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TOPIC: The Small Business Tax Deduction: Impact of Proposed Section 199A Regulations on Life Insurance Businesses

The Treasury Department and IRS recently released proposed regulations regarding the 20% tax deduction for income earned by owners of passthrough businesses that was enacted in the Tax Cuts and Jobs Act of 2017 (TCJA). The proposed guidance regarding the provisions of section 199A of the tax code is lengthy and complex, and there are still a number of questions about the types of businesses that give rise to income that qualifies for the passthrough deduction, including the applicability of the deduction to income earned by businesses involved in the sale of life insurance products. As currently proposed, these regulations could potentially prevent many life insurance businesses from taking advantage of the 20% deduction.

AALU submitted comments on the proposed section 199A regulations, including a request for clarity around several critical issues detailed below. AALU believes that the business of selling life insurance products should fully qualify for the passthrough deduction, a point we reinforced in our comments. However, several categories of businesses that give rise to income that does not qualify for the deduction likely involve activities that a large number of our members participate in, such as "financial services" and "investment management." Depending on how the final section 199A regulations modify the proposed section 199A regulations, the deduction may ultimately apply to some life insurance businesses, but both its current and likely ultimate application to diversified life insurance practices offering financial, retirement, or investment services is unclear.

Before making any decisions about your business or with your clients related to this deduction, you should carefully review the rules and their application to the individual circumstance of each business with a tax professional.

We will keep you informed as more information or additional analysis becomes available.

The Quick Read: Section 199A 20% Passthrough Deduction

- **All passthrough filers under the $157,000 (single) /$315,000 (married joint filer) threshold qualify for the full 20% deduction, regardless of the type of business.**
- **Phaseouts begin thereafter and extend the thresholds to $207,500 (single filer) or $415,000 (married joint filer).**
- **While AALU believes that the business of selling life insurance products is an activity that should qualify for the full deduction, the application of the deduction to owners of diversified life insurance practices offering financial, retirement, or investment services and whose income is above the phaseout cap is unclear.**
- **Where a life insurance business owner's taxable income is above those thresholds outlined above, he or she must thoroughly evaluate their business with respect to the statutory text and proposed regulatory guidance on SSTBs (defined below) and should consult with a tax professional.**

The Tax Cuts and Jobs Act of 2017 – Deduction for Passthrough Entities

The TCJA enacted a new 20% income tax deduction for income earned by owners of passthrough entities and sole proprietorships, with a number of requirements and limitations. Importantly, for owners of personal services businesses structured as passthroughs—including all life insurance professionals—the full 20% deduction is available where the owner's taxable income is under $157,500 (single filer) or $315,000 (joint filer). In some cases, as described in more detail below, the deduction is then phased out over the next $50,000 in taxable income for single filers and $100,000 in taxable income for joint filers, with the benefit completely phased out once the taxable income exceeds $207,500 (single filer) or $415,000 (married joint filer). **All owners of passthrough businesses whose taxable income is under the $157,000/$315,000 threshold qualify for the full 20% deduction, regardless of the type of business.**

For owners of businesses whose taxable income is above those thresholds, the deduction is generally **not** allowed with respect to income earned by passthroughs and small proprietorships engaged in certain types of businesses, denominated in the statute as "specified services trades or businesses" (**SSTBs**). These generally ineligible types of businesses are defined in the statute as those engaged in any of the following fields: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset is the reputation or skill of one or more of its employees. However, the section 199A statute does not actually provide any detail about how to identify an SSTB. There are a number of other limitations and exclusions with respect to the deduction, including what qualifies as income for the purposes this deduction. For more details on the provisions of the passthrough deduction, see our WR Marketplace {12.20.17 – hyperlink}.

Specified Services Trades or Businesses (SSTBs)

The proposed Treasury regulations with respect to the passthrough business deduction provide a lot of detail missing from the statue, but a number of key questions remain.

As noted above, the TCJA lists thirteen categories of trades or businesses that are treated as SSTBs, and income with respect to these categories of businesses is ineligible for the deduction where the owner's taxable income exceeds the $207,000/$415,000 limit. The proposed Treasury regulations follow the statute in identifying the thirteen categories of SSTBs.[1]

In contrast to the vagueness of the statute, the proposed regulations provide a number of rules with respect to identifying SSTBs. The focus of these rules is on the **actual performance** of the listed specified services by the business in question, **not** the manner by which that business is compensated for its performance.

There is a de minimis exemption from being treated as an SSTB for businesses that only perform a small amount of SSTB activity. For businesses with $25 million or less in gross receipts, the exemption applies where less than 10% of gross receipts are "attributable to" SSTB activities. For businesses with over $25 million in gross receipts, the exemption applies where less than 5% of gross receipts are attributable to SSTB activities. There is also an exception from a business being treated as a consulting services SSTB where the business provides consulting services that are embedded in non-SSTB activities and which aren't billed separately, though this exception does not currently extend to other categories of SSTB activities.

Thus, outside of these limited exceptions, if a business provides any of the listed specified services in any category of a listed SSTB, the business is considered an SSTB regardless of how its compensated.

[1] Prop. Treas. Reg. sec. 1.199A-5(b)(1).

The rules go into some detail as to what activities constitute the provision of various listed specified services,[2] and provide examples,[3] but the guidance is not clear about all factual scenarios; and in all likelihood never can be. The use of general descriptions and non-exclusive lists makes it particularly challenging to know with certainty whether any particular business fits within a listed SSTB category.[4] For example, the proposed rules sometimes describe a non-exclusive list of tradespersons acting in their capacity "as such."[5]

The specific facts and circumstances of each business will play a large role in determining whether a business is considered to be engaging in SSTB activities. Therefore, great care should be taken by business owners to ensure they understand the array of services a business may conduct with respect to a particular listed SSTB category. Further, a business cannot rely on generalizations based upon broad categories to determine whether it will be treated as an SSTB, but must examine all of the facts relevant to its business.

SSTB Categories Related to Life Insurance

The TCJA identifies thirteen categories of businesses whose income would not generally qualify for the 20% passthrough deduction, and "life insurance" was not one of those categories. AALU believes that Congress intended the selling of life insurance products to fully qualify for the passthrough deduction.

However, we know that many of our members offer their clients a wide array of products of services to meet their retirement security or other needs, and it unclear how all such services will be treated in regard to the income from such a business qualifying for the 20% deduction. In particular, financial services and investment management are two categories of business identified in the TCJA as being generally not eligible for the passthrough deduction, both of which could involve a large number of our members' businesses depending on how the final regulation shakes out.

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[2] Prop. Treas. Reg. sec. 1.199A-5(b)(2).

[3] Prop. Treas. Reg. sec. 1.199A-5(b)(3).

[4] For example, the IRS could always challenge the propriety of an owner's section 199A deduction by alleging that the trade or business he or she undertakes is makes him or her a "similar professional" as with respect to a particular listed SSTB category. The phrase "similar" is imprecise and allows for differing viewpoints as to whether a trade or business fits into a category, suggesting that it many cases taxpayers and the IRS might ultimately disagree as to whether trades or businesses of a particular listed SSTB category are being undertaken. In turn, this increases the likelihood that in at least some cases the rules will not be fully determined until courts interpret the meaning (and boundaries) of the term "similar."

[5] *See, e.g.*, Prop. Treas. Reg. sec. 1.199A-5(b)(2)(ii) (describing the performance of services in the field of "health" as the provision of "medical" services by individuals "such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar "healthcare professionals" performing services in their "capacity as such").

As we explain in our comment letter, AALU believes that providing insurance products that meet the retirement savings needs of clients and incidental professional financial advice as part of selling beneficial products are activities that should not disqualify our members from receiving the full deduction, and we ask the Treasury and IRS for this clarification. However, it is ultimately unclear how the final regulations will treat these activities (and other relevant activities), and the deduction may not be available for a number of businesses.

Specifically, out of the thirteen categories of SSTB businesses, there are five types of specified services that could result in an insurance business being treated as an SSTB. Specifically, those categories are:

- Consulting
- Brokerage Services
- Actuarial Science
- Financial Services
- Investing and Investment Management

Consulting Services

It is unlikely that many (or potentially any) AALU members will be treated as being engaged in consulting services, because there is a limited exception that applies solely to the provision of consulting services.

The proposed rules provide that the performance of listed specified consulting services involves the "provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems."[6] This broad rule would seem to be potentially applicable to at least some insurance businesses conducted by AALU members. However, the rule explains that consulting services do not include the performance of services other than advice and counsel, including sales or training.[7] Whether a business is engaged in consulting or sales or economically similar services is determined based upon all of the facts of a particular business.[8]

Further, the rule provides a limited exception for consulting services, the "**Ancillary of Embedded Services Rule**." It clarifies that "the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a business that is otherwise not an SSTB" is not the provision of specified consulting services so long as "no separate payment [is provided] for the consulting services."[9] Thus, a business can perform consulting services that are "embedded in" or "ancillary

[6] Prop. Treas. Reg. sec. 1.199A-5(b)(2)(vii).
[7] *Id.*
[8] *Id.*
[9] *Id.*

to" sales or other non-specified services so long as it is not specifically and separately paid for the embedded consulting services.[10]

As currently proposed, the Ancillary or Embedded Services Rule does not apply to any other category of listed specified services. However, the reasoning behind the rule's application to consulting services, namely, that the de minimis rule may not provide sufficient relief in certain instances, applies equally well to any other category of listed specified services.

In our comment letter requesting a broad application of the Ancillary or Embedded Services Rule, we explain that applying the exemption more broadly does not violate the purposes of section 199A's SSTB restriction. We further explain that requiring businesses to prove out what income is attributable to specified services that are never separately sold or paid for is a nearly impossible task that will be perilous for taxpayers to apply, and a time-consuming challenge for the IRS to administer.

Brokerage Services

Brokerage services is another category that may not apply to many AALU members. The proposed rule stipulates that the provision of brokerage services:

> *[I]ncludes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals,* ***but does not include services provided by real estate agents and brokers, or insurance agents and brokers.***[11]

While the reference to "insurance agents and brokers" is not clarified,[12] many AALU members would likely be able to meet any coherent definition of the term.

However, one key question revolves around brokerage services with respect to securities. As proposed, the rules are not clear on the overlap between an "insurance" broker and a "securities" broker.

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[10] But for this rule, there is a potential argument that the section 199A regulations could be read to implicitly provide a general exception for "embedded" specified services performed by a trade or business that otherwise does not provide listed specified services. Utilizing the cannons of statutory (and regulatory) construction, however, the existence of a specific rule that makes this concept explicit as with respect to consulting services strongly belies the possibility that the concept is generally implicit with respect to other listed specified services. *See, e.g.*, *United States v. Granderson*, 511 U.S. 39, 65 (1994) (finding that certain text of a statute could not be read to implicitly include a concept where other, related text provided for the concept explicitly); *Adams Fruit Co. v. Barrett*, 494 U.S. 638, 644-45 (1990) (finding an argument resting on an allegedly implicit meaning that contravenes explicit language to be "extraordinary and unjustified").

[11] Prop. Treas. Reg. sec. 1.199A-5(b)(2)(X).

[12] On this point, the Preamble simply restates the section 199A regulations' proposed rule. *See* 83 Fed. Reg. 40,884, 40,898 (Aug. 16, 2018).

It is unclear how the proposed rules would apply for AALU members who are engaged in selling life insurance and also selling other "securities"—whether more traditional stock and bonds or variable life insurance or annuity products. AALU asked Treasury to clarify that insurance products are not treated as "securities" for purposes of the definition of specified brokerage services.

Actuarial Science

The proposed rules around actuarial sciences is fairly straightforward, and it is unlikely to apply to many AALU members. However, businesses that employ or otherwise engage actuaries in some capacity should carefully review the rules around this category with a tax professional.

Investing and Investment Management

This category has the potential to include a large number of AALU members, depending on the composition of the final regulations. The proposed guidance defines investing and investment management is as:

> *[A] 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. The performance of services of investing and investment management does not include directly managing real property.*[13]

The Preamble to the section 199A regulations elaborates that this category of listed specified services involves:

> *[A] trade or business that earns fees for investment, asset management services, or investment management services including providing advice with respect to buying and selling investments.*[14]

The rules also clarify that the fees for such services could be any combination of commissions, flat fees, or fees calculated as a percentage of assets under management.[15]

Whether a business is treated as being engaged in investing and investment management services is a function of whether such member "provides advice with respect to buying and selling investments" or a similar activity. While more traditional "insurance" businesses are less likely to be considered to be so engaged, it is possible that insurance businesses that also recommend other types of "investments" (including

[13] Prop. Treas. Reg. sec. 1.199A-5(b)(2)(xi).
[14] 83 Fed. Reg. at 40,900.
[15] *Id.*

variable or annuity products) may be considered to be engaged in such services. Neither the TCJA or the proposed guidance define "investment," creating significant uncertainty as to whether or not certain products typically sold by "insurance" businesses (e.g., high cash-value whole life policies, endowment contracts, variable products, annuities) are considered "investments."[16]

AALU submitted comments asking Treasury to clarify that an insurance product is not considered an "investment" for purposes of this rule, consistent with the broker-dealer exclusion for the sale of insurance products. We also asked that the final guidance clarify that such agents and brokers selling insurance products are not treated as being engaged in investment or investment management services.

Financial Services

Another category that AALU members should pay close attention to is financial services, defined as:

> *[T]he provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals performing services in their capacity as such.*[17]

This broad category could include a number of services that relate to our members' businesses, including "developing retirement plans," "developing wealth transition plans," "the provision of advisory and other similar services regarding…mergers, acquisitions, dispositions," acting as a "financial advisor" for clients, acting as a "wealth planner" for clients, acting as a "retirement advisor" for clients, or performing any number of "similar" services.

If Treasury does not extend the Embedded or Ancillary Services Rule to financial services as requested by AALU, an AALU member that holds itself out as providing "wealth planning" or "retirement advice" services could very well be engaged in financial services regardless of whether it is directly paid for such services, or merely receives commissions from selling insurance.[18]

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[16] As noted above, certain insurance products are generally considered "securities" for purposes of section 475 and its regulations (but do not give rise to "dealer" status because of an explicit exception in the applicable regulations). If such products can be "securities," it is at least conceivable that they would be considered "investments" by some.
[17] Prop. Treas. Reg. sec. 1.199A-5(b)(2)(ix).
[18] *See, e.g.*, *infra* note 10 and accompanying text.

Additional Key Provisions

Reputation and Skill Category:

One positive for the life insurance profession is the narrow definition of a "reputation or skill." There was serious concern that this category would apply to a broad array of businesses that have an owner or employee whose reputation is somehow important to the business. Despite such fears, the proposed guidance narrowly construe the phrase "any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners."[19] Businesses where the reputation of an owner or employee is important, but not the business itself, will not be treated as a reputation or skill listed SSTB.

De Minimis **Exceptions:**

As noted above, there is a "de minimis" exception from the SSTB rules. A business with gross receipts of $25 million or less does not qualify as an SSTB if less than 10% of the gross receipts are "attributable to" listed specified services.[20] For businesses with gross receipts of more than $25 million, a business is not an SSTB if less than 5% of the gross receipts are "attributable to" listed specified services.[21] Unfortunately, the guidance describing the exceptions does not precisely define what term "attributable to" means:

> *Although the statute, read literally, does not suggest that a certain quantum of specified service activity is necessary to find an SSTB, the Treasury Department and the IRS believe that requiring all taxpayers to evaluate and quantify any amount of specified service activity would create administrative complexity and undue burdens for both taxpayers and the IRS. Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.*[22]

The rules further note that these *de minimis* exceptions are the two primary exceptions applicable to circumstances where "very small amounts of SSTB activity" could otherwise cause a business to be treated as an SSTB.

The uncertain application of the *de minimis* rules in situations where it is not obvious what services (*i.e.*, listed specified services or non-listed services) a particular payment

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[19] *See* sec. 199A(d)(2)(A) (insert "employees or owners" where "employees" appears in section 1202(e)(3)(A)); sec. 1202(e)(3)(A).
[20] Prop. Treas. Reg. sec. 1.199A-5(c)(1)(i).
[21] Prop. Treas. Reg. sec. 1.199A-5(c)(1)(ii).
[22] 83 Fed. Reg. at 40,896.

is "attributable to" would create a significant burden for taxpayers relying on the exceptions. A further problem with the *de minimis* rules is that proving out the exception would be time-consuming, costly, and risky for the particular taxpayer, as well as challenging for the IRS to administer in a uniform and efficient manner—even if the application of the rule was crystal clear. We explained the issues around the *de minimis* exception in our comment letter.

Anti-Abuse Rules

There are three important anti-abuse rules in the proposed guidance that apply to the SSTB rules:[23]

- Any business that provides 80% or more of its property or services to an SSTB whose ownership is 50% or more in common with it (including direct and indirect ownership[24]) is itself considered an SSTB even if none of the services it provides involve the provision of listed specified services.[25]
- Where a business provides less than 80% or more of its property or services to an SSTB but there is 50% or more common ownership between the two businesses, a proportionate amount of the otherwise non-SSTB business that provides property or services to the SSTB business is treated as being part of the SSTB business, and is ineligible for the deduction.[26]
- If an otherwise non-SSTB business has 50% or more common ownership with an SSTB, and has shared expenses with the SSTB, such as wages or overhead, then such business is treated as "incidental" to the SSTB, and therefore part of the SSTB, where its gross receipts are 5% or less of sum of its gross receipts plus the gross receipts of the SSTB.[27]

The purpose of these three anti-abuse rules is quite clear: Treasury was concerned about circumstances where taxpayers would take businesses engaged in some listed specified services and some non-listed services, and formally separate out the listed specified services while retaining common ownership of the businesses. This strategy has been referred to as "crack and pack."

Importantly, in order to be eligible for the section 199A deduction, it may be necessary for some businesses to economically separate themselves from parts of their businesses that conduct listed specified services (*i.e.*, to sell or otherwise transfer to unrelated parties aspects of a business involving the performance of listed specified activities) in order for the "core" business to be eligible for the 20 percent deduction. So long as

[23] Prop. Treas. Reg. sec. 1.199A-5(c)(2)-(3).
[24] The proposed rule uses the rules with respect to common ownership found in section 267(b) and/or 707(b)). *See* Prop. Treas. Reg. sec. 1.199A-5(c)(2)(iii).
[25] Prop. Treas. Reg. sec. 1.199A-5(c)(2)(i).
[26] Prop. Treas. Reg. sec. 1.199A-5(c)(2)(i)(ii).
[27] Prop. Treas. Reg. sec. 1.199A-5(c)(3)(i).

such transfer was a bona fide transfer of ownership to an unrelated party, the anti-abuse rules are unlikely to apply.

Conclusion

The section 199A guidance proposed by Treasury and IRS is unclear in a number of key respects. AALU has provided comments, along with industry partners, and will update members as more details become available.

Before making any decisions about your business or with your clients related to this deduction, you should carefully review the rules and their application to the individual circumstance with of each business a tax professional.

We will keep you informed as more information or additional analysis becomes available.