Qualified Business Income Deduction Regulations

THE QBI REGULATIONS DISCUSSED IN THIS ARTICLE WERE UPDATED AND ISSUED AS FINAL REGULATIONS ON JANUARY 18, 2019, WITH SOME CHANGES TO THE FOLLOWING. SEE OUR LATER ARTICLE FOR CHANGES.

We sent an email out back in early January 2018 with our explanation of the Qualified Business Income (QBI) deduction based on information available at that time. We have presented information about QBI at many seminars since then. On August 8, 2018, IRS released a News Release about proposed regulations on the Qualified Business Income deduction.

Today's email contains answers to many of the questions we have heard regarding QBI. We will give the question and then the answer as we read it. Are we going to discuss QBI in length in this email? No. The many details of the QBI require a much longer discussion than an email. We suggest every tax professional attend at least two seminars involving QBI. This will give you an opportunity to hear different interpretations. Two or more different presentation styles will also help the understanding of this new tax issue. We recently presented a webinar of 4 CPE of QBI for NAEA (September 11), and barely finished in the time allotted and were unable to answer all questions that normally arise in a live face-to-face seminar.

These regulations can be found by going to www.irs.gov and entering in the SEARCH box "IR-2018-162". The first paragraph of the News Release contains a link to the proposed regulations. The third paragraph contains a link to Notice 2018-64 which includes an unnumbered proposed Revenue Procedure which discusses Wages for this purposes.

The pdf version of these regulations includes 104 pages of Preamble (covering IRS reasoning for some of its interpretations) and 80 pages of the actual six regulations. The regulations also include over 50 examples.

The regulations answer some of the questions we've had since the law was enacted, but still leave some issues unclear.

The regulations are titled:
- Regulation §1.199A-1 – Operations Rules.
- Regulation §1.199A-2 – Determination of W-2 Wages and unadjusted basis immediately after acquisition of qualified property.
- Regulation §1.199A-3 – Qualified business income, qualified REIT dividends, and qualified PTP income.
- Regulation §1.199A-4 – Aggregation.
- Regulation §1.199A-5 – Specified service trades or businesses and the trade or business of performing services as an employee.
- Regulation §1.199A-6 – Relevant passthrough entities (RPEs), publicly traded partnerships (PTPs), trusts, and estates.

Q&A #1 – HOW DOES A LOSS FROM ONE BUSINESS AFFECT OTHER BUSINESSES? The QBI for each business is calculated separately. This is basically the net profit shown on the tax form showing the business income.

If a business has a negative QBI (i.e., loss), the negative QBI reduces the QBI profits from other businesses. The loss from one or more businesses is allocated to all businesses that have profits based on each businesses profit compared to the total of all business profits.

EXAMPLE – Wilma has a $30,000 QBI loss from Business A, a QBI profit of $100,000 from Business B, and a QBI profit of $50,000 from Business C. The total of her QBI profits is $150,000 ($100,000 + $50,000) which results in rations of 2/3 and 1/3, respectively.

2/3 of $30,000 is $20,000 and is allocated to Business B.
1/3 of $30,000 is $10,000 and is allocated to Business C.

Therefore Business B's QBI profit of $100,000 is reduced by $20,000, which results in $80,000 of QBI. And Business C's QBI profit of $50,000 is reduced by $10,000 which results in $40,000 of QBI. These new amounts of $80,000 and $40,000 are used in the remaining calculations.
END EXAMPLE

Q&A #2 – ARE RENTAL ACTIVITIES ELIGIBLE FOR THE QBI DEDUCTION? QBI includes trade or business income. The code does not define "trade or business" for this purposes. IRS regulation §1.199A-1(b)(13) defines "trade or business" in part as "a section 162 trade or business other than the trade or business of performing services as an employee." IRC §162 is the IRC section that gives us the deduction for business expenses such as wages, travel expenses, rent paid, etc. This can be compared to IRC §212 which allows us to claim deductions in connection with the "production or collection of income" activities, which is where rentals fall UNLESS they rise to the level of a business.

The regulation further states: "In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a IRC §162 trade or business…". This implies to us that a rental is NOT QBI normally but would be QBI if it RISES to the level of a business. The regulation continues with "In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a IRC §162 trade or business, is nevertheless treated as a trade or business for purposes of IRC §199A, if the property is rented or licensed to a trade or business which is commonly controlled.

An example in the regulations create confusion because it includes renting of land and states the taxpayer is denied a QBI because he has high income and has wages paid nor depreciable property (required for high income taxpayers). If rentals are NOT QBI, then why does this example exist. But the example does state the rental activity is a business, which means this particular rental activity has "risen to the level of a business." The regulations do not provide any guidance on this so we will have to look at case law to determine what causes a rental activity to rise to the level of a business. We will not be addressing that in this email.

Q&A #3 – HOW IS THE QBI DEDUCTION CALCULATED FOR TAXPAYERS WITH TAXABLE INCOME ABOVE THE THRESHOLD BUT NOT ABOVE THE CEILING? The amount phased out is basically a pro-rata portion of the difference between the 20% of QBI calculation and the wage/property test calculation. The phase-out is applied by:

1) Subtracting the taxpayer's threshold amount ($157,500 ($315,000 for MFJ)) from the taxpayer's taxable income to determine the portion of the phase-out applicable to the taxpayer.
2) Divide the portion of the phase-out from step 1) by the phase-out range of $50,000 ($100,000 for MFJ) to come up with the percentage this portion represents to the total phase-out level.
3) Subtract the deduction limit using the wage/property test calculation rules from the deduction limit using the 20% of QBI rule.
4) Multiply the difference found in step 3) by the percentage found in step 2).
5) Reduce the 20% of QBI deduction amount by the result found in step 4). This results in the QBI deduction.

Q&A #4 – WHAT ARE THE CALCULATIONS FOR TAXPAYERS WITH A SPECIFIED SERVICE TRADE OR BUSINESS (SSTB)? A taxpayer with a SSTB and taxable income at or below the threshold has a tentative QBI deduction equal to 20% of QBI, just as any nonSSTB activity. A taxpayer with a SSTB and taxable income above the ceiling has a QBI deduction of $0 (denied for high income taxpayers). A taxpayer with taxable income that EXCEEDS the "threshold amount" and does NOT EXCEED the ceiling has a more complex computation to arrive at the tentative QBI deduction. For these taxpayers the amount of income, wages, and property is reduced by the percentage that the taxpayer is into the phase-out range. Then the same calculations that are used for taxpayers in the phase-out range are applied except they use these reduced amounts determine.

EXAMPLE – Charlie & Debra are married with a taxable income of $350,000 before the tentative IRC §199A deduction. Charlie has a SSTB business with a profit of $125,000. $10,000 in wages was paid during the year. The business owns no property.

Subtracting the threshold ($315,000) from their taxable income ($350,000) is $35,000. This is 35% into the phase-out range ($35,000/$100,000). This leaves 65% of the phase-out range left (100% – 35%).

The reduced amounts are:
Profit of $125,000 x 65% is $81,250
Wages of $10,000 x 65% is $6,500.
No property in this example just to keep it simple.

Then the normal calculations are used as described above.
END EXAMPLE

Q&A #5 – HOW ARE WAGES DETERMINED? Notice 2018-64 gives us three methods. The most common method used will probably be the "Modified Box 1 method", which basically takes the amounts shown in Box 1 of the W-2s, subtracts any income that is not wages for

Federal income tax withholding purposes, then adds the amounts reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

Q&A #6 – WHAT IS THE UNADJUSTED BASIS IMMEDIATELY AFTER ACQUSITION (UBIA)? This includes depreciable property used in the business. It does not include intangible property. Qualified property remains qualified property for a limited period of time, which is the longer of its normal MACRS recovery period OR 10 years from the date the property is first placed in service. This does include property acquired prior to 2018. Therefore, qualified property that meets the tests above placed in service in 2009 is "qualified property" for the year 2018, but not 2019. Qualified property placed in service in 2010 is "qualified property for years 2018 & 2019, but not 2020. Etc.

There are special rules in the regulations for determining this period for property acquired through a like-kind exchange or an involuntary conversion, as well as special rules for property acquired through IRC §721 or §351. This is more in depth than this email permits.

There are also special rules in the regulations to determine the UBIA of property acquired through a like-kind exchange or an involuntary conversion, as well as special rules for property acquired through various code section transactions such as IRC §§ 721, 351, 734, 743, 751, and 1014. This is more in depth than this email permits.

Property purchased within 60 days of the end of the year and disposed of within the first 120 days of the following year MUST be used for at least 45 days during this time frame or the property will NOT be considered qualified property for this deduction. However, this rule can be overcome if the taxpayer can show the acquisition/disposition took place for valid business reasons and was not done primarily to get a higher QBI deduction.

Q&A #7 – HOW DO THE REGULATIONS DEFINE "REPUTATION OR SKILL OF ONE OR MORE EMPLOYEES OR OWNERS" WHEN IT COMES TO IDENTIFYING A BUSINESS AS A SSTB? IRS 1.199A-5(b)(2)(xiv) defines this as:

1) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services,

2) A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity.

3) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

EXAMPLE 7 from the regulation – G owns 100% of Corp, an S corporation, which operates a bicycle sales and repair business. Corp has 8 employees, including G. Half of Corp's net income is generated from sales of new and used bicycles and related goods, such as helmets, and bicycle-related equipment. The other half of Corp's net income is generated from bicycle repair

services performed by G and Corp's other employees. Corp's assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Several of the employees and G have worked in the bicycle business for many years, and have acquired substantial skill and reputation in the field. Customers often consult with the employees on the best bicycle for purchase. G is in the business of sales and repairs of bicycles and is not engaged in an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.
END EXAMPLE

EXAMPLE 8 from the regulation – H is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to H's skill and reputation as a chef, H receives an endorsement fee of $500,000 for the use of H's name on a line of cooking utensils and cookware. H is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB. However, H is also in the trade or business of receiving endorsement income. H's trade or business consisting of the receipt of the endorsement fee for H's skill and/or reputation is an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.
END EXAMPLE

Q&A #8 – IS THERE AN OPPORTUNITY TO COMBINE TWO OR MORE BUSINESSES TOGETHER AND TREAT THEM AS ONE? Yes, the regulations, permit aggregating multiple business if they meet certain tests, including common control. This is covered in regulation 1.199A-4 and takes more space than we have in this email.

This text has been shared with you courtesy of: David & Mary Mellem, EAs & Ashwaubenon Tax Professionals, 920-496-1065 (920-496-9111).

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