



The business income deduction: What do the proposed regulations on the business income deduction say about the crack and pack strategy?

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They Say That Breaking Up Is Hard to Do

What Do the Proposed Regulations on the Business Income Deduction Say About the Crack and Pack Strategy?

When Congress gave a new 20 percent tax deduction to sole proprietors, owners of S Corporations, and partners (including members in limited liability companies), it essentially denied that deduction to people in the business of providing professional services.

This means doctors, lawyers, accountants, stock brokers, investment advisers, traders, consultants, athletes, and artists do not get to deduct 20 percent of their business income. (See [“Are You in the Consulting or the Sales Business?”](#) on this site for more details on what types of service providers are denied the business income deduction.)

Not surprisingly, this has inspired many tax advisers to consider breaking service businesses into separate components so that a portion of the business might qualify for the business income deduction. For example, some commentators have suggested a law firm might create a separate entity to manage its human resources and/or property management functions and treat the income generated by that entity as qualified business income. This has been referred to as the “crack and pack” strategy. The Internal Revenue Service and Department of Treasury recently issued Proposed Regulations on the Section 199A business income deduction that will significantly limit any efforts to break up service businesses to qualify for the business income deduction.

There will still be opportunities for businesses to divide separate lines of business or, in the alternative, to combine separate entities to maximize the business income deduction. Owners of these businesses, however, should be aware of the limitations set forth in the proposed regulations and structure their enterprises with those guidelines in sight.

In the proposed regulations, these limitations are set forth as “special rules” for determining when two businesses that have common ownership will be treated as a single trade or business engaged in one of the professional services that do not get the benefit of the business income deduction above certain taxable income limits. Such service businesses are known as “specified services trade or business,” or SSTB. The special rules also address when a single businesses that engages in both a professional services business and a non-professional service line of business will be considered an SSTB.

One such rule is specifically targeted at the “crack and pack” strategy. Under this rule, if 80 percent or more of the property or services of a non-SSTB entity are provided to an SSTB, then, if there is a 50 percent or more overlap of ownership between those two entities, they will be combined and considered an SSTB. To continue the example described above, if a human resources and property management business created by a law firm to service the law practice is owned by the same people (presumably the law partners) who own the law firm and if that business provides all of its services to the law firm, then the effort to break out those lines of business to qualify a portion of the income for the business income deduction will not work. This special rule will treat both entities, on those facts, as a single SSTB, so the deduction would be limited over the threshold and eliminated over the phase-out range.

If the separate entity providing services to an SSTB provides less than 80 percent of its property or services to an SSTB, and there is a 50 percent or more overlap in ownership, then the portion of the products and services provided to the SSTB will be considered part of that SSTB. This should create some opportunity to qualify the business income not arising from products or services going to the SSTB for the deduction, even in common ownership situations.

The Proposed Regulations use the following example: A dentist owns a dental practice and also owns an office building. The dental practice leases half of the building and the other half is leased to unrelated persons. The income associated with the rent from the dental practice will be treated as generated by the dental practice and ineligible for the business income deduction as an SSTB.

Another special rule addresses the treatment of a business providing both the specified professional services of an SSTB and other products and services. On this point, it seems the bar has been set very low, so even a small percentage of specified services can cause a business to be characterized as a SSTB. Specifically, if the business’s gross receipts are \$25 million or less, then it will be considered an SSTB if 10 percent or more of the gross receipts of the trade or business are attributable to the specified professional services. If the business’s gross receipts are more than \$25 million, then the business will be considered to be an SSTB if 5 percent or more of its gross receipts are attributable to those specified services.

Under yet another special rule, if an SSTB has 50 percent or more overlapping ownership with a business that is not otherwise an SSTB, and the businesses share expenses (including wages or overhead expenses), then the non-SSTB business will be treated as an SSTB, as being “incidental to the SSTB.”

The IRS and Treasury have proposed these rules, in part, because they believe separating out parts of what otherwise would be an integrated specified services trade or business is

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inconsistent with the purposes of the business income tax. There are, of course, legitimate business purposes for separating commonly-owned trades of businesses from one another, even when one of those trades or businesses is an SSTB, so business owners will look for the opportunities under these proposed regulations to isolate business activities that can generate qualified business income from activities involving specified services trades or business. This will be particularly useful if the specified services are a relatively small portion of the gross receipts of a business.

We also anticipate there will be changes to the proposed regulations or additional regulations proposed. The IRS and Treasury moved relatively quickly to issue the regulations because there were so many questions affecting taxpayers in 2018. It seems very likely there will be many more questions and comments on the Proposed Regulations, so there could be refinements to the rules discussed here.

Thanks for reading this. Please be aware it does not describe all the rules that may apply to your situation. The circumstances of your particular business need to be separately analyzed to determine, in light of all the available guidance, whether and to what extent you may be able to deduct a portion of your business income or make adjustments to increase the amount of your deduction. Consult with a tax professional. In many cases, the savings will be well worth the effort.



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I have extensive experience helping business owners and executives negotiate compensation and ownership agreements and develop retirement and estate plans. I understand that they do not want problems; they want it done.

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