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TAX REFORM'S 199A REDEFINES "CONSULTING" FOR GOVERNMENT CONTRACTORS

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Government contractors provide many different types of services across many different industries, such as IT, R&D, operations and professional services.

In the past, many of these contractors may have used the term "consultant" or "consulting" to describe the wide range of services they provide. Yet this 2018 tax season, it may be time for contractors to revisit this terminology, particularly if they are structured as a flow-through entity for tax purposes (i.e., an S corporation, a partnership, or an LLC taxed as a partnership).

When Congress passed tax reform, commonly known as the Tax Cuts and Jobs Act, in December 2017, C corporations immediately benefitted from the corporate tax cut, which sliced a maximum tax rate of 35 percent to a flat rate of 21 percent. Notwithstanding this significant income tax rate reduction, individual income tax rates were only reduced from a

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maximum rate of 39.6 percent to 37 percent. In order to provide a relatively comparable individual rate reduction on certain income, code Section 199A was introduced for flow-through entities and sole proprietors. The new Section 199A allows a deduction of up to 20 percent of a qualifying taxpayer's qualified business income (QBI). If applicable, Section 199A can lower the maximum effective rate on qualified business income from 37 percent to 29.6 percent. Importantly, however, to the extent a taxpayer's QBI is generated from a specified service trade or business (SSTB) a significant limitation may apply. The 20 percent deduction under Section 199A attributable to QBI generated from an SSTB is limited based on the taxable income reported by the taxpayer. This taxable income limitation is \$415,000 for married taxpayers filing a joint return and \$207,500 for all other taxpayers. Consequently, QBI generated from an SSTB that is allocated to an individual owner of that business will be ineligible for the Section 199A deduction if their taxable income exceeds \$415,000 (for a joint filer) or \$207,500 (for all other filers).

Now that tax reform is law, many government contractor service providers operating as pass-through entities or sole proprietorships have had to determine whether they will be able to take advantage of this new deduction, especially since the law itself is often complex and unclear. Given the significant limitation imposed on QBI generated from an SSTB, determining whether government contractor service providers operate an SSTB is of critical importance. Under Section 199A, an SSTB includes the provision of "consulting" services. However, there is limited guidance defining what is meant by the term consulting for purposes of Section 199A. On August 16, the Internal Revenue Service published proposed regulations relating to Section 199A to provide some clarification on the application of Section 199A including determination of an SSTB.

CONSULTING AS AN SSTB

The proposed Section 199A regulations address treatment of consulting services as an SSTB by defining consulting as "the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems." Further, the proposed regulations provide that "the performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses... Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services."

Fortunately, there is a de minimis rule included in the proposed regulations as well. If a company's gross receipts are over \$25 million in a taxable year, up to 5 percent of the company's gross receipts can come from consulting services without causing the entire business activities to be treated as an SSTB; if gross receipts are under \$25 million, that threshold increases to 10 percent. It's important to note, however, that the proposed regulations aren't clear as to the results when a taxpayer's gross receipts from an SSTB exceed the 5 percent or 10 percent threshold.

The below examples from the proposed 199A regulations help illustrate the intended meaning of the term "consulting." The first example represents a contractor providing services that would be classified as an SSTB, and therefore, subject to the taxable income limitations discussed above, generate QBI that would not be eligible for the 20 percent income tax deduction. The second example represents a contractor providing services that would not be classified as an SSTB, and therefore could generate QBI that may be eligible for the 20 percent income tax deduction.

Example 1

Company C is in the business of providing services that assist unrelated entities in making their personnel structures more efficient. C studies its client's organization and structure and compares it to peers in its industry. C then makes recommendations and provides advice to its client regarding possible changes in the client's personnel structure, including the use of temporary workers. C is engaged in the performance of services in an SSTB in the field of consulting within the meaning of paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

Example 2

Company D is in the business of licensing software to customers. D discusses and evaluates the customer's software needs with the customer. The taxpayer advises the customer on the particular software products it licenses. D is paid a flat price for the software license. After the customer licenses the software, D helps to implement the software. D is engaged in the trade or business of licensing software and not engaged in an SSTB in the field of consulting within the meaning of paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

NEXT STEPS FOR CONTRACTORS

Now is the time for government contractors to ask themselves, "Am I **really** a consultant?" Maybe the term is included in a company's name or website, but a closer inspection of their deliverables, contracts, or NAICS code may reveal whether they are providing consulting services that fit the definition outlined in the proposed regulations. Further, it's possible that government contractors have multiple "trades or businesses" as defined for purposes of Section 199A. Existence of separate trades or businesses may create opportunities to allow the owners of these businesses to benefit from the 20 percent deduction. An immediate determination may not be necessary, but flow-through entities will be required to report on their 2018 Schedules K-1 the amount of QBI, W-2 wages, and UBIA of qualified property attributable to each trade or business conducted and indicate whether such amounts are generated from a qualified trade or business or an SSTB. Notably, the results could be different from year-to-year based on how income was derived; a contractor could be an SSTB in 2018 and not in 2019.

Tax reform, and Section 199A in particular, has created an entirely new tax landscape for contractors that extends far beyond changes to the definition of consulting. This fall, government contractors should take the time to review the tax code changes and proposed regulations to better understand their business impact and take advantage of planning opportunities.

For more information on how tax reform is impacting businesses, visit BDO's [Tax Reform Resources Hub](#).



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