Gauging the Height of the Specified Service Business Guardrail

by Daniel L. Mellor

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In this article, Mellor examines the limited guidance available on the key definitional element of the new 20 percent deduction for passthrough income under the Tax Cuts and Jobs Act: the incorporation of section 1202(e)(3)(A) in defining a specified service business.

While much of the initial discussion regarding the Tax Cuts and Jobs Act (P.L. 115-97) has rightfully revolved around new section 199A, it would not be surprising if little-known section 1202(e)(3)(A) will soon become the most heavily debated section in the Internal Revenue Code. Section 1202(e)(3)(A) was merely one of several exclusions from a relatively rarely used exclusion — a list of trades or businesses that do not qualify for the exclusion from gross income of 50 percent of the gain on the sale or exchange of small business stock held for more than five years.

As of January 1, 2018, however, section 1202(e)(3)(A) became the key to unlocking the new 20 percent income tax deduction available to high-income owners of passthrough entities. Specifically, the TCJA created new section 199A, under which a taxpayer (other than a corporation) may deduct up to 20 percent of the taxpayer's qualified business income (QBI). QBI does not include income from a specified service trade or business. The TCJA mostly[1] incorporates the list in section 1202(e)(3)(A) in its definition of specified service trade or business. Thus, an owner of a business entity performing the services specified in section 1202(e)(3)(A), as modified, is generally prohibited from taking advantage of the new QBI deduction.

Historical Background

As enacted in 1993, section 1202 provided a 50 percent exclusion of gain on the sale of qualified small business stock, subject to specific alternative minimum tax adjustments.[2] According to its legislative history, section 1202 was designed to provide "targeted relief for investors who risk their funds in new ventures [and] small businesses" and encourage investments in these enterprises.[3] The exclusion was intended to "encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing," especially start-up and research-based businesses.[4]

The legislative history indicates that section 1202 was designed by Congress to provide a special preference for investors willing to risk capital in new and small businesses. Consistent with this preference for capital-intensive firms, section 1202(e)(3)(A) excluded from qualification for the exclusion a broad list of service-based industries:

> any trade or business involving the performance of services in the fields of

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[1] Section 199A(d)(2)(A) removes from the list in section 1202(e)(3)(A) the categories of "engineering" and "architecture."

[2] Christopher Karachale, "Qualified Small Business Stock Under IRC Section 1202: Tax-Free Money for the Masses?" 31 *Cal. Bus. L. Prac.* 73 (Summer 2016).

[3] H.R. Rep. No. 103-111, at 831 (1993).

[4] *Id. See* section 1202(e)(2).

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> health, law, engineering, architecture, 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 1 or more of its employees.

There is a virtually no guidance available regarding the application or interpretation of section 1202(e)(3)(A). The two regulations under section 1202 do not discuss or provide examples of what qualifies as a specified service trade or business. There are no reported federal district or Tax Court decisions or revenue rulings that turned on a question involving section 1202(e)(3)(A).

Perhaps recognizing this lack of direction, an explanatory statement from the House-Senate conference committee[5] for the TCJA includes in its discussion of specified service trade or businesses several footnote citations to section 448, specifically subparagraph (d)(2)(A), which defines "personal service corporations" and includes a list of professions nearly identical to the list in section 1202(e)(3)(A) and the regulations thereunder. Section 448 was enacted in 1986, and consequently, there is a great deal more authoritative guidance available on its application and interpretation.

However, section 199A does not reference section 448 in the statutory language itself. Thus, considering the potential tax savings that can be realized by avoiding classification as a specified service trade or business, it is likely future taxpayers will take more aggressive positions and appeal adverse determinations more vigorously until the IRS and the courts provide additional guidance directly regarding section 199A.

IRS Guidance

Until then, section 1202 is the statutory touchstone, and the only direction available comes from two letter rulings: LTR 201436001 and LTR 201717010. In LTR 201436001, taxpayers owned stock in a company (Pharmco) that provided products and services primarily in connection with the pharmaceutical industry, helping commercialize experimental drugs. Pharmco's business activities included research, development, manufacture, and commercialization. Pharmco advised its clients in developing successful drug manufacturing processes and addressing other problems. In performing these services, Pharmco used its physical assets, such as manufacturing and clinical facilities, as well as its intellectual property assets, including its patent portfolio. Pharmco's successful performance earned the company several valuable relationships in the pharmaceutical industry.

Before selling their stock in the company, the taxpayers requested a letter ruling on whether they would be able to exclude a portion of the gain under section 1202. Based on the plain language of section 1202(e)(3)(A), Pharmco would appear to fall within its scope — in fact, within the first-listed trade or business.

The IRS looked at the different service and non-service industries excluded from qualification under section 1202(e)(3), and found that "the thrust of 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners)." With that understanding, the IRS found the company was not in the business of offering services in the form of individual expertise. Instead, the company's activities involved "the deployment of specific manufacturing assets and intellectual property assets to create value for customers."

The IRS likened the company to a parts manufacturer in the automobile industry. Even though the company operated in the pharmaceutical industry, which the IRS considered a component of the health industry, Pharmco did not perform services in the health industry within the meaning of section 1202(e)(3). Thus, Pharmco's business activities did not fall within any of the section's prohibited categories.

In LTR 201717010, a taxpayer was the founder and CEO of a C corporation (Testco), which had developed a patented diagnostic tool for the precise detection of a particular disease. Testco's business was to use its proprietary tool and other

[5] "Joint Explanatory Statement of the Committee of Conference" (Dec. 18, 2017).

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technologies to test patients for this disease, analyze the results, and prepare laboratory reports for healthcare providers. Only Testco was legally permitted to perform the test.

The taxpayer sold 100 percent of his stock in Testco in a taxable transaction and requested a letter ruling on whether a portion of the gain on the sale could be excluded under section 1202. Like Pharmco's, Testco's business appeared to involve the performance of services in the field of health. However, the IRS again found that the company fell outside the scope of section 1202(e)(3)(A), based on several key representations made by the taxpayer:

- Even though Testco's clients were doctors and other healthcare providers, the laboratory reports produced by Testco did not discuss diagnosis or treatment, nor was Testco informed by the providers about the patients' diagnosis or treatment.
- Testco did not take orders from or explain the laboratory reports to patients. Instead, Testco would direct patients to contact their healthcare provider if they had any questions. Testco's only direct contact with patients came when billing patients whose insurer did not pay the full cost of the test.
- Even though Testco's employees were well educated, the skills they brought when hired were "almost useless" for performing the tests.[6] The employees received up to a year of training to perform the testing, but the skills they acquired were unique to the job and not useful to other employers.
- The laboratory director was the only employee required to have an MD, a DO, or a PhD, according to the laboratory personnel requirement of 42 C.F.R. section 493.1441 et seq. However, the laboratory director's sole function was to review lab results for quality control and quality assurance; the director never had direct contact with patients.
- Other than the laboratory director, Testco's laboratory personnel were not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority. None of Testco's personnel diagnosed, treated, or managed any aspect of a patient's care.

Based on these representations, the IRS said that "none of Company's revenue is earned in connection with patients' medical care."

Analysis

The IRS analyses of the taxpayers in LTR 201436001 and LTR 201717010 share an interpretation of section 1202(e)(3)(A). While the statutory language seems to broadly encompass all services in the given industries, the IRS's application was narrower. Rather than reject the two taxpayers because their businesses involved "the performance of services in the field of health," the IRS focused on whether services were provided to the end-user, that is, the patient. In other words, the IRS read the exception as limited to taxpayers whose businesses involved "the performance of health services." "Health services" was even more strictly construed (explicitly in LTR 201436001 and implicitly in LTR 201717010) as the diagnosis and direct treatment of patients.

In the IRS's LTR 201436001 automobile analogy, the "car" was the provision of medical services to patients, and pharmaceuticals were gears or engine parts. Medical services include the use of pharmaceuticals in the same way cars require wheels, but because Pharmco's business involved only the production of pharmaceuticals (that is, the parts) and not the actual provision of pharmaceuticals to patients, the IRS found it fell outside the scope of section 1202(e)(3)(A).

That analogy was not made in LTR 201717010, but the IRS's analysis still fit. In that case, Testco's business was even closer than Pharmco's to constituting a health service in that Testco's primary service was using a diagnostic tool to test for a disease. Testco even had direct, although limited, contacts with patients. However, because the actual diagnosis and treatment was provided by a physician, Testco was still considered a "parts" trade or business.

This narrow interpretation opens up a wide avenue for professionals who may otherwise think they fall within a specified service industry

[6] LTR 201717010.

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and are barred from taking advantage of the preferential treatment available under the TCJA. For example, a talent agent who represents athletes is certainly performing services — arguably in the field of athletics — and thus, from a superficial reading of the statute, he would be excluded from the lower passthrough rate. However, the agent is not performing athletic services, so based on LTR 201436001 and LTR 201717010, the agent's business would not constitute a specified service trade or business.[7] The same would hold true for stadium owners, transportation, security providers, sportswriting, broadcasting, and promotional services.

The categories of law, financial, and brokerage services are exceptionally broad, and their inclusion would seem to deny hundreds of thousands of taxpayers who typically operate as passthrough entities the benefit of the QBI deduction. However, under LTR 201436001 and LTR 201717010, passthrough entities in these fields that provide services to lawyers or financial advisers, and not directly to clients, should still be entitled to the QBI deduction.

The IRS's parts manufacturer analogy in LTR 201436001 was based on an analysis of how value is created for the company's customers. Even though Pharmco provided extensive services to its clients, including research, clinical testing, and help in developing drug manufacturing processes, the IRS found that the value created arose from the deployment of specific manufacturing and intellectual property assets, and not from individual expertise. This analogy could easily be extended to financial advisers, most of whom now rely on proprietary modeling systems, software, and algorithms to provide investment advice, rather than individual expertise.

LTR 201717010 also examined the role of expertise. The last clause of section 1202(e)(3)(A) is a catchall that includes any business whose principal asset is "the reputation or skill of 1 or more of its employees."[8] Most businesses, and certainly most service businesses, would likely admit their principal asset is the skill of their employees. However, in LTR 201717010, the IRS discounted the expertise of Testco's employees, even though they were highly educated and well trained, because their skills were unique to the work they performed for Testco and not useful to other employers. Although Testco's position as the sole entity legally permitted to perform its primary service is uncommon, there are likely many businesses that could claim the services they offer are one of a kind and thus that the skills their employees develop are not useful to other employers.

Conclusion

Congress was aware of the possibility of abuse of the preferential treatment of passthrough entities and, accordingly, included guardrails in the TCJA to discourage or prevent taxpayers from incorporating themselves and converting wage income into business income eligible for the passthrough deduction. Along with the Form W-2 wage income/unadjusted property basis limitation, the specified service industry limitation is one of the highest guardrails. The wage/unadjusted basis limitation is a quantitative, bright-line rule that will be difficult to game. Conversely, the specified service industry limitation is qualitative and subjective, and thus a beacon for creative tax planning.

Taxpayers should be careful, however. The TCJA amends section 6662(d)(1) to reduce the threshold for imposing the substantial underpayment penalty from 10 percent to 5 percent for taxpayers claiming a QBI deduction under section 199A. Thus, the significance of section 1202(e)(3)(A) has increased because the risks and rewards in its interpretation are amplified, with minimal guidance to rely on. ■

[7] *Compare* reg. section 1.448-1T(e)(4)(iii).

[8] Section 199A(d)(2)(A) expands this term to include "employees *or owners*," presumably to broaden its application to include partners (emphasis added).

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