ICBA Independent Community Bankers of America®

# THE SUBCHAPTER S BANK DEDUCTION: KEY POINTS OF FINAL RULE UNDER 199A

## KEY POINTS OF FINAL RULE UNDER 199A[1]

On Jan. 18, Treasury released its final rule under Section 199A of the Tax Cuts and Jobs Act (TCJA), which allows shareholders in Subchapter S banks and other pass-throughs to take a 20 percent deduction on "qualified business income." As described below, the final rule is, in several respects, a significant improvement over the proposed rule released in August. ICBA thanks the thousands of community bankers nationwide who joined in our advocacy before Congress and Treasury.

ICBA advocated for the creation of the pass-through deduction in the act and advocated for expanding the definition of qualified business income in the implementing regulation so that it captures income derived from a broad array of services offered by community banks.

By way of background, Section 199A provides that income derived from a "specified service trade or business" (SSTB) is not "qualified business income" and is not eligible for the deduction. The statute provides that SSTBs include: "financial services," "brokerage services," "investing or investment management services," and "dealing in securities." If a shareholder has taxable income of less than $157,500 (individual return) or $315,000 (joint return), all pass-through income is eligible for the deduction. These thresholds are indexed for inflation.

The final rule under Section 199A provides definitions and guidance for the application of the 20 percent deduction. This is our initial analysis of the key points for community banks. More detail will follow.

### INCOME FROM THE ORIGINATION AND SALE OF MORTGAGES IS QUALIFIED BUSINESS INCOME

The final rule provides that income from the origination and sale of loans, including mortgage loans, is qualified business income and therefore eligible for the deduction under Section 199A. This is a significant, positive change from the proposed rule which had provided that such income was not qualified business income. As a result of our advocacy, Treasury and the IRS recognized that loan sales are a core feature of the community banking business model.

### TRADITIONAL BANKING INCOME AND INSURANCE BROKERAGE INCOME IS QUALIFIED BUSINESS INCOME

Under the proposed and final rules, income from deposit taking and lending is "qualified income," as is income from insurance brokerage. Before the proposed rule was issued, there was some doubt as to whether "banking" would be categorized as "financial services," or whether insurance brokerage would be categorized as "brokerage services," and thus disqualified from the deduction.

### INVESTING AND INVESTMENT MANAGEMENT

Under the proposed and final rules: "The performance of services that consist of investing and investment management refers to 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." It remains unclear how this would apply to trust or fiduciary services offered by a bank.

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[1] This overview of the 199A rule is not tax advice. Community bankers should consult with their accounting and legal advisors to determine the application of the new rule to their specific circumstances.

### DE MINIMIS THRESHOLD

The proposed and final rules use a de minimis threshold to determine whether a passthrough trade or business is a "specified service trade or business" and is thus disqualified from the deduction.

- The final rule provides that if a trade or business has gross receipts of $25 million or less and less than 10 percent of its total revenues are attributable SSTBs, then all income of the trade or business is qualified business income.
- If a trade or business has gross receipts greater than $25 million and less than 5 percent of its total revenues are attributable to SSTBs, then all of the income of the trade or business is qualified business income.
- The de minimis thresholds were not changed in the final rule.
- A Subchapter S bank may include more than one trade or business.

### NO "CLIFF EFFECT" FOR PASSING DE MINIMIS THRESHOLD

- The final rule clarifies that there is no "cliff effect," meaning that if SSTB receipts exceed the de minimis threshold, this does not automatically disqualify all of the income of the bank from being qualified business income. Crossing a threshold does not mean stepping off a cliff.
- A bank that exceeds the threshold may create a separate trade or business for the disqualifying SSTB and thereby preserve its qualified business income from other services. The SSTB trade or business would have to keep separate books and records. The rule allows expense allocation according to any reasonable method.
- This is not an ideal solution and will create additional accounting burden, but it is better than disqualifying the income of the entire bank.

## ICBA ADVOCACY

Since Congress first began to consider tax reform, ICBA has consistently advocated for greater tax parity between S and C corporation community banks. The initial versions of tax reform introduced in the House were simply unworkable with respect to Subchapter S banks and would have effectively provided little to no tax relief.

When the Senate first proposed a pass-through deduction, it was set at 15 percent and excluded Sub S shares held in estates or trusts. ICBA engaged Congress directly and through successful grassroots campaigns with the support of thousands of community bankers. The final version of Section 199A raised the deduction to 20 percent and provides that it is available to shares held by estates and trusts as well as individuals.

Since enactment of the Tax Cuts and Jobs Act in December 2017, ICBA has lobbied the Treasury Department, the White House, and the Office of Management and Budget to implement the law in a way that reflects Congress's intention of providing tax relief for Subchapter S banks in all of the ways in which they serve their communities.

The August proposed rule clarified that community bank qualified business income included income from the traditional banking services of deposit taking and lending. It also provided that income from insurance brokerage is qualified business income. However, it would have excluded critical community bank services such as origination and sale of mortgages, SBA loans, and other loans. ICBA responded with an intensive advocacy campaign which included CEO Rebeca Romero Rainey's meeting with Deputy Treasury Secretary Justin Muzinich, initiating a Senate sign-on letter to Treasury Secretary Steven Mnuchin, numerous meetings with Treasury's Office of Tax Policy, and a grassroots campaign with the support of thousands of community bankers. We believe that this advocacy directly resulted in the improvements to the final rule described above. We remain concerned about the tax treatment of income from fiduciary services and wealth management, among other activities, if such income exceeds the de minimis thresholds.