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WRNewswire: ***The 199A Deduction Series***

Impact of Final Treasury Department Section 199A Regulations on Availability of Passthrough Deduction for Life Insurance Professionals

Favorable results for commission-based life insurance sales

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With the disclaimer that this piece is not intended to be considered "advice,"[1] the purpose of this memo is to review the outcome of the recently released final Treasury Regulations issued under section 199A ("**Final 199A Regulations**") with respect to life insurance professionals. In short, I am pleased to report that the additional guidance provided by the Treasury Department ("**Treasury**") as to the application of the 20 percent deduction under section 199A for qualified business income ("**Section 199A Deduction**") in the context of the commission-based sale of an insurance policy ("**Insurance Sales**") is a very favorable outcome for life insurance professionals who are either owners of a life insurance business or independent contractors for a life insurance business, and in most ways addresses the industry's concerns. As will be illustrated in examples below, the tax savings of this provision could be very significant for insurance business owners or contractors engaged in Insurance Sales.

By way of background refresher on section 199A, in relevant part the provision allows a business owner or independent contractor (employees of a business are not eligible for the deduction) to take up to a 20 percent deduction for such owner's or contractor's net qualified business income ("**QBI**"). Net QBI is determined by taking into account all of the items of income and deduction with respect to a "qualified trade or business." If a business is not a qualified trade or business, an owner or independent contractor cannot take any deduction. If a business is qualified, an owner's or independent contractor's deduction may be limited by a cap based upon a fraction of the owner's or contractor's share of wages paid by the business (or in some cases, fraction of the share of wages paid plus the share of tax basis of property used in the business).[2]

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[1] **Note**: this memorandum is not intended to constitute tax or legal advice. Persons seeking tax or legal advice with respect to any aspect of section 199A of the Internal Revenue Code and the Treasury Regulations and other guidance promulgated thereunder should consult their own legal and/or tax advisors.

[2] There are obviously other factors that could limit a life insurance professional's Section 199A Deduction, such as the amount of "W-2 wages" that the professional pays, or the value of such professional's unadjusted tax basis in his or her business property. This so-called "wages cap" applies to taxpayers whose income exceeds the phaseout,

Except for business owners or independent contractors whose combined household taxable income is below the cut off for a phased-out threshold ($415,000 for joint-filing taxpayers in 2018), one requirement for a business to be treated as a qualified trade or business is that such business is not considered a "specified services trade or business" ("**SSTB**"). The statute defines an SSTB to be any one of several listed types of businesses, based upon the services such businesses provide.

Since section 199A was enacted, the life insurance industry has in particular been concerned that Treasury guidance with respect to the provision would treat the sale of life insurance as the performance of a SSTB, thereby making the Section 199A Deduction unavailable for life insurance business owners or independent contractors whose taxable income exceeds the threshold phaseout. More specifically, the industry was concerned that the sale of life insurance could be considered the provision of "financial services," "brokerage services," or "investing" or "investment management." In significant part, the Final 199A Regulations address these concerns.

Definition of Financial Services

In relevant part, the Final 199A Regulations do not change the definition of a financial services SSTB that was proposed in the initial Treasury Regulations proposed with respect to the Section 199A Deduction ("**Proposed 199A Regulations**"). Importantly, however, several aspects of Treasury's explanations of the Final 199A Regulations—known as the "Preamble" to these regulations—clarify the meaning of a financial services SSTB in a way that is very favorable to life insurance professionals. As some have noted, the Preamble's reference to the fact that the provision of services with respect to the "commission-based sale of an insurance policy will generally not be considered the provision of financial services" is of course very positive. However, an important aspect of what the Preamble actually says is lost in this generalized description. Specifically, the Preamble notes that:

The Treasury Department and the IRS decline to categorically exclude services provided by insurance agents from the definition of financial services as financial services such as managing wealth, advising clients with respect to finances, and the provision of advisory and other similar services that can be provided by insurance agents. However, the Treasury Department and the IRS note that the provision of these services **to the extent that they are ancillary** to the commission-based sale of an insurance policy will generally not be considered the provision of financial services for purposes of section 199A. (emphasis added)

Among many observations that could be made about this guidance, there are two that are very important. First, the lack of a "categorical" exclusion for insurance agents from being considered to be engaged in the provision of financial services is a red herring. Just as with respect to the determination of whether a specific trade or business exists, the question of what "type" of business exists is intensely factual. Treasury declined as part of the Final 199A Regulations to create a categorical description of what constitutes the conduct of a "trade or business," noting that this was a question of fact. It is thereby not at all surprising that Treasury

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and can significantly reduce the value of the deduction. One of the examples highlighted in this memo includes facts that necessitate a review of this wage cap.

likewise declined to categorically define insurance agents as not providing (or even as providing) financial services. At the margins, this will always be a question of fact and not law.

Second, as I emphasized in the excerpt above, a most important insight Treasury made in the Preamble is that where the provision of financial-type services that could be considered financial services—*e.g.*, managing wealth, advising clients with respect to finances, etc.—is "ancillary" to Insurance Sales, the provision of such services will generally not be considered the undertaking of a financial services SSTB. The reference to the word ancillary is a key distinction. As we have previously noted, the Proposed 199A Regulations included (and the Final 199A Regulations retain) a rule with respect to consulting services that specifies that consulting services that are "embedded in, or ancillary to" a sale of goods or services do not cause an activity to be a consulting services SSTB provided that there is no separate payment for the services. Thus, the refence in the Preamble to the Final 199A Regulations to "ancillary" financial-type services provided in the course of conducting Insurance Sales relates to this concept,[3] and clarifies how financial-type services are to be analyzed in this context. To the extent such services are ancillary to or embedded in an Insurance Sale, they generally do not create a financial services SSTB.

There is a further important observation to make about the guidance Treasury provided in the Final 199A Regulations with respect to the definition of a financial services SSTB. Per the Preamble:

One commenter stated that the determination that banking is not a financial service appears to be wrong and inconsistent with statutory construction since any common definition of financial services includes banking services. As stated in the preamble to the proposed regulations, banking is listed in section 1202(e)(3)(B) but not section 1202(e)(3)(A). As a matter of statutory construction, the Treasury Department and the IRS believe that banking must therefore be excluded from the definition of financial services for purposes of section 199A. **Another commenter suggested that insurance should be categorically excluded from the meaning of financial services because insurance is described in section 1202(e)(3)(B). The Treasury Department and the IRS agree that by operation of section 1202(e)(3)(B), insurance cannot be considered a financial service for purposes of section 199A**.

As noted in the excerpt, the basis for the discussion above is a public comment Treasury received that "banking" should be included in the definition of financial services for purposes of the Final 199A Regulations. The Proposed 199A Regulations had not so provided, and the preamble guidance with respect to the Proposed 199A Regulations made it clear that financial services did not include "banking" in the traditional sense of "taking deposits or making loans." The Preamble to the Final 199A Regulations addresses criticism with respect to this decision by observing that the rules of "statutory construction"—*i.e.*, interpreting statutes—require ("must") the conclusion that "banking" is not the one of the "financial services" because of the fact that it is listed separately in another part of section 1202(e)(3).

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[3] It is important to note that this is not the same as extending the ancillary or embedded services exception to the definition of financial services SSTBs. Recall that the ancillary or embedded services exception requires that no separate payment be given for the ancillary or embedded services in order for the rule to apply. In contrast, the incorporation of the "ancillary services" concept with respect to determining whether insurance professionals are engaged in the provision of financial services does not include the formal restriction that there be no separate payment for the ancillary services. Thus, in a sense this application of the concept is more favorable for insurance professionals than had the rule simply been extended.

Importantly for life insurance professionals, the Preamble then notes that this same argument would also apply to "insurance," which Treasury notes "cannot be considered a financial service for purposes of section 199A." Thus, so long as a life insurance professional only provides "insurance" services, he or she is not engaged in a financial services SSTB. Though the Final 199A Regulations do not define what "insurance" services are, a reasonable definition would include those customarily provided by insurance professionals. In addition to the Preamble's further guidance with respect to a financial services trade or business, the Final 199A Regulations broadly retain the so-called "de minimis" exception to SSTB status. In relevant part, this rule stipulates that where a trade or business has gross receipts equal to or less than $25 million, the business is not considered an SSTB so long as less than 10 percent of such gross receipts are attributable to the performance of services in SSTB fields. When viewed in conjunction with the helpful guidance regarding those ancillary financial services provided in the course of Insurance Sales, as well as the *de minimis* rule, the guidance clarifying that "insurance" does not constitute a financial services SSTB helps provide comfort that it would likely be a rare set of facts for a life insurance professional to be found to be engaged in the performance of financial services.

A clear upshot of this conclusion is that the additional guidance provided by Treasury in the Final 199A Regulations has essentially addressed all of the industry's concerns with respect to the possibility that life insurance professionals would be considered to be engaged in financial services SSTBs.

Definition of Brokerage Services

As we have previously noted, the Proposed 199A Regulations already provided guidance that defined brokerage services to include services provided in arranging transactions between a buyer and seller with respect to securities for a commission or fee, not to include "insurance" agents or brokers. While helpful, this guidance did not clarify that Treasury understood the rule's reference to "securities" to only refer to those products that are treated as securities under <u>all</u> of the rules of Internal Revenue Code Section 475. This is relevant because Treasury Regulations provide that <u>life insurance</u> products are not considered "securities" for purposes of section 475, notwithstanding the fact that some life insurance products can be considered a security for some federal or state securities law purposes.

The Preamble to the Final 199A Regulations sheds further light on this matter, and in a way that is helpful to the life insurance industry. The Preamble specifically notes that:

Another commenter suggested that final regulations clarify that life insurance products are not securities for purposes of section 199A or that life insurance brokers engaged in their capacity as such are not brokers in securities for purposes of section 199A…**The final regulations define securities by reference to section 475(c)(2)**. (emphasis added)

The highlighted statement provides helpful guidance to life insurance professionals because it affirms that for purposes of determining whether "life insurance" products are considered "securities" one must look to section 475. By induction, this confirms that the exclusion of life insurance products under Treasury Regulations issued with respect to section 475 applies for purposes of identifying whether a life insurance product is a "security" for purposes of this rule.

As a result of the Final 199A Regulations, there should be no doubt that life insurance products are not considered securities for purposes of section 199A.

Definition of Investing or Investment Management

The Final 199A Regulations favorably help clarify whether life insurance professionals could be seen as being engaged in an "investment management" SSTB. The industry had some concerns about this possibility because the term "investment" was not defined for purposes of the rule, and thereby could conceivably include life insurance products. On this point, the Preamble notes that:

Another commenter suggested that final regulations clarify that investing and investment management does not include the sale of life insurance products and that life insurance products are not investments for purposes of section 199A. The Treasury Department and the IRS decline to define investment for purposes of section 199A but note that commission-based sales of insurance policies generally will not be considered the performance of services in the field of investing and investing management for purposes of section 199A.

This guidance helpfully confirms that Insurance Sales will generally not be considered "investing" or "investment management. In addition, the guidance clarifies that Treasury's unwillingness to define the term "investment" to not include life insurance products does not relate to any concern that such products are considered an "investment." As noted above, the general rule is that they are not. Rather, the guidance indicates that Treasury and the IRS hesitate to define the meaning of the term investment for any purposes of section 199A. Viewed through this lens, the outcome for life insurance professionals is relatively quite favorable, as life insurance products are one of the only products with some investment-like features that Treasury explicitly confirms will generally not be treated as an investment for purposes of the Section 199A Deduction.

Examples of How the Section 199A Deduction Could Apply

The following two examples illustrate how the Section 199A deduction could apply to two hypothetical life insurance professionals. Unless otherwise specified, the hypothetical assumes that all compensation for the sale of life insurance products is commission-based.

<u>Example 1</u>

Facts: B, a life insurance agent, is an independent agent who maintains a small office, but primarily works out of his home. Rather than employ a secretary directly he utilizes a vendor that provides such services for a fee. He does not directly employ any other person in his business. Assume that the unadjusted basis of all qualified property that he utilizes in his business is only $3,500, and that his business has $25,000 in various deductions. B sells a variety of life insurance and annuity products.

As part of selling these products, B will review a potential client's finances and financial goals and risk tolerance in order to understand what types of products to offer a client. B will always fully disclose the information and financial projections with respect to a life insurance product he recommends, but may or may not provide a client or potential client a copy of the household financial projections he makes assuming a base case as well as a scenario where the client

acquires one or more life insurance or annuity products. B makes $175,000 in commissions in 2018. B files jointly with his spouse, who earns $75,000.

Result: B may take a $30,000 deduction on his 2018 federal tax return with respect to his life insurance business, calculated by multiplying B's net income from his trade or business ($150,000) by twenty percent. B's taxable income (not factoring in the impact of the Section 199A Deduction) is less than the phaseout threshold for married joint-filers. This means that regardless of whether his business is an SSTB, he is eligible for the deduction, and further, that his Section 199A Deduction is not limited by the so-called "wage cap." Based upon B's income level, and assuming an average state tax rate of 5 percent, B's actual tax savings[4] from the Section 199A Deduction would be $8,700.[5]

Example 2

Facts: C is also an independent life insurance agent. C has no material amount of tax basis in property used in C's life insurance business, and also no wages. C works entirely from a home office, and has deductions attributable to her life insurance business of $10,000. C earns $325,000 in commissions, and no other income, and files jointly with her spouse. C's household income is equal to the income she earns from the business. C provides a variety of advice to her clients with respect to household finances, wealth and legacy planning, and other investments that the client can make. C will occasionally assist clients with acquiring non-insurance investments, and if she is compensated for it, receives only commissions. C's clients consider her advice with respect to their personal finances and wealth and legacy planning an indispensable part of the services they receive from her.

Result: C may take a deduction of $63,000 on her 2018 federal tax return, calculated by multiplying C's net income, $315,000, by twenty percent. Notwithstanding the fact that C may be providing specified services to her clients, her taxable income is equal to the threshold amount, and all of her income is QBI. Likewise, she is not subject to the wage cap. Based upon C's income level, and assuming an average state tax rate of 5 percent, C's actual tax savings[6] from the Section 199A Deduction would be $18,270.[7]

Example 3

Facts: P is a member of a life insurance group that specializes in helping businesses design and implement life insurance programs. The group is structured as a partnership, and employs a variety of staff—in addition to having 10 owner-members of the group. P's allocable share of group income is $1.175 million, and she also is allocated $175,000 of expenses, including $125,000 of compensation expenses that are treated as W-2 wages for purposes of the Section 199A Deduction.

Assume that P's allocable share of the unadjusted basis of all qualified property used in the business is only $15,000. In the course of P's services to her business clients, she will routinely

[4] In other words, the marginal after-tax value of B's deduction, assuming no other deductions.
[5] Calculated as $30,000 x (.24 [federal rate, not including NIIT/Medicare Surtax] + .05 [state rate, assuming capped state tax deduction]).
[6] In other words, the marginal after-tax value of C's deduction, assuming no other deductions.
[7] Calculated as $63,000 x (.24 [federal rate, not including NIIT/Medicare Surtax] + .05 [state rate, assuming capped state tax deduction]).

review a client's books and financial projections, a client's compensation arrangements (including amongst members of the client, in the case of passthrough businesses), and benefits plans, and will make recommendations to the client with respect to various life insurance products that fit the client's needs. As part of making such recommendations, P will routinely prepare detailed models and projections based upon the client's financial data, as well as publicly-available (e.g., stock market indices) and proprietary data sources. P will share these models and projections with the client, and will prepare regular reports on the performance of various categories of insurance products that P has recommended the client to acquire. Once a client determines to acquire products and/or implement a plan, P will coordinate the acquisition of the products with the respective life insurance carrier(s) and will make recommendations for legal and tax professionals who can assist the client with undertaking various steps with respect to the plan. P receives no direct compensation for any of these services.

Result: P may take a $65,000 deduction with respect to her insurance business. Assuming she is eligible to claim the deduction, P's tentative maximum deduction would be $200,000, which is equal to her $1,000,000 in net business income multiplied by twenty percent.

P's overall eligibility for the Section 199A Deduction turns on whether she is seen to be engaged in an SSTB. As a preliminary matter, she is engaged in an insurance business, which is not a listed category of SSTB. However, P does provide clients various financial-type services, as well as helping to manage a client's portfolio of life insurance and annuity products, some of which have at least some investment-like characteristics. She also helps broker transactions between her clients and the carriers who originate these products.

P is not engaged in a brokerage SSTB because the Final 199A Regulations are clear that life insurance products do not constitute securities, and further because insurance professionals are excluded from being otherwise engaged in brokerage services.

P is also not engaged in an investment management SSTB. The Final 199A Regulations clarify that the commission-based sale of life insurance products will generally not be considered investing or investment management, and there are no facts here that suggest an alternative result is warranted.

Furthermore, P is not engaged in a financial services SSTB. The Final 199A Regulations clarify that the commission-based sale of insurance products will generally not give rise to a financial services SSTB. It is likely that P's services would be considered "ancillary" to her commission-based sale of products. Even if this was not the case, P would likely qualify for the de minimis exception to SSTB status, no small part because it does not appear that any percent of P's gross receipts are attributable to financial services (let alone the 10 percent that would apply in her case).

Since the SSTB rules do not prevent P from taking the deduction, the next consideration is to calculate the actual deduction. In P's case, she is subject to the wage cap (*i.e.*, because her taxable income far exceeds the phaseout amount) meaning her deduction is the lesser of twenty

percent of $1,000,000, or $200,000, or fifty percent of $125,000, or $62,500.[8] Thus, notwithstanding the general rules, P can only deduct $62,500.

Based upon P's income level, and assuming an average state tax rate of 5 percent, P's actual tax savings[9] from the Section 199A Deduction would be $29,770.[10]

Example 4

Facts: G is a member of an insurance business, E. E largely sells life insurance products that are designed to assist clients with wealth transfer, legacy planning, and asset protection. In addition, E offers clients a service of creating estate plans, for which it charges a separate fee. E will retain various outside experts as necessary in order to provide clients with a complete estate plan, and will often, but not always, sell one or more life insurance products to the client as part of enacting such plan. E's total gross receipts for the year are $6.2 million, of which $750,000 are fees collected from creating client estate plans (and the rest commissions from the sale of insurance products). E incurs $1.2 million of expenses for the year, of which $800,000 are compensation to various employees of E. G's share of E's $5 million of net income is $600,000 (of which $75,000 are client fees), and G's share of E's expenses is $170,000, of which $145,000 are employee compensation.

Result: G is not entitled to any Section 199A Deduction for the taxable year. Of E's gross receipts, 12 percent[11] are clearly attributable to E's wealth planning services. As such, E is engaged in more than a de minimis amount of listed specified services, and E is an SSTB. Since G's taxable income will clearly exceed the income cutoff, all of the income G is allocated from E is ineligible to be QBI. Had E not conducted such services,[12] or had the value of such services been below the *de minimis* cutoff, E would have been able to fully claim the Section 199A Deduction.[13]

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[8] P could elect to apply the alternative cap rule. However, the amount of the cap would be even lower in such case, namely, 25 percent of $125,000 (i.e., $31,250) plus 2.5 percent of $15,000, or $31,625. As a rational person, P would not make the election, but would utilize the basis cap rules—which have a higher cap.

[9] In other words, the marginal after-tax value of P's deduction, assuming no other deductions.

[10] Calculated as $65,000 x (.408 [federal rate, including NIIT/Medicare Surtax] + .05 [state rate, assuming capped state tax deduction]).

[11] $750,000 divided by $6,200,000.

[12] The Final 199A Regulations broadly retain the various "anti-abuse" rules provided for in the Proposed 199A Regulations, including a restriction on attempts to separate SSTB businesses from non-SSTB businesses (sometimes referred to in the press as the "crack and pack" or "slice and dice" strategies).

[13] In such case, G would have had $525,000 of gross income and $170,000 of expenses, for $355,000 of net income. G would also have had $145,000 of wage expenses, fifty percent of which is $72,500. Thus, since this amount is greater than G's tentative maximum deduction of $71,000, G would be able to fully claim the deduction.