two helpful examples in the regulations:

Treas. Reg. §1.707-1(c), Ex. (1). Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of \$10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has \$50,000 ordinary income. A must include \$15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends (\$10,000 guaranteed payment plus \$5,000 distributive share).

# Guaranteed Payments

Treas. Reg. §1.707-1(c), Ex. (2). Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than \$10,000. The income of the partnership is \$60,000, and C is entitled to \$18,000 (30 percent of \$60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of \$20,000 instead of \$60,000, \$6,000 (30 percent of \$20,000) would be partner C's distributive share, and the remaining \$4,000 payable to C would be a guaranteed payment.

# Allocations

- These examples make clear that a regular allocation of income will not be treated as a guaranteed payment because allocations are completely dependent on partnership income.
- However, regular allocations pose business issues to both the guaranteed partner and to the rest of the partners.

# Allocations

- Example 1: Newco initially agreed to pay \$100 to Adam, the manager of Newco . Eve, the other member of Newco, and Adam agree instead to a pro rata 10% allocation to Adam.
- For the year, Newco has \$800 of income. Under the allocation approach, Adam gets \$80, rather than the \$100 he would have received as a guaranteed payment.
- Adam can treat the \$80 as QBI, but even on an after-tax basis he is probably worse off.
- Eve is better off – she has \$20 more in cash and all of her income is QBI.

# Allocations

- Example 2: Same facts, but Newco has \$1,200 of income.
- Under the allocation approach, Adam gets \$120, rather than the \$100 he would have received as a guaranteed payment.
- Adam can treat the \$120 as QBI and should be better off in all regards.
- Eve is worse off – she has \$20 less in cash as a result of agreeing to the allocation approach.

# Priority Allocations

- The key business risks of the allocation approach are that:
  - the service partner may receive less than under the guaranteed payment approach if partnership income goes down, and
  - the remaining partners may receive less if partnership income goes up.
- This risk may be eliminated if a priority allocation rather than a pro rata allocation is used.
- *(Note that these risks could be seen as advantages if you want to structure a system with high incentives!)*

# Priority Allocations

- Example 3: Same facts, but Adam and Eve agree to make a priority allocation to Adam of the first \$100 of income.
- Under this approach, Adam gets exactly the same amount as under the guaranteed payment approach so long as partnership income is at least \$100.
- Adam therefore does retain the risk that in a very bad year he will get less than he would with a guaranteed payment.
- In no event will Adam ever receive more than \$100, which eliminates Eve's risk.

# Priority Allocations

- There is little guidance on whether a priority allocation is treated as other than a guaranteed payment.
- As reproduced above, example (2) in Treas. Reg. §1.707-1(c) contains an allocation that appears to contain elements of a priority allocation, but also have a floor. The key language is “Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than \$10,000.”
- The regulations concludes that so long as the partnership has at least \$10,000 of income, this is not a guaranteed payment.

# Restructuring Partnership Agreements

- Assume that the decision is made to convert a guaranteed payment into a priority allocation.
- If the partnership agreement or operating agreement is amended to make the change in the following tax year, it seems clear that this will have effect in that subsequent period.
- But the more common question is whether you can make such a change retroactively.

# Restructuring Partnership Agreements

- IRC §761(c) appears to permit retroactive allocations under certain circumstances:
- “For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.”

# Retroactivity and Allocations

- Therefore, it seems possible that partnership agreements can be amended retroactively to convert a guaranteed payment into a priority allocation.
- Can a partnership wait until after the year is closed and then convert? That is, can a partnership wait until the year is closed and overall partnership income is known, and then amend the partnership agreement to give pro rata allocations to all service partners?
- This approach would eliminate much of the business risk (upside and downside) by waiting until after the close of the year.

# Retroactivity and Allocations

- It does not appear that IRC §761(c) will pose a barrier (provided the tax-return-filing-date deadline is satisfied), but there is an additional obstacle that could arise in this context.
- In particular, the “shifting” and “transitory” allocation rules under the substantial economic effect rules may create issues.

# Substantial Economic Effect

- The relevant §704(b) regulations state that the “economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account.”
- Treas. Reg. §1.704-1(b)(2)(iii)(a) (emphasis added).

# Substantial Economic Effect

- Under Treas. Reg. §1.704-1(b)(2)(iii)(b)(1), a shifting allocation can be disregarded if, among other things, “The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).”
- A similar test is set forth in Treas. Reg. §1.704-1(b)(2)(iii)(c) for so-called “transitory” allocations.

# Substantial Economic Effect

- The risk here is that a service partner whose guaranteed payment is converted into a priority allocation each year will have a lower tax liability that would be the case if the allocation were not made.
- There are at least two arguments that this should not be the case.

# Substantial Economic Effect

- First, converting a guaranteed payment into a priority allocation should not be viewed as a shifting or transitory allocation because it does not change the amount of income allocated to that partner in each year.
- Second, under both tests the regulations require scrutiny of the “interaction of the allocation with such partner's tax attributes that are unrelated to the partnership.” In this case the benefit to the service partner does not come from a tax attribute (such as an NOL or tax credit) but is solely a function of the disparate treatment of guaranteed payments and allocations under §199A.

# Substantial Economic Effect

- Even if a switch to a priority allocation from a guaranteed payment is treated as a shifting or transitory allocation, that is not fatal.
- Such treatment means that the allocation fails the substantial economic effect test.
- If a partnership arrangement lacks substantial economic effect, then the income of the partnership is required to be allocated to each partner in on the basis of each partner's interest in the partnership (the “PIP” test).

# Substantial Economic Effect

- There is no significant guidance on how to allocate income on a PIP basis. Most commentators suggest that first the terms of the partnership arrangement would have to be scrutinized.
- Under that approach, the argument would be that a priority allocation should be sustained because it represents a true economic arrangement.

# Payment as Lower Tier Wages

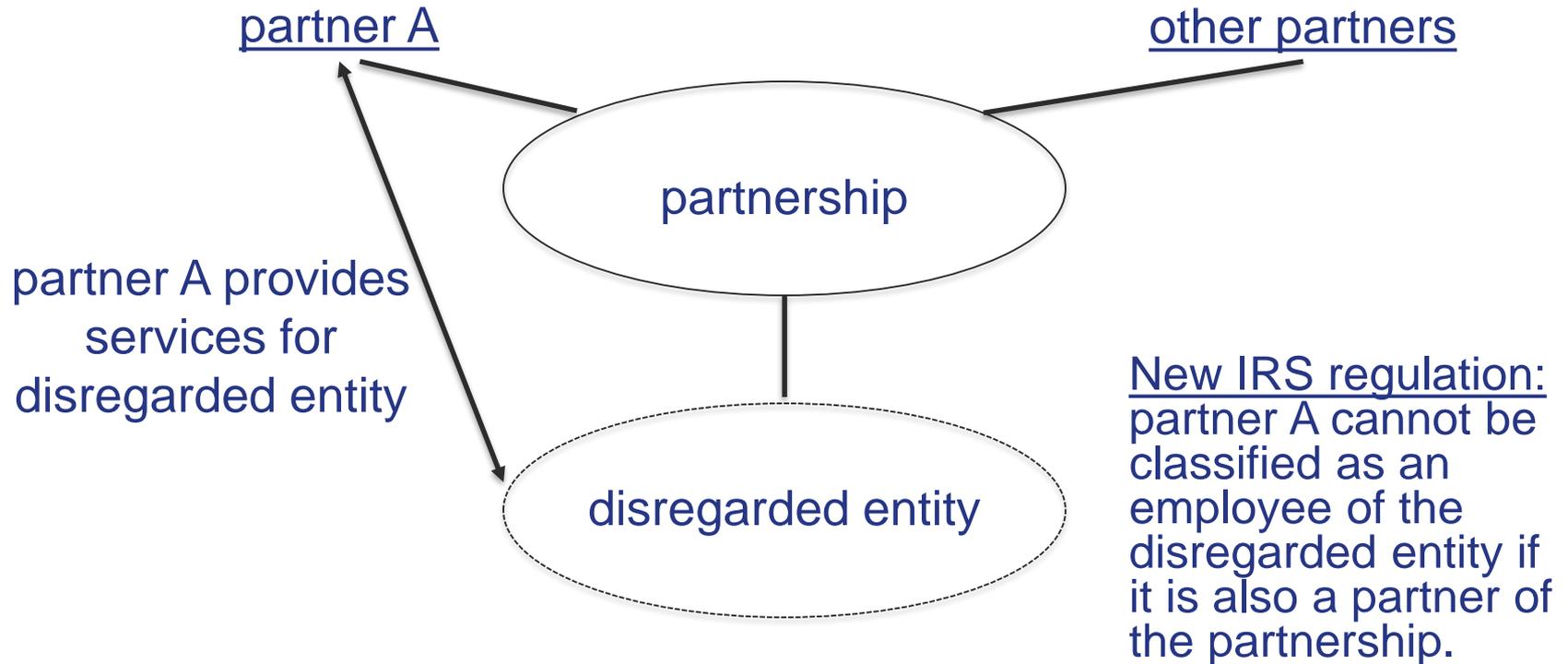
# Wages Characterization

- As noted, the §199A regulations do not treat guaranteed payments as wages for purposes of the W-2 wages limitation.
- Thus, amounts paid as guaranteed payments not only do not generate QBI for the recipient, they do not result in W-2 wages for the partnership and therefore cannot be used to increase the otherwise permitted §199A deduction.
- One alternative is to re-structure a guaranteed payment as an explicit salary. But can a partner also be an employee of the same entity?

# Employee/Partner Status

- Consistent with common law, the IRS takes the position that a partner in a partnership cannot be an employee of the same partnership. See, e.g., Rev. Rul. 69-184.
- In 2016, the IRS issued regulations that address the employment tax consequences of a partnership that in turn owns a disregarded entity (“DRE”).
- §301.7701-2T(c)(2)(iv)(C)(2) clarifies that an individual who is paid for services rendered to a DRE and is also a partner of the partnership that owns the DRE cannot be an employee of the DRE for employment tax purposes.

# Employee/Partner Status



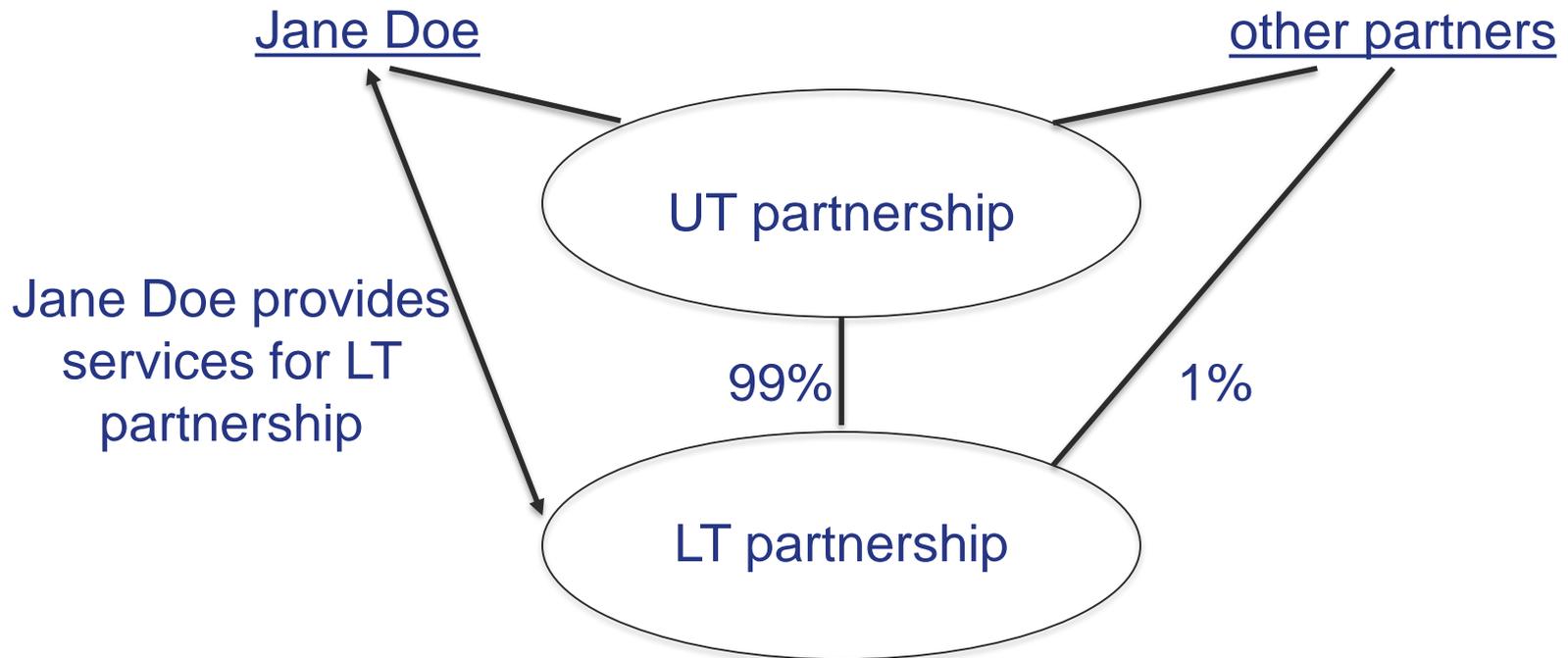
# Employee/Partner Status

- While this rule is logical given that a DRE is often ignored for tax purposes, what if a worker is a partner in a related but separate partnership?
- The IRS requested comments on this in the preamble to the new regulation: “The Treasury Department and the IRS request comments on the appropriate application of the principles of Rev. Rul. 69-184 to tiered partnership situations, the circumstances in which it may be appropriate to permit partners to also be employees of the partnership, and the impact on employee benefit plans (including, but not limited to, qualified retirement plans, health and welfare plans, and fringe benefit plans) and on employment taxes if Rev. Rul. 69-184 were to be modified to permit partners to also be employees in certain circumstances.”

# Lower Tier Partnerships

- This appears to raise the possibility that a partner could be an employee of a lower tier partnership.
- If this is possible, presumably the W-2 wages paid at the lower tier partnership would count for purposes of the wages limitation within §199A.

# Lower Tier Partnership Wages



# Lower Tier Partnership Wages

- Assume Jane Doe is a partner in the UT partnership (“Parent”) and has no direct ownership interest in the LT partnership (“Sub”). Assume further that she provides services for Sub.
- Should Jane be classified as a W-2 employee of Sub?
- If we look through the entities, Jane clearly has a beneficial interest in Sub. The IRS could argue that by analogy to Rev. Rul. 69-184 her payment from services rendered to Sub should be treated as self-employment earnings rather than W-2 wages.
- Conversely, should Jane be treated as a W-2 employee of Sub? She is strictly speaking not a partner of Sub so Rev. Rul. 69-184 should not apply by its terms.

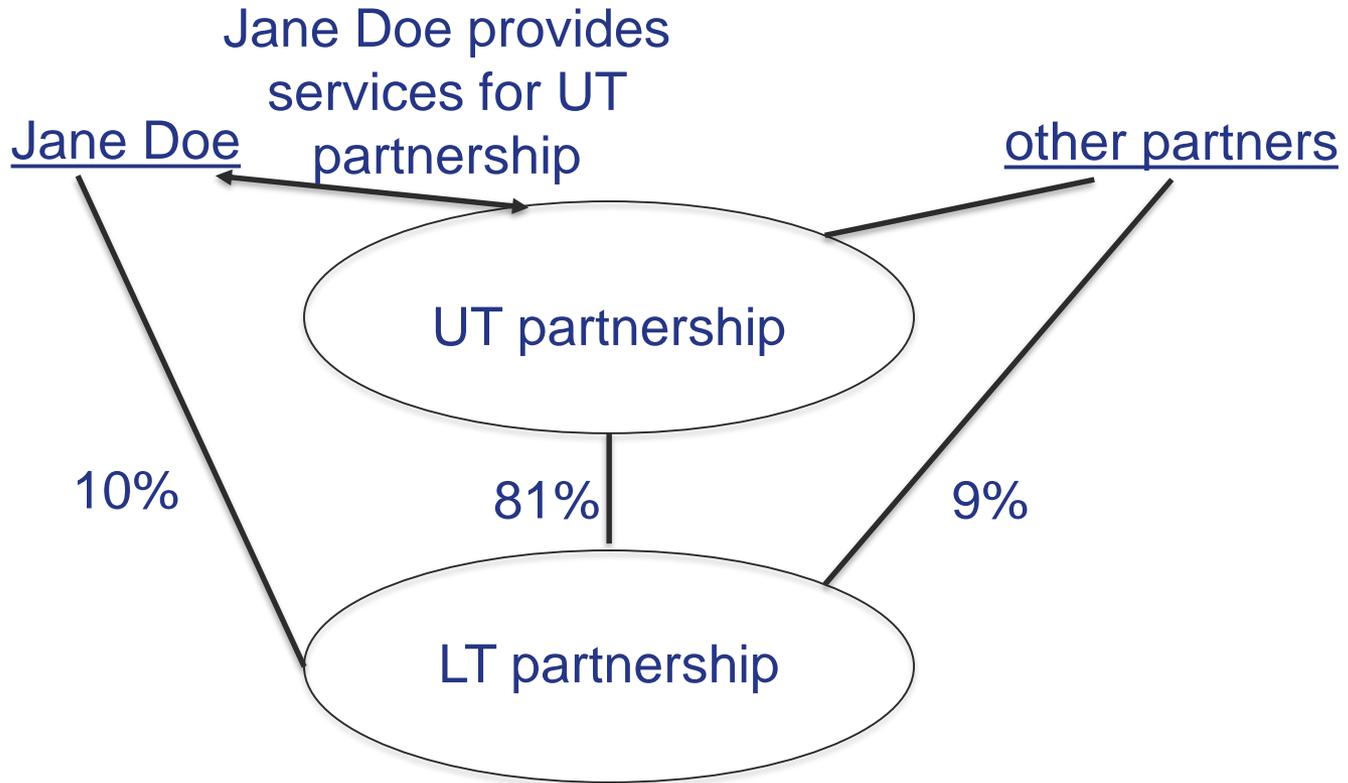
# Lower Tier Partnership Wages

- Because the IRS has specifically requested comments on this arrangement, it would seem likely that there is at least a return position that Jane Doe can be a W-2 employee of Sub.
- In that case, Jane will receive a fixed payment from Sub. Although this will not qualify as QBI, any guaranteed payment that she received from Sub or Parent would also not qualify as QBI.
- Presumably, however, Jane's W-2 wages from Sub can be counted towards the §199A deduction for Jane and the rest of Parent's partners.

# Upper Tier Partnerships

- The previous slides consider whether a partner can be a W-2 employee of a lower tier partnership.
- Can a partner of a lower tier partnership be a W-2 employee of an upper-tier partnership?

# Upper Tier Partnership Wages



# Upper Tier Partnership Wages

- Now assume Jane Doe is a partner in LT partnership (“Sub”). Sub is majority owned by UT partnership (“Parent”). Assume further that Jane provides services to Parent.
- Should Jane be classified as a W-2 employee of Parent?
- Jane clearly has a direct interest in Sub, but no direct or indirect interest in Parent, which is the entity for which she provides services. Therefore Rev. Rul. 69-184 would not seem to apply, even by analogy.

# Upper Tier Partnership Wages

- If Jane is treated as a W-2 employee of Parent, then Jane will receive a fixed payment from Parent. Although this will not qualify as QBI, any guaranteed payment that she received from Sub or Parent would also not qualify as QBI.
- Presumably, however, Jane's W-2 wages from Parent can be counted towards the §199A deduction for Parent's partners. It will have no effect on Jane's §199A deduction (if any) because that is computed at the Sub level.
- Note that this design may raises issues about whether Jane is appropriately incentivized.

# Allocable Wages Issue

- Throughout these examples we have assumed that if Jane was paid as a W-2 employee by an entity that the underlying services were properly allocated to that entity.
- In fact, if the services are simply paid through one entity but are more properly treated as for the benefit of an entity in which Jane is a partner, then the IRS may have an additional argument for disallowing W-2 treatment.
- Accordingly, in either variation there should be a good business reason for the arrangements or the IRS may be able to re-characterize them.

# Partner/W-2 Modification

- The mischaracterization of partnership income as W-2 wages is very common.
- In some cases, it does not result in significant tax consequences because W-2 wages would incur withholding taxes at least as high as what would be borne by a partnership allocation.
- This is often the case for service partnerships where all partnership income is subject to SE taxes.
- Can a partnership re-characterize partnership income as lower-tier W-2 wages after the fact?

# Partner/W-2 Modification

- This poses a challenge because the proposed regulations have fairly strict rules on what qualifies as W-2 wages and in many cases it would require contemporaneous reporting of the payments as W-2 wages along with the making of contemporaneous withholding payments.
- Re-characterizing distributions made to a partner over the course of a year after the fact as W-2 wages would be difficult to square with the requirement to report and withhold on such payments as W-2 wages.

# Partner/W-2 Modification

- While retroactive modification may be problematic, the same issue would not be present in the case of a modification that only has effect going forward.

# Thanks!

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