199A Planning Strategies Put Spotlight on Foreign-Source Income

by Eric Yauch

One focus since the release of the final passthrough deduction regulations is how to structure operations so what may have been foreign-source income can qualify for the new provision.

The IRS and Treasury's antiavoidance rules halt the "crack-and-pack" planning strategy of spinning off real estate from specified service trades or businesses (SSTBs) to take advantage of the 20 percent deduction. However, Adam Kool of Kirkland & Ellis LLP pointed out that there are no analogous rules to address planning by taxpayers with foreign-source income.

"The anti-'crack-and-pack' rules in Treasury reg. section 1.199A-5(c)(2) could have been extended to apply to both SSTBs and non-U.S. trades or businesses, but the final regulations clearly limit the application of these rules to SSTBs," Kool told *Tax Notes*.

That was an interesting decision on the government's part, Kool said. "Taxpayers with non-U.S. trades or businesses face very similar incentives under section 199A compared to taxpayers who are engaged in SSTBs, but the final regulations much more forcefully attack planning with respect to SSTBs," he said.

In fact, that was something Congress had hoped for in enacting the 20 percent passthrough deduction in section 199A, Kool said, calling it "a core policy goal behind the deduction and incentivizing onshore investment and business activity."

> ***Kool said the text of section 199A and the final regulations are fairly clear that the deduction is permitted for effectively connected income.***

The 20 percent deduction was created by the Tax Cuts and Jobs Act and applies to business owners up to specific income thresholds, above which some SSTBs can't use the deduction. The ones that can are limited by wages paid to employees and basis in property. SSTBs that can't use the income deduction include health professionals, lawyers, and financial services.

The deduction applies to qualified business income, which doesn't include W-2 wages earned as an employee for guaranteed payments received for services. It also only applies to income effectively connected with a U.S. trade or business. Kool said the text of section 199A and the final regulations (T.D. 9847) released January 18 are fairly clear that the deduction is permitted for effectively connected income.

"Generally speaking, compensation for labor or personal services performed in the U.S. will meet this standard, whereas compensation for labor or personal services performed outside of the U.S. will not satisfy this standard," Kool said. "Taxpayers wishing to maximize their section 199A deduction have an incentive to convert non-U.S.-source service income into U.S.-source service income."

Not 'One Size Fits All'

Casey S. August of Morgan, Lewis & Bockius LLP said the incentive for individual qualifying business owners shouldn't be uniform, principally because causing otherwise foreign-source income to become ECI removes any foreign tax credit benefit associated with that income. "For example, an owner could be in an excess foreign tax credit position, and freeing up the tax credits with additional foreign-source income may provide a greater benefit than the additional [section 199A] deduction associated with that income," August said.

Jordan D. August of Carlton Fields PA told *Tax Notes* that he didn't anticipate wholesale changes being made to the business operating structures of owners who could benefit from additional ECI to support section 199A benefits, in part because the provision sunsets in 2026.

It's foreseeable that businesses will plan for the section 199A benefit on the margins, where the changes don't materially affect operations, Jordan August noted. "For example, a services business could provide additional services in the United States rather than a foreign country to source the associated income in the U.S," he said. "Also, for the sale of inventory property not produced by the business, the location of the sale could be moved from a foreign country to the United States to have the income sourced to the U.S."

Sourcing Rules Matter

Shari Forman of PwC recently highlighted the importance of disregarded entities (DRE) when it comes to foreign-source income planning. "The final regulations actually clarified that the trade or business of a DRE is deemed to be conducted directly by its owners," Forman said during a webcast hosted by her firm February 12. "That means that that entity is disregarded, but it can still be a separate trade or business."

Forman said that in the general federal income tax context, that means intercompany transactions are disregarded, but now the question becomes whether those items should be reallocated based on the trade or business concepts. "The thing we've been kicking around is whether that really matters," Forman said. "If I have intercompany transactions and I reallocate those to my separate trade or business DREs, does that change the sourcing and the outcome?"

For example, if a U.S. manufacturing company produces goods and sells them to a foreign subsidiary that is a DRE, which then sells the goods to a third party, the intercompany sale will be eliminated. The sale to the third party is likely ECI that could qualify for section 199A because the manufacturing is performed in the United States under new sourcing rules, Forman said.

By contrast, assume a foreign manufacturer structured as a DRE sells products to the U.S. parent company, which sells the product to third parties. "Again, I've eliminated that [intercompany] transaction, so when I'm analyzing from an ECI perspective what the sourcing is, I look to the manufacturing of those goods, and in this case it's foreign," Forman said. "So that entire transaction becomes foreign-sourced and non-ECI."

Forman said practitioners have been trying to figure out whether that outcome changes if the taxpayer takes those activities and allocates them to separate trades or businesses. Based on informal conversations with the government, ECI would be determined first and separately from section 199A considerations.

George Manousos of PwC said that it's important to look outside section 199A in making ECI determinations. ■