PUBLICATION

Qualified Business Income Deduction Guidance Package Released

Authors: Thomas J. Mahoney, Jr., Allen Brooks Blow
January 24, 2019

Despite the ongoing partial government shutdown, the IRS issued four sets of guidance (the Guidance Package) on January 18 related to the new deduction for owners of pass-through entities of up to 20 percent of their "qualified business income" (the QBI Deduction). Those entities include (i) partnerships (including LLCs taxed as partnerships); (ii) entities that have elected to be taxed as S corporations; and (iii) sole proprietorships (including LLCs with a single owner or otherwise treated as disregarded from their owner).

Final Regulations

The Guidance Package includes final regulations with respect to the QBI Deduction. The IRS had previously issued proposed regulations on August 8, 2018. The final regulations are largely consistent with the proposed regulations; however, the IRS made a number of technical changes and clarifications in the final regulations.

Importantly, in recognition that taxpayers may have already begun to prepare returns in reliance on the proposed regulations, solely for tax years ending during 2018, the final regulations permit taxpayers to rely on either the final regulations or the proposed regulations in preparing their tax returns.

Final Regulations – Aggregation Rules

Consistent with the proposed regulations, the final regulations provide elective rules pursuant to which commonly owned businesses may be aggregated for purposes of the QBI Deduction.

Aggregation by Pass-Through Entities

Under the proposed regulations, elective aggregation was available only to individuals. However, under the final regulations, aggregation is permitted at the entity level, such that a pass-through entity which operates more than one trade or business may elect to aggregate such trades or businesses so long as the other requirements for elective aggregation are satisfied. To the extent a pass-through entity elects to aggregate at the entity level, such pass-through entity must attach a schedule to each owner's Schedule K-1 disclosing the aggregation and each such owner must report consistently with such entity level aggregation. A pass-through entity's decision not to aggregate, however, does not prevent each of its owners from making personal elections to aggregate, as appropriate, which personal elections need not be consistent with those made by other owners.

Clarification Regarding Aggregation of Real Estate Trade or Business

Under the proposed regulations, separate trades or businesses could not be aggregated unless, among other requirements, at least two of the three criteria for aggregation set forth in the proposed regulations were satisfied. One of those criteria was that the two trades or businesses provide products and services that are the same or are customarily offered together. Because real estate is neither a product nor a service, it was unclear how this criterion would apply to real estate enterprises. Under the final regulations, this criterion will be satisfied if the trades or businesses provide products, property, or services that are the same or are

customarily offered together. Therefore, a real estate enterprise may satisfy such criterion under the final regulations.

Final Regulations – Specified Service Trade or Business Rule

Elimination of "Incidental to" Specified Service Trade or Business Rule

A taxpayer engaged in a specified service trade or business (SSTB) who has taxable income above $415,000 (in the case of a joint return) or $207,500 (in the case of other returns), generally may not treat any of the income from an SSTB as qualified business income for purposes of the QBI Deduction. Under the proposed regulations, if a trade or business which would not otherwise constitute a SSTB (for purposes of this paragraph, a non-SSTB) has 50 percent or more common ownership with an SSTB and shares expenses with an SSTB (including wage and overhead expense), such non-SSTB was treated as incidental to, and a part of the SSTB, if the gross receipts of the non-SSTB represented no more than five percent of the total combined gross receipts of the non-SSTB and the SSTB in a taxable year. The final regulations eliminate this forced aggregation rule. However, the final regulations retain other forced aggregation rules meant to prevent taxpayers from engaging in the so-called "crack and pack" strategy, whereby a taxpayer separates the portion of their business which would qualify for the QBI Deduction from the portion of the business which would not qualify due to the exclusion for SSTBs. You can see our discussion of these provisions in our Tax Alert on the proposed regulations here.

Franchising of Specified Service Trades or Businesses

Under the proposed regulations, it was unclear whether a taxpayer who was engaged in the business of franchising a brand involving the performance of services which, if performed by the taxpayer would constitute an SSTB, would themselves be deemed to be engaged in an SSTB. The final regulations include an example which makes it clear that, where a franchisor is merely engaged in the business of franchising a brand to an SSTB, and is not itself engaging in specified services, the franchisor's business will not be deemed an SSTB. So, for example, a franchisor's business of franchising a financial planning brand will not constitute an SSTB, even though the franchisee's business of operating such financial planning business would constitute an SSTB.

Proposed Revenue Procedure Providing Safe Harbor for Rental Real Estate Enterprises

As part of the Guidance Package, the IRS Issued Notice 2019-07 (the "Proposed Revenue Procedure"). The Proposed Revenue Procedure provides a safe harbor pursuant to which a rental real estate enterprise (RREE) may be treated as a trade or business for purposes of the QBI Deduction. In order to qualify for the QBI Deduction, income must be derived from a "qualified trade or business." The final regulations provide that a "qualified trade or business" is a "trade or business under Section 162 [of the Internal Revenue Code] (a Section 162 trade or business) other than the trade or business of performing services as an employee." Whether a particular RREE constitutes a "trade or business" under Section 162 is a fact specific inquiry, which has generated much litigation and uncertainty through the years. Under the Proposed Revenue Procedure, solely for purposes of the QBI Deduction, an RREE will be treated as a "trade or business" if each of the following requirements are satisfied:

Separate books and records are maintained to reflect income and expenses for each RREE.

For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed per year with respect to the RREE. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years (ending with the current taxable year), 250 or more hours of rental services are

performed per year with respect to the RREE.

The taxpayer maintains records with respect to (a) hours of all services performed, (b) descriptions of all services performed, (c) dates on which services are performed, and (d) who performed such services.

For purposes of the Proposed Revenue Procedure, "rental services" include (i) advertising to rent or lease the property, (ii) negotiating and executing leases, (iii) verifying information contained in prospective tenant applications, (iv) collection of rent, (v) daily operation, maintenance, and repair of the property, (vi) management of real estate, (vii) purchase of materials, and (viii) supervision of employees and independent contractors. Such services may be performed by the owner, or by employees, agents, or independent contractors.

The Proposed Revenue Procedure does not apply if (1) the real estate is used by the taxpayer as a residence for any part of the year, or, importantly, (2) *if the real estate is rented under a triple net lease*.

In order to elect to have the Proposed Revenue Procedure apply, a taxpayer must attach a statement to the tax return on which he or she claims the QBI Deduction for the RREE, signed under penalties of perjury, stating that each of the requirements set forth in the Proposed Revenue Procedure has been satisfied.

Please remember that advice and counsel regarding your particular tax related issues, including the potential impact and application of the developments outlined above, are dependent on your specific facts and circumstances. For more information about how these issues may affect you, your business, or related matters, contact the co-authors of this alert, Tom Mahoney and Allen Blow, or any member of Baker Donelson's Tax Group.