Final Regs on QBI Have Changes

On Friday, January 18, 2019, IRS released final regulations on the Qualified Business Income (QBI) deduction, Section 199A. These regs (247 pages) contain changes from the proposed regs (184 pages) issued last August. The preamble to the final regs cover almost 150 pages, leaving the remaining 90+ pages for the actual regs. The preamble is the portion of the package where IRS discusses some of the over 300 comments it received, its thinking, and its decision.

It is extremely likely that any seminar you attended or article you read dealing with QBI prior to last Friday has information that was correct at the time, but is now different. Here are some of the changes that affect most taxpayers.

LOSS BUSINESS – the final regs state a loss from a business must be allocated prorate to offset the profits from other businesses. For example, Business A has a loss of 10, Business B has a profit of 60, and Business C has a profit of 40. The total of the profits is 100. Business B's portion of this profit is 60% and Business C's portion is 40%. Business B is allocated 6 (60% x 10) of the loss, reducing Business B's profit down to 54 for QBI calculation purposes. Business C is allocated 4 (40% of 10) of the loss, reducing Business C's profit down to 36 for QBI calculation purposes.

The regs also state the allocation to a Specified Service Trade or Business (SSTB) is calculated AFTER any reduction in the SSTB's income that is required if the taxpayer's taxable income exceeds the threshold.

QUALIFIED BUSINESS INCOME – Normally for a sole proprietorship, this would be the net income from the bottom of Schedule C. The final regs address the following in connection with QBI:
1) The deduction of a portion of the self-employment tax reduces QBI.

2) The deduction for self-employed health insurance reduces QBI.

3) The deduction for contributions to qualified retirement plans (we believe this includes SEPs and SIMPLEs but not traditional IRAs but our opinion can change).

4) The deduction for unreimbursed partnership expenses, the interest expense to acquire an ownership in a partnership or S corporation, and state and local taxes are items the preamble states will specifically NOT be addressed currently. (We feel the unreimbursed partnership expenses should reduce QBI, but at this time we are not expressing an opinion on the other items.)

5) Form 4797 income/losses that are carried to Schedule D are NOT QBI, while any Form 4797 income/losses that are treated as ordinary income bypassing the Schedule D are QBI.

6) Rentals – The preamble to the final regs state that meeting the real estate professional provisions of Section 469(c)(7) does NOT make a rental activity a business. It is still based on whether the rental activity rises to the level of a business. Notice 2019-07 covers QBI & rental activities by providing a safe harbor. (We addressed this Notice in an email we sent out January 18, 2019.)

7) Suspended losses – QBI related to losses suspended under the passive, at-risk, or basis rules is not QBI until the suspended losses are included in the taxpayer's taxable income. If only part of the suspended losses is included in taxable income in a year, that prorata portion of the suspended QBI is taken into account. For example, for 2018 a taxpayer receives a Schedule K-1 showing a 12 loss and -10 of QBI. The entire loss is suspended under the passive loss rules for 2018. The Schedule K-1 for 2019 shows a profit of 4, which releases 4 of the 2018 loss. Since this 4 represents 33% of the 2018 suspended loss, 33% of the -10 QBI is taken into account in 2019. The suspended losses are based on FIFO – the first suspended losses are the first ones to be used. The released suspended QBI is considered a separate activity and is NOT linked to the activity that created it.

8) Employee status – Basically the regs say "once an employee, always an employee." Briefly an employee who terminates the employee status and becomes an independent contractor doing the same work for the same company will be treated by IRS as an employee and ineligible for the QBI deduction. This can be rebutted by the taxpayer and will be judged on the facts and circumstances. The regs include the example of an employee who worked for the firm long enough to become a partner. Since a partner of a partnership cannot be an employee, this is sufficient to rebut the IRS position. This rule appears to discourage a taxpayer from recharacterizing his/her employee status to that of an independent contractor.

MULTIPLE TRADES OR BUSINESSES – The preamble states the Treasury Department and IRS feels multiple trades or businesses will generally not exist within one entity (individual, partnership, etc.) UNLESS a different method accounting could be used for each business. Regulation §1.466-a(d) explains that no trade or business is considered separate and distinct unless a complete and separable set of books and records is kept for the business.

UNADJUSTED BASIS IMMEDIATELY UPON ACQUISITION (UBIA) –
1) Like kind exchanges and involuntary conversions – the regs now state the "placed in service" date for the old property is the same date that would have been used if the old property still existed (in most cases this will be the purchase

date of the old property). The boot continues to use the date the new property was acquired.

The regs also state the UBIA of the old property carries over. The UBIA of the boot will normally be the amount of boot paid. However sometimes the UBIA of the boot will actually be lower, such as when the old property decreased in value. If you have an exchange, we suggest you read the examples in the regs for the calculations.

2) Property contributed to a partnership under Section 721 or into a corporation under Section 351 – The regs continue to say the "placed in service" date is the date the partner or shareholder originally placed the property in service. But the regs now say the UBIA for the partnership and S corporation is the UBIA the partner or shareholder would have used if they kept the asset. In most cases this will be the cost of the asset to the partner or shareholder. (The proposed regs required the UBIA for the partnership and S corporation to be the adjusted basis of the property in the hands of the partner and shareholder as of the date it was contributed to the entity.)

3) Section 754 election in place - A partnership which has made a Section 754 election has triggered §§734(b) & 743(b). The increase or decrease in basis in assets under §743(b) will result in changes to the UBIA for the partner(s) affected by the 754 election. Again, the regs have examples going through the calculations required for this.

4) Disposition of a relevant passthrough entity (RPE) ownership during the year. The UBIA is allocated to the owners of the RPE based on their ownership on the last date of the year. Therefore, any taxpayer who disposed of the ownership during the year will have an allocation of QBI and wages, but no allocation of UBIA.

SPECIFIED SERVICE TRADE OR BUSINESS (SSTB) –
1) In response to comments received, the regs provide more examples of various SSTB categories, especially in the field of health.

2) The final regs state a business that has ANY SSTB is considered to be an SSTB except if it meets the di minimis provision. The di minimis provision did not change from the proposed regs and states the entity is not an SSTB if its average annual gross receipts is not over $25,000,000, and less than 10% of its gross receipts is from an SSTB. This percentage is lowered to "less than 5% for those businesses that have average annual gross receipts of over $25,000,000.

3) A business that provides part of its property, products, or services to a commonly controlled SSTB (at least 50% common ownership) operated by an individual or RPE has to treat that portion of its business as an SSTB. The remainder of the business is an eligible QBI if it meets the normal provisions of

QBI. In a way this contradicts the statement above that says “ANY” SSTB, but this is the way we read the regs.

RELEVANT PASSTHROUGH ENTITIES (RPEs)
1) Each RPE must passthrough to its owners the proper allocated QBI, wages, and UBIA. These items need to be reported for each business the RPE has AND be further identified as an SSTB if applicable. These items are noted in the OTHER box of the Schedule K-1. The amounts shown in boxes 1 & 2 of the Schedule K-1 may not be the same amount as the QBI.

2) The recipient of the Schedule K-1 does have to use common sense and may need to contact the RPE if information appears to be missing.

3) The regs say:
- Failure to passthrough wages means the activity does not have wages.
- Failure to passthrough UBIA means the activity does not have UBIA.
- Failure to passthrough POSITIVE QBI means the activity does not have positive QBI. This implies the taxpayer cannot ignore a Schedule K-1 that appears to have a negative QIB.

4) The RPE can amend the Schedule K-1 to report this information up through the RPE’s normal 3-year statute of limitations.

AGGREGATION
1) An election to aggregate multiple businesses can be disregarded by IRS if the election is not attached to the return. Once IRS disaggregates the businesses, the taxpayer cannot re-aggregated those same businesses for the following three tax years.

2) An aggregation elected by an RPE cannot be ignored by the recipient of the Schedule K-1, although the recipient can elect to add to the aggregation for any OTHER businesses the recipient has that qualify.

3) The aggregation election cannot be made on an amended return with the exception of the 2018 return. IRS feels making the exception for 2018 is reasonable since this is new.

4) An aggregation election does NOT have to be made in the first year. It can be made in any year and is binding for all future years after made.

FINAL TEST CALCULATION – The final test calculation takes taxable income and reduces it by the net capital gains. The proposed regs said this was the net long-term capital gains from Schedule D less any net short-term capital losses. The final regs keep this same definition BUT qualified dividends are also considered “net capital gains” for this purpose.

Why did these changes happen? Partly because comments were sent to IRS with concerns, suggestions, and clarification requests. Your voice can be heard if you want it heard. The preamble contains information on submitting comments to IRS.

News Release 2019-04 contains links to the final regs discussed above as well as links to the official Revenue Procedure 2019-11 which defines "wages" for purposes of QBI, Notice 2019-07 containing a proposed Revenue Procedure dealing with QBI & rental activities, and proposed regs dealing with suspended losses as well as RICs.

You can find this News Release by going to irs.gov and entering "IR-2019-04" in the SEARCH box and then clicking on the link in the news release.

If you have questions about a certain area of QBI, you should check the examples in the regs because they may illustrate your issue.

THE END (for now).

This text has been shared courtesy of David & Mary Mellem, EAs & Ashwaubenon Tax Professionals.