Republicans’ 2017 overhaul of the tax code created a new 20-percent deduction of qualified business income (QBI), subject to certain limitations, for pass-through entities (sole proprietorships, partnerships, limited liability companies, or S corporations). The controversial QBI deduction, also commonly referred to as the pass-through deduction, has remained an ongoing topic of debate among lawmakers, tax policy experts, and stakeholders.

Background

The Tax Cuts and Jobs Act (TCJA) (P.L. 115-97), enacted at the end of 2017, created the new Section 199A QBI deduction for noncorporate taxpayers, effective for tax years beginning after December 31, 2017. However, under current law the QBI deduction will sunset after 2025. In addition to the QBI deduction’s impermanence, its complexity and ambiguous statutory language created many questions for taxpayers and practitioners.

The IRS first released the much-anticipated proposed regulations for the new QBI deduction, REG-107892-18, on August 8, 2018. The proposed regulations were published in the Federal Register on August 16, 2018. The IRS released the final regulations and notice of additional proposed rulemaking on January 18, 2019, followed by a revised version of the final regulations on February 1, 2019. Additionally, Rev. Proc. 2019-11 was issued concurrently to provide further guidance on the definition of wages. Also, a proposed Revenue Procedure, Notice 2019-7, was issued concurrently providing a safe harbor under which certain rental real estate enterprises may be treated as a trade or business for purposes of Section 199A.

Wolters Kluwer recently interviewed Tom West, a principal in the passthroughs group of the Washington National Tax practice of KPMG LLP, about the Section 199A QBI deduction regulations. Notably, West formerly served as tax legislative counsel at the U.S. Department of the Treasury’s Office of Tax Policy. This article represents the views of the author only and does not necessarily represent the views or professional advice of KPMG LLP.

Wolters Kluwer Interview: A Two-Part Q&A Series on the Section 199A Deduction will be published on Monday, April 8 and Tuesday, April 9.

**Wolters Kluwer:** What is your general overview of the revised, final regulations for the Section 199A Qualified Business Income (QBI) or "pass-through" deduction?

**Tom West:** I think it is admirable that Treasury and IRS were able to publish these final regulations so quickly and address so many of the comments and questions that the proposed regulations generated. I think they realized how important this particular package was to so many taxpayers for the 2018 filing season and, while questions obviously remain, having these rules out in time to inform decisions for this year’s tax returns is helpful. In particular, the liberalized aggregation rules and the additional examples regarding certain specified service trades or businesses (SSTBs) are the most consequential in my mind.

**Wolters Kluwer:** What should taxpayers and practitioners keep in mind in consideration of relying on either the proposed or final regulations for the 2018 tax year?

**Tom West:** I have to imagine that when choosing between the two, for most taxpayers the final regulations will ultimately provide the better result. The ability to aggregate at the entity level, which was only provided in the final regulations, may be a key consideration for those taxpayers with more complicated or tiered structures. That said, I do think taxpayers need to be careful in their aggregation modeling because you are going to be stuck with your aggregation once you’ve filed. It may be that some taxpayers wait on getting locked into a particular aggregation and continue to study the new rules – and even wait on additional guidance that may be coming. However, it may be important to note that the final regulations provide that if an individual fails to aggregate, the individual may not aggregate trades or businesses on an amended return – other than for the 2018 tax year.
Wolters Kluwer: How is the removal of the proposed 80 percent rule regarding specified service trades or businesses (SSTBs) from the final regulations likely to impact certain taxpayers?

Tom West: First of all, I think the removal of this rule is a demonstration of two important dynamics. One, the critical importance of the engagement of taxpayers in the comment process, and, two, the government’s willingness to listen and adapt in their rule-making. I don’t know if there are particular industries or taxpayers who will be impacted, but I do know that the change is a very logical and appropriate one, and logic doesn’t always prevail in these processes, so I’m happy to give the regulators credit when it does.

Wolters Kluwer: Which industries may have been helped or hindered by the final regulations with respect to SSTB rules?

Tom West: I’m not sure specific industries were helped, but the biggest positive in terms of the SSTB final rules is the carryover from the proposed regulations of the treatment of the skill or reputation provision. Had Treasury and the IRS gone in a different direction, there was a risk of that provision swallowing the rest of the 199A regime—not to mention how much more subjective the already sometimes difficult SSTB determinations would have become.

Wolters Kluwer: Are there any lingering, unanswered questions among taxpayers or practitioners that particularly stand out when determining what constitutes SSTB income?

Tom West: I think many taxpayers who have both SSTB and non-SSTB activities were hoping for more clarity, either in rules or examples, on how to acceptably segregate business lines or on when (or if) certain activities are inextricably tied together. There are also still lingering questions regarding when a trade or business is an SSTB–particularly in the field of health.

Wolters Kluwer: Were there any surprises in the final regulations?

Tom West: I don’t know if I’m surprised, knowing the concerns that led them to the decisions they made, but the fact that Treasury and IRS held the line on some of the SSTB-related rules is notable. I’m thinking specifically of the so-called “cliff” effect of the de minimis rule and the fact that owners of certain kinds of SSTB businesses, e.g., sports teams, are not allowed to benefit from the Section 199A deduction.

The second segment of the Wolters Kluwer Interview: A Two-Part Q&A Series on the Section 199A Deduction will be published on Tuesday, April 9.

By Jessica Jeane, Senior News Editor

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Part II

Wolters Kluwer: Neither the proposed nor final regulations for Section 199A give guidance as to when rental real estate activity constitutes a Section 162 trade or business. How might the application of the safe harbor provided for in IRS Notice 2019-7 offer taxpayers clarity? And how might failure to qualify for the safe harbor impact the determination of whether the rental activity is a trade or business under Section 199A?

Tom West: The safe harbor is helpful but it appears to be intended for relatively smaller taxpayers who may have had questions about their activities rising to the level of a trade or business. I don’t think falling outside of the safe harbor is dispositive – especially in light of the recent policy statement from Treasury regarding sub-regulatory guidance.

Wolters Kluwer: Can you speak to the some of the complexity that may be involved in tax planning with respect to achieving the right balance between adequate W-2 wages and QBI?

Tom West: Other than for small taxpayers, there is only a benefit under Section 199A if the limitations are met. It does not do any good to have QBI but then have insufficient W-2 wages and qualified property to meet the limitations. So when taxpayers are evaluating what constitutes a qualified trade or business (or whether to aggregate qualified trades or businesses) they will need to determine the amount of W-2 wages with respect to each QTB. Aligning the W-2 wages with the QTB will be important – but the salary expense will also result in a reduction in the amount of QBI and therefore the amount of any Section 199A benefit – so modeling becomes...
critical. Consideration should also be given to any collateral consequences – for instance the impact of the alignment on allocation and apportionment for state taxes.

**Wolters Kluwer:** According to a March 18, 2019, Treasury Inspector General for Tax Administration (TIGTA) report, Reference Number: 2019-44-022, IRS management indicated that the timeline related to the issuance of Section 199A guidance did not provide enough time for the IRS to develop a QBI deduction tax form. Although the IRS did create a worksheet, do you have a prediction on what key elements may be included on the new form once released?

**Tom West:** I do think that worksheets could be developed that would facilitate the reporting of Section 199A information – particularly through tiered structures – so as to ease the reporting burden and enhance compliance.

**Wolters Kluwer:** The IRS has estimated that nearly 23.7 million taxpayers may be eligible to claim the Section 199A deduction and that more than 22.2 million (94 percent) of those eligible taxpayers will not require a complex calculation for the deduction. What notable differences do you expect there are between "complex" and the majority of calculations?

**Tom West:** For taxpayers under the Section 199A income thresholds ($157.5K single, $315K joint), the deduction is very easy to calculate and claim. Those taxpayers don’t need to worry about being in an SSTB, how much wages they paid, or the basis of their property. Once those taxpayers hit those income thresholds though, even in the phase-out range, things very quickly get complex – and that’s as a consequence of the statute; it is not something that the regulators can change.

**Wolters Kluwer:** Do you anticipate the IRS will issue further guidance on the Section 199A deduction?

**Tom West:** I do. As I said at the top, I think part of the government’s motivation in finalizing these regulations so quickly was providing guidance to taxpayers ahead of the tax-filing season. And while for the majority of taxpayers who are below the 199A cap there is probably now sufficient guidance, I think there are still a lot of questions for those with more complex situations. Given the number of taxpayers who are eligible for this deduction, and the importance of Section 199A as the big benefit to non-corporate businesses in what the Administration views as a signature legislative achievement, I have to believe that the government will be responsive to taxpayers’ requests for additional help on this provision. However, given that the provision is due to sunset, it will be important that any guidance is forthcoming in fairly short order to be of any usefulness to taxpayers.

**Wolters Kluwer:** At this time, do you have any recommendations for taxpayers and practitioners moving forward?

**Tom West:** As people are going through their tax filings this year, I’d keep a list of issues, questions, and areas where additional guidance would be helpful. It often happens that problems with new legislation or regulations don’t reveal themselves until taxpayers have to put pencil to paper and track their real-world numbers through returns. We’ll all have that experience this year and, with those lists of issues and questions in hand, there may be an opportunity to approach the IRS and Treasury in the hopes of getting resolution going forward. Keeping that list could also help identify areas for tax planning and perhaps ease the complexity of filing for 2019.

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