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# HOW TRADERS, HEDGE FUNDS, AND INVESTMENT MANAGERS CAN QUALIFY FOR THE NEW 20% QBI DEDUCTION

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# Robert Green’s content

- Mr. Green is a leading authority on trader tax.

- He is the author of Green’s 2018 Trader Tax Guide, which GreenTraderTax published as an annual tax guide every year since 1997. The 2018 edition discusses the Tax Cuts and Jobs Act’s impact on investors, traders, and investment managers.

- Mr. Green has been a contributor to Forbes.com since 2010. Leading brokerage firms and other financial media feature Mr. Green's blog posts and Webinar content.

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# Webinar description

- The IRS released proposed reliance regulations (Proposed §1.199A) for the 2017 Tax Cuts and Jobs Act's new 20% deduction on qualified business income (QBI) in pass-through entities.

- Join trader tax expert Robert A. Green, CPA, of GreenTraderTax.com as he shows traders, hedge funds and investment managers how they can qualify for this lucrative tax cut.

# 20% QBI DEDUCTION

Section 199A is complicated: There are several limitations, thresholds, and income caps for service businesses, including trading, hedge funds, and investment management.

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# 20% QBI deduction in pass throughs

- An individual taxpayer may deduct whichever is lower: either 20% of qualified business income (QBI) from pass-through qualified trades or businesses or 20% of their taxable income minus net capital gains, subject to other limitations, too.
- Example: Assume you have QBI of $100,00. You might get a QBI deduction up to $20,000, even though you did not spend any money related to this deduction.
- It's not a business expense, AGI deduction or itemized deduction. It's a deduction from taxable income.

# Some traders and hedge funds might qualify

- Traders and hedge funds, eligible for trader tax status, are service businesses (SSTBs).
- Trading QBI *likely* includes Section 475 ordinary income on securities trades. QBI excludes capital gains, dividends, interest, commodities and forex transactions, and more.
- If the taxpayer does not exceed taxable income caps for an SSTB, they might get a 20% QBI deduction.
- The QBI deduction and calculation are done at the owner level, not on the entity level.

# Investment managers qualify

- Investment managers are a service business (SSTB).
- QBI includes advisory fees from U.S. clients.
- QBI *likely* includes carried interest of Section 475 ordinary income on securities trades allocated from hedge funds.
- QBI excludes carried interest (profit allocation) of capital gains, dividends, interest, commodities and forex transactions, and more.

# Income cap for service businesses

- Owners of SSTBs won't get a deduction on QBI if their taxable income (TI) exceeds the SSTB income cap of $415,000/$207,500 (married/other taxpayers).

- The phase-out range is $100,000/$50,000 (married/other taxpayers) below the income cap, in which the QBI deduction phases out for SSTBs.

  The W-2 wage and property limitations apply within the phase-out range.

# No income cap for non-SSTBs

- The new law favors non-service businesses (non-SSTBs), which don't have an income cap for the deduction.
- Non-SSTBs do have the W-2 wage and property limitations above the TI threshold of $315,000/$157,500 (married/other taxpayers).
- The 2018 income cap, phase-out range, and taxable income threshold will be adjusted for inflation in each subsequent year.

# W-2 wage and property limitations

- Taxable income higher than the threshold of $315,000/$157,500 (married/other taxpayers) is subject to W-2 wages and property limitations. Either:

- 50% of the W-2 wages for the qualified trade or business.

  Or,

- 25% of the W-2 wages for the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.

# QBI also includes REITs and PTP and the deduction applies to individuals, trusts and estates

- See the IRS Basic questions and answers on new 20% deduction for pass-through businesses.
- "Eligible taxpayers may also be entitled to a deduction of up to 20 percent of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.
- This component of the section 199A deduction is not limited by W-2 wages or the UBIA of qualified property."
- Individuals, trusts and estates with qualified business income, qualified REIT dividends or qualified PTP income may qualify for the deduction.

# TRADERS

Traders eligible for trader tax status (TTS) might get a 20% QBI deduction on Section 475 ordinary income from securities trades if they are under taxable income caps for a service business (SSTB).

# TTS traders are an SSTB

- The proposed regulations confirm that traders eligible for trader tax status (TTS) are a service business (SSTB) subject to the SSTB income cap on the QBI deduction.

- "Trading: Proposed §1.199A-5(b)(2)(xii) provides that any trade or business involving the "performance of services that consist of trading" means a trade or business of trading in securities, commodities, or partnership interests. Whether a person is a trader is determined taking into account the relevant facts and circumstances…

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# Proposed §1.199A-5(b)(2)(xii)

"…Factors that have been considered relevant to determining whether a person is a trader include the source and type of profit generally sought from engaging in the activity regardless of whether the activity is being provided on behalf of customers or for a taxpayer's own account. See Endicott v. Commissioner, T.C. Memo 2013-199; Nelson v. Commissioner, T.C. Memo 2013-259, King v. Commissioner, 89 T.C. 445 (1987). A person that is a trader under these principles will be treated as performing the services of trading for purposes of section 199A(d)(2)(B)."

- These are trader tax status court cases.

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# Trading income included in QBI

- The proposed regulations do not expressly answer this essential question: What types of trading income are included in QBI?

- The proposed regulations define a trading business, so I presume tax writers contemplated some types of income might be included in QBI.

# QBI excludes capital gains and losses

- QBI expressly excludes: "Capital gain or loss, dividends, interest income other than interest income properly allocable to a trade or business, amounts received from an annuity other than in connection with a trade or business, certain items described in section 954, and items of deduction or loss properly allocable to these items."
- Section 954 includes transactions in commodities, foreign currencies (forex) and notional principal contracts (swaps). The latter two are ordinary income, but they are excluded from QBI.
- The regulations do not expressly exclude, or include, Section 475 ordinary income on securities trades in QBI.

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# Regs discuss Section 1231

- "If gain or loss is treated as capital gain or loss under section 1231, it is not QBI. Conversely, if section 1231 provides that gains or losses are not treated as gains and losses from sales or exchanges of capital assets, section 199A(c)(3)(B)(i) does not apply and thus, the gains or losses must be included in QBI (provided all other requirements are met)."

- If you overlay Section 475 on top of the above wording for Section 1231, there is a similar result: Section 475 ordinary income is not from the sale of a capital asset, and it should be included in QBI.

# Section 64 defines ordinary income

- Section 64: "The term ordinary income includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). Any gain from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as ordinary income shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)."
- The tax code does not define "business income."
- If it's ordinary income from a business activity (Section 162) and not expressly excluded from QBI, then it should be included in QBI. Section 475 ordinary income on securities for a TTS trader should be included in QBI.

# IRS Chief Counsel

- An IRS attorney in the Chief Counsel's office for pass-throughs, who worked on the 199A proposed regulations, called me after seeing my August 30, 2018 interview in *Tax Notes*.

- The attorney told me my rationale for including Section 475 ordinary income on securities in QBI sounded "plausible" in his opinion.

- He asked me to provide an example, which they might include in the final regulations.

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# Example 1: Trader with 475 ordinary income

- A securities trader filing single is eligible for trader tax status and has QBI of $100,000 from Section 475 ordinary income minus trading business expenses. His taxable income (TI) minus net capital gains is $80,000.
- He is under the SSTB TI threshold of $157,500 for single, so there is no phase-out of the deduction, and the W-2 wage and property limitations do not apply.
- His deduction on QBI is $16,000 (20% x $80,000) since TI minus net capital gains is $80,000, which is lower than QBI of $100,000.

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# Example 2: Trader with 475 ordinary income

- If his taxable income is greater than $157,500 but less than the SSTB income cap of $207,500, then the deduction on QBI phases-out and the W-2 wage and property limitations apply inside the phase-out range.

- If his taxable income is higher than the SSTB income cap of $207,500 (single), there is no deduction on QBI in a trading SSTB.

# W-2 wage limitation for traders

- TTS traders form an S-Corp to unlock health insurance and retirement plan deductions in connection with officer compensation.

- If a trader's taxable income is in the QBI phase-out range, they need W-2 wages for a QBI deduction.

- These two strategies dovetail nicely: The TTS trader can determine wages that maximize tax savings.

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# HEDGE FUNDS

Investors in hedge funds eligible for TTS might get a 20% QBI deduction on Section 475 ordinary income from securities trades if they are under taxable income caps for a service business.

# *Tax Notes* quotes from Robert Green

- "Before the proposed regulations were released, some other tax experts argued that a hedge fund wouldn't be a barred service activity in section 199A because technically a management company was providing the service, and the hedge fund was merely receiving it.
- To claim trader tax status and elect Section 475, a hedge fund partner must do the trading, not an outside manager. Typically, a management company would be a partner in a hedge fund and would be trading for the fund."
- The regs make it clear that a hedge fund is an SSTB.

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# Hedge funds with TTS can elect 475

- A hedge fund that qualifies for trader tax status is entitled to elect Section 475 ordinary income or loss treatment on securities and/or commodities.

- Section 475 ordinary income or loss on securities is likely included in QBI.

- The taxable income thresholds and SSTB income cap apply to each investor in the hedge fund; some may get a QBI deduction, whereas, others may not, depending on their TI, QBI aggregation and more.

# Section 475 election considerations

- Before 2018, many hedge funds did not elect Section 475 since they did not want to use mark-to-market (MTM) accounting, which causes investors to owe taxes on unrealized trading gains. Investors might request cash distributions to pay those taxes, which might cause liquidity problems.

- With the advent of the 20% QBI deduction for non-upper income hedge fund investors, it changes the calculus for managers to consider TTS, a Section 475 election, and carried interest provisions.

- New Tax Law Favors Hedge Funds Over Managed Accounts.

# Section 475 election deadlines

- *Existing taxpayers*: For a 2018 Section 475 election, an existing hedge fund had to file an election statement with the IRS by March 15, 2018. A prior year election applies in subsequent years. Second step: The hedge fund submits a Form 3115 (Change of Accounting Method) with its 2018 partnership tax return.

- *New taxpayers*: A new hedge fund, can elect Section 475 by internal resolution within 75 days of its inception.

# Section 475 election on securities and/or commodities

- A trader or hedge fund, eligible for trader tax status, may elect Section 475 on securities and/or commodities.
- Most trading companies elect Section 475 on securities only, to retain lower 60/40 capital gains rates on Section 1256 contracts (i.e., commodities futures). (60% is a long-term capital gain and 40% is short-term.)
- The QBI regs exclude commodities transactions, so a Section 475 election on commodities is likely excluded from QBI.

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# Example 3: Hedge fund investor

- Married taxpayers invest in a hedge fund, which is eligible for trader tax status and elected Section 475 on securities. Their 2018 Schedule K-1 lists QBI of $100,000.
- The couple's taxable income (TI) is $355,000, and net capital gains are $25,000. QBI is less than TI minus net capital gains, so the QBI deduction is based on QBI.
- The couple's TI is $40,000 above the threshold of $315,000, and below the SSTB income cap of $415,000. They are 40% into the $100,000 phase-out range, so they lose 40% of the QBI deduction.

# Example 3: Hedge fund investor Wage and property limitation

- The wage and property limitation applies since the couple is in the TI phase-out range.

- The 50% W-2 wage limitation is zero because the hedge fund does not have payroll; the management company does. The 25% W-2 wage plus 2.5% property limitation is zero since trading capital does not count as property.

- Unless the couple has another source of QBI with excess W-2 wage and property limitations, they won't get a QBI deduction in connection with this investment. (See QBI aggregation rules below).

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# INVESTMENT MANAGERS

Investment managers are an SSTB, and their QBI includes advisory fees from U.S. clients. QBI also likely comprises carried interest of Section 475 ordinary income from trading securities.

# Investment managers are SSTBs

- The proposed regulations describe “investing and investment management” as SSTBs subject to the income cap on a QBI deduction.
- QBI includes management fees and incentive fees earned from U.S. clients, but not foreign clients. QBI must be from domestic sources.
- QBI excludes a carried-interest share (profit allocation) of capital gains but should *likely* include a carried-interest percentage of Section 475 ordinary income on securities.

# Investment managers: W-2 wage and property limitation

- Investment managers often choose an S-Corp to reduce payroll taxes (FICA/Medicare) on earned income. The IRS requires “reasonable compensation” for officer/owners.

- Having more payroll is helpful for generating a larger QBI deduction if the owner is in the phase-out range when the W-2 wage and property limitation applies.

- Investment managers have some office equipment, but they don’t usually have a significant property limitation.

# Example 4: Investment manager

- An S-Corp investment management business pays the 100% owner an officer compensation of $50,000, and net income after wages is $150,000. There are no other salaries.
- All advisory fee revenues are from U.S. clients, so 100% of net income is QBI.
- The owner is single, and his taxable income is $177,500. He has no capital gains or losses. QBI is less than TI minus capital gains, so he calculates his QBI deduction on QBI.

# Example 4: Investment manager 50% W-2 wage limitation

- The owner is $20,000 above the TI threshold of $157,500, and under the SSTB income cap of $207,500, so he phases-out 40% of the QBI deduction and the W-2 wage and property limitations also apply.

- The 50% W-2 wage limitation is $25,000 (50% x $50,000 wages). The potential QBI deduction is $30,000 (20% x $150,000 QBI). The alternative 25% W-2 wage and 2.5 property limitation is lower.

- The owner's QBI deduction is $15,000 (60% remaining phase-out range x $25,000 50% W-2 wage limitation).

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# SERVICE BUSINESSES

The proposed regs narrow the definition of SSTBs making the 20% QBI deduction available to more business owners. SSTBs are subject to an income cap.

# Specified service trades or businesses (SSTBs)

- "The definition of an SSTB for purposes of section 199A is (1) any trade or business involving the performance of services in the fields of health, law, 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, and (2) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2))."

# The regs narrow the SSTB list

- The proposed regulations exempted some types of service businesses from SSTBs, including real estate agents and brokers, insurance agents and brokers, property managers, and bankers taking deposits or making loans.
- It also focused SSTBs on professional services — for example, sales of medical equipment are not an SSTB, even though physician health care services are.
- Performing artists are an SSTB, but not the maintenance and operation of equipment or facilities for use in the performing arts.

# The regs narrowed the definition of "reputation and skill"

- The proposed regulations significantly narrowed the catch-all category of SSTBs based on the "reputation and skill" of the owner.

- The updated definition is "(1) receiving income for endorsing products or services; (2) licensing or receiving 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 (3) receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players)."

# ANTI-ABUSE MEASURES

The IRS proposed regs prevent taxpayers and their advisors from abusing the new law.

# Limits on “cracking and packing” schemes

- The proposed regulations prevent “cracking and packing” schemes where an SSTB might contemplate spinning-off non-SSTBs to achieve a QBI deduction because they are over the SSTB income cap.

- “Proposed §1.199A-5(c)(2) provides that an SSTB includes any trade or business with 50 percent or more common ownership (directly or indirectly) that provides 80 percent or more of its property or services to an SSTB. Additionally, if a trade or business has 50 percent or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (meaning the income will be treated as income from an SSTB).”

# Independent contractors

- Other anti-abuse measures prevent employees from recasting themselves as independent contractors and then working for their ex-employer, which becomes their client.

# AGGREGATION, ALLOCATION, AND QBI LOSSES

The regs allow business owners to aggregate QBI and wage/property limitations to achieve a higher aggregate QBI deduction.

# Aggregation and allocation rules

- There are QBI aggregation and allocation rules which come in handy for leveling out W-2 wage and property limitations among commonly owned businesses.
- If you own related businesses and one has too much W-2 wages and property, and the other not enough, you don’t need to restructure to improve W-2 wage and property limitations.
- Aggregation rules allow you to combine QBI, W-2 wage and property limitations to maximize the QBI deduction on aggregate QBI.
- Allocation rules are a different way to accomplish a similar result.

# QBI losses and carryovers

- There are rules for how to apply and allocate QBI losses to other businesses with QBI income.
- Unapplied QBI losses are carried over to subsequent tax year(s).
- QBI loss application does not affect any other tax matters.

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# PROPOSED VS. FINAL REGULATIONS

The IRS stated that taxpayers are entitled to rely on these “proposed reliance regulations” pending finalization.

# The pressure is on

- The 2017 Tax Cuts and Jobs Act was a significant piece of legislation. I presume the IRS will attempt to issue final regulations in time for the 2018 tax-filing season, which starts in January 2019.

- The IRS needs to produce tax forms for the 2018 QBI deduction, and that is best accomplished after finalization of the regulations.

- Tax software makers need time to program these rules, too.

# More tax compliance for businesses

- The new tax law reduced tax compliance for employees by suspending many itemized deductions. They may have a "postcard return."
- However, the new law and proposed regulations significantly increase tax compliance for business owners, many of whom would like to get a 20% deduction on QBI in a pass-through entity.

# CLOSING REMARKS, QUESTIONS & ANSWERS

# Closing Remarks

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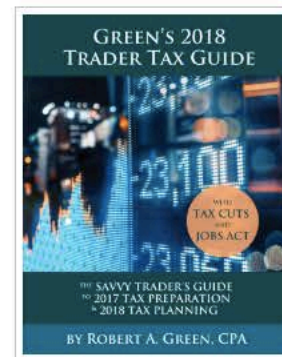


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