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TO: Our Clients and Friends

FROM: Grossman Yanak & Ford LLP

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Qualified Business Income Deduction Clarified with the Release of Proposed Rules

A major provision allowing “pass through” business entities a deduction equal to 20% of their qualified business income (QBI) for tax years 2018 through 2025 was enacted as part of the [Tax Cuts and Jobs Act](#) (TCJA), which was signed into law on December 22, 2017. Taxpayers and tax practitioners have been awaiting further clarification and guidance on the application of this important tax break, one of the more complex provisions of that law.

The Internal Revenue Service had [earlier promised this guidance](#) to be available by the end of July, however, it was not released until August 8. [IRS Notice IR-2018-162](#) announces the release of proposed Treasury regulations setting forth additional clarification of the statute and its application. These regulations may add a level of clarity with respect to certain matters in the statute itself, but do little for minimizing complexity as the [proposed rules](#) number 184 pages.

The new deduction – referred to as the Section 199A deduction or the deduction for qualified business income – allows many owners of sole proprietorships, partnerships, trusts and S corporations to deduct 20% of their qualified business income. Qualified business income includes domestic income from a trade or business. Employee wages, capital gain, interest and dividend income are excluded. The regulations confirm the motivation that the deduction is intended to decrease the tax burden on business income only.

The deduction is generally available to eligible taxpayers whose 2018 taxable incomes fall below \$315,000 for joint returns and \$157,500 for other taxpayers. It is generally equal to the lesser of 20% of their qualified business income, plus 20% of their qualified real estate investment trust dividends and qualified publicly traded partnership income, or 20% of taxable income minus net capital gains. Deductions for taxpayers above the taxable income thresholds may be limited. Those limitations are fully described and expanded upon in the proposed regulations.

The deduction is available for tax years beginning after Dec. 31, 2017. As such, eligible taxpayers can claim it for the first time on the 2018 federal income tax return they file next year.

Primary Areas of Clarification

Essentially, the information set forth in the proposed regulations are encompassed in Sections 1.199A-1 through 1.199A-6.

Proposed regulation Section 199A-1 provides a number of operational rules addressing “Defined Terms” cited throughout the proposed regulations. Paramount to properly computing the deduction is the definition of “trade or business,” as that term is intended in the statutory language. For this purpose, the proposed rules defer to Internal Revenue Code Section 162, Trade

or Business Expenses as the guiding principle. In one single circumstance, the proposed regulations expand the Section 162 rules to include, solely for purposes of Section 199A, the rental or licensing of tangible or intangible property to a related trade or business is included if the rental and licensing activity and the other trade or business are “commonly controlled.” Common control is defined in the proposed rules under Section 1.199A-4(b)(1)(i). This inclusion is appropriate as many business owners tend to move real property, in particular, from their operating businesses due to business risk and other strategic purposes.

Proposed regulation section 1.199A-1 also sets out computational rules related to the basic deduction as well as carryover loss rules, including guidance for taxpayers exceeding certain income levels, which invoke the limitations imposed under the law.

The guidance provided in Section 1.199A-2 addresses the determination of W-2 wages and qualified business income (assets) property. Both are integral in computing the limitation that taxpayers must confront when they pass a certain income level. Rules are included for abusive transfers of property among related organization as well as like kind exchange and other nonrecognition asset transfers.

Proposed regulation Section 1.199A-3 provides guidance on the determination of Qualified Business Income, qualified REIT dividends and qualified PTP income.

The guidance provided in Section 1.199A-4 is intended to address taxpayers that choose to aggregate two or more trades or businesses. Since the law’s passage, taxpayers have requested that the Treasury develop rules allowing for “grouping” of multiple taxpayer activities as is the case under the Treasury regulations supporting the passive activity rules. For various reasons explained in the proposed regulations, these rules were found to be inappropriate by the Service. The key element of this section of the proposed rules is that aggregation of activities will be permitted, but not required.

Proposed regulation Section 1.199A-5 addresses the meaning of the term “Specified Service Trade or Business,” and the “Trade or Business of Performing Services as an Employee.” Both are important concepts, in that these activities are not entitled to the Qualified Business Income deduction.

One of the most-awaited elements of the proposed rules was guidance on what constitutes a Specified Service Trade or Business (SSTB). The definition set forth in section 199A incorporates, with modifications, the text of Section 1202(e)(3)(A), which substantially tracks the definition of “qualified personal service corporation” under Section 448. Therefore, consistent with ordinary rules of statutory construction, the guidance in proposed regulation Section 1.199A-5(b) is informed by existing interpretations and guidance under both Sections 1202 and 448 when relevant.

However, existing guidance under those sections is sparse, and the scope and purpose of those sections and section 199A are different. The Treasury Department and the IRS also note that, unlike those other Sections, the purpose of section 199A is to provide a deduction based on the character of the taxpayer’s trade or business. Distinct guidance for section 199A is warranted. As such, the proposed regulations provide the following clarifications to the definition of an SSTB for purposes of Section 199A.

A Specified Service Trade or Business is:

- (1) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, and
- (2) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

These rules are very similar to definitions for qualified personal service corporations contained in Sections 1202 and 448, as noted above.

The last section of the proposed regulations, Section 1.199A-6, is required for pass through entities that report Section 199A information to their owners and beneficiaries. It is necessary to report Section 199A information to the Internal Revenue Service in order to ensure that taxpayers properly report in accordance with the rules of the proposed regulations the correct amount of deduction under Section 199A.

Additional Information

The IRS also issued a second release, [Notice 2018-64](#), which provides methods for calculating Form W-2 wages for purposes of the limitations on the deduction. Additional information about the proposed regulations can be found on the IRS website at [FAQs on Section 199A](#).

Since these proposed regulations are so extensive, the Tax Services Group at Grossman Yanak & Ford LLP will continue to study the details and assess the implications. We expect to continue to provide an ongoing commentary as more information about the rules becomes available.

Questions and comments can be directed to the GYF Tax Executives listed below.

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