



February 21, 2018

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. William M. Paul
Principal Deputy Chief Counsel and
Deputy Chief Counsel (Technical)
Internal Revenue Service
Washington, DC 20224

RE: Request for Immediate Guidance Regarding IRC Section 199A – Deduction for Qualified Business Income of Pass-Through Entities (Pub. L. No. 115-97, Sec. 11011)

Dear Messrs. Kautter and Paul:

The American Institute of CPAs (AICPA) respectfully requests immediate guidance on various issues regarding the new Internal Revenue Code (IRC or “Code”) section 199A, the deduction for qualified business income (QBI) of pass-through entities. Taxpayers and practitioners need clarity regarding QBI in order to comply with their 2018 tax obligations and to make informed decisions regarding cash-flow, entity structure, and other tax planning issues.

While we have identified many items affecting QBI that we recommend the government address in the coming months, we urge the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) to focus their immediate attention on six questions in need of priority guidance. Our letter includes both the AICPA priority questions as well as our suggested responses to those questions. We have also attached a list of other issues affecting QBI that warrant guidance.

Specifically, we recommend that Treasury and IRS immediately provide guidance on the following issues:

- I. Definition of section 199A Qualified Business Income
- II. Aggregation method for calculation of QBI of pass-through businesses
- III. Deductible amount of QBI for a pass-through entity with business in net loss
- IV. Qualification of wages paid by an employee leasing company
- V. Application of section 199A to an owner of a fiscal year pass-through entity ending in 2018
- VI. Availability of deduction for Electing Small Business Trusts (ESBTs)

The AICPA is the world’s largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to

individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact me at (408) 924-3508 or Annette.Nellen@sjsu.edu; Troy Lewis, Chair, AICPA Qualified Business Income Task Force, at (801) 523-1051 or tlewis@sisna.com; or Amy Wang, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9264 or Amy.Wang@aicpa-cima.com.

Sincerely,

A handwritten signature in black ink, appearing to read "Annette Nellen". The signature is fluid and cursive, with the first name "Annette" written in a larger, more prominent script than the last name "Nellen".

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

Encl.

cc: The Honorable David J. Kautter, Acting Commissioner, Internal Revenue Service
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation

AMERICAN INSTITUTE OF CPAs

**Request for Immediate Guidance Regarding
IRC Section 199A Deduction for Qualified Business Income of Pass-Through Entities
(Pub. L. No. 115-97, Sec. 11011)**

Developed by the AICPA Qualified Business Income Task Force

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AMERICAN INSTITUTE OF CPAs

Request for Immediate Guidance Regarding IRC Section 199A Deduction for Qualified Business Income of Pass-Through Entities (Pub. L. No. 115-97, Sec. 11011)

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I. Definition of Section 199A Qualified Business Income

Overview

For purposes of Internal Revenue Code (IRC or “Code”) section 199A,¹ qualified business income (QBI) is income related to a qualified trade or business. A qualified trade or business is defined as a trade or business other than a specified service trade or business, or the trade or business of performing services as an employee. Income from a specified service trade or business is defined as income from a trade or business described in section 1202(e)(3)(A), but excluding the income from “engineering” and “architecture” services.

Recommendations

The Department of the Treasury (“Treasury”) and Internal Revenue Service (IRS or “Service”) should provide clarity on the definition of the term “qualified business income” by defining what activities constitute a qualified trade or business under section 199A. This request includes defining a trade or business that generates QBI and clarifying what activities are excluded as a specified service trade or business.

Specifically, the AICPA recommends that Treasury and IRS provide the following items:

1. Guidance that a trade or business is identified at the activity level, rather than entity level, whereby a business composed of multiple types of activities should have the ability to segregate qualified and nonqualified business income from services.
2. Guidance that defines what constitutes a “business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners” in the interpretation of section 1202(e)(3)(A).
3. Guidance that provides a gross receipts safe harbor test whereby nonqualified income generated by a trade or business is deemed as QBI for each taxable year if the nonqualified gross receipts are 5 percent or less of the total combined qualified and non-qualified gross receipts from the same trade or business.
4. Guidance that income from a qualified trade or business is eligible for the QBI deduction when received by a passive shareholder/partner.
5. Guidance that rental real estate is included in the definition of qualified trade or business under section 199A.

¹ Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury Regulations promulgated thereunder.

6. Guidance on what activities are included in the definition of specified service trade or business under section 199A.
 - a. Specify that precedents established in section 448² apply to section 1202(e)(3)(A), where appropriate.
 - b. Specify that specified service trade or businesses do not include:
 - i. Valuation;
 - ii. Appraisals;
 - iii. Billing/accounts management; and
 - iv. Software solution development and sales.

Analysis

1. *Guidance that a trade or business is identified at the activity level, rather than entity level, whereby a business composed of multiple types of activities should have the ability to segregate qualified and nonqualified business income from services.*

The term “trade or business” is widely used yet does not have a formal definition in the Code or Treasury regulations. The common interpretation is to apply the term to activities that are conducted on a regular basis with the intent of making a profit. In some cases, a taxpayer may have an ownership share of an entity with multiple lines of business activities, similar to a conglomerate. Alternatively, for legitimate business purposes, a taxpayer may have an ownership share of a business that uses multiple operating entities contributing to a single trade or business activity, such as commercial real estate. Qualification for the section 199A deduction should not depend on the legitimate operating structure of a taxpayer’s trade or business activities.

Section 199A, in conjunction with its reference to section 1202(e)(3)(A), seeks to subtract ill-defined businesses from a currently vague definition of what constitutes a “trade or business.” Businesses that have both qualified and nonqualified business components need to understand how to segregate and then calculate the amount of any QBI attributable to their multiple activities. Without further guidance on what activities are considered a trade or business, uncertainty will remain. For example, a trade or business providing veterinarian services could offer healthcare services for animals while also offering non-healthcare goods and services (such as, grooming, pet food, toys, and other products). Such a trade or business should have the ability to segregate their net business income between specified service and non-service activities for purposes of calculating the section 199A deduction.

Once taxpayers identify the qualified and nonqualified business activities, they should segregate by revenue, then allocate expenses. The taxpayer should allocate expenses and costs of goods sold based upon concepts applied under Treas. Reg. § 1.199-4, applying simplified methods.

² See Temp. Reg. § 1.448-1T(e)(5)(vii), at Example 1: “...a Corporation, is engaged in the business of providing accounting services to its clients. These services consist of the preparation of audit and financial statements and the preparation of tax returns. For purposes of section 448, such services consist of the performance of services in the field of accounting. In addition, for purposes of section 448, the supervision of employees directly preparing the statements and returns, and the performance of all administrative and support services incident to such activities (including secretarial, janitorial, purchasing, personnel, security, and payroll services) are the performance of services in the field of accounting.” Additionally, guidance on section 448 definitions includes Private Letter Rulings (PLRs) and other similar guidance, that apply to section 1202(e)(3)(A), where appropriate.

2. *Guidance that defines what constitutes a “business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners” in the interpretation of section 1202(e)(3)(A).*

Subtracting the specified service activities referenced in section 1202(e)(3)(A) requires taxpayers to determine if their businesses’ principal asset is the reputation or skill of themselves or their employees, or something else. Also, if this section applies, taxpayers need a clear definition as to whether their activities are fully excluded from the definition of qualified trade or business, partially excluded, or not excluded at all.

We suggest that the guidance focus on the reputation or skill in providing services based on whether customers, patients, or clients look to specific individuals to perform the required tasks. For example, the assignment of a task to any trained or qualified employee, is not a business relying on the reputation or skill of one or more of its employees. However, a business that is dependent upon a *specific* employee’s or owner’s skill in performing a task, is a specified trade or business.

3. *Guidance that provides a gross receipts safe harbor test whereby nonqualified income generated by a trade or business is deemed as QBI for each taxable year if the nonqualified gross receipts are 5 percent or less of the total combined qualified and non-qualified gross receipts from the same trade or business.*

For administrative convenience and ease of compliance, Treasury and IRS should provide a gross receipts safe harbor *de minimis* test that is consistent with existing rules in Treas. Reg. § 1.199-1(d)(3). This *de minimis* rule should provide that nonqualified income generated by a trade or business is disregarded as nonqualified income and deemed as QBI for each taxable year if the nonqualified gross receipts are 5 percent or less of the total combined qualified and non-qualified gross receipts from the same trade or business. This guidance will help alleviate compliance burdens for small and large businesses that participate minimally in nonqualified trade or business activity each year.

4. *Guidance that income from a qualified trade or business is eligible for the QBI deduction when received by a passive shareholder/partner.*

According to section 199A(c)(1): “the term ‘qualified business income’ means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.” Therefore, the law has no requirement for taxpayers to actively participate in a qualified trade or business. Treasury and IRS should specifically state that passive shareholders and partners qualify for the QBI deduction.

5. *Guidance that rental real estate is included in the definition of qualified trade or business under section 199A.*

The definition of “trade or business” in section 199A is unclear as to what real estate activities are included in the definition of qualified trade or business. In particular, certain real estate rentals

were considered by the IRS historically as a section 212 activity rather than trades or businesses.³ Therefore, Treasury and IRS should clarify that the income from rental real estate owned in part or in full by the taxpayer and leased to the taxpayer's trade or business entity as part of the taxpayer's trade or business activity is included in QBI. Similar guidance exists in the treatment of self-rental activity.⁴ In addition, guidance should specify that real estate rental activity of a real estate professional, as defined in section 469(c)(7), generates QBI. Finally, guidance should specify whether there are any specific circumstances in which other rental real estate activities would not generate qualified trade or business income under section 199A.

6. *Guidance on what activities are included in the definition of specified service trade or business under section 199A.*

Treasury and IRS should provide guidance on what activities are included in the definition of specified service trade or business under section 199A. For example, the guidance should clarify that the definition of the term "accounting services" includes any services associated with the determination of tax liabilities including preparation, tax planning, cost segregation services, services rendered with respect to tax credits and deductions, and similar consultative services. The guidance should further state that precedents established in section 448,⁵ along with Private Letter Rulings (PLRs) and similar guidance under section 448, apply to section 1202(e)(3)(A), where appropriate.

Additionally, health, law, accounting, actuarial science, and other specified services that are provided by individuals and businesses performing essentially the same activities should have the same tax treatment irrespective of any degree, license, training or credentials of the service provider. Similar service activities should receive similar tax treatment. Such treatment applies a key principle of good tax policy,⁶ specifically equity and fairness, which highlights the importance that Treasury and IRS treat and tax similarly situated taxpayers similarly.

Further, taxpayers need clarification that activities including valuations, appraisals, billing/accounts management and software solution development and sales are qualified trade or businesses for the QBI deduction.

³ See the commentary in Treasury Decision (TD) 9644, at 5.E.iii, effective date: December 2, 2013: "However, for several reasons, the Treasury Department and the IRS do not believe that every real estate professional is necessarily engaged in the trade or business of rental real estate."

⁴ See Treas. Reg. § 1.1411-4(g)(6)(i): "Gross income from rents. To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section."

⁵ See Temp. Reg. § 1.448-1T(e)(5)(vii), at Example 1: "...a Corporation, is engaged in the business of providing accounting services to its clients. These services consist of the preparation of audit and financial statements and the preparation of tax returns. For purposes of section 448, such services consist of the performance of services in the field of accounting. In addition, for purposes of section 448, the supervision of employees directly preparing the statements and returns, and the performance of all administrative and support services incident to such activities (including secretarial, janitorial, purchasing, personnel, security, and payroll services) are the performance of services in the field of accounting."

⁶ AICPA, "[Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals](#)," January 2017.

II. Aggregation Method for Calculation of QBI of Pass-through Businesses

Overview

For each qualified trade or business, the taxpayer is allowed a deductible amount equal to the lesser of 20 percent of the QBI with respect to such trade or business or the Form W-2 wage limit. (For this purpose, we refer to the two alternative limits in section 199A(b)(2)(B) as a single limit.) Although section 199A(b)(2) requires the calculation of the deductible amount described in the preceding sentence on a trade or business by trade or business basis, the provision does not provide a restrictive definition of the term “trade or business.”

Recommendations

Treasury and IRS should invoke, in part, the regulation promulgation authority provided in section 199A(f)(4) to adopt a method of aggregation for calculating QBI for pass-through businesses. For example, guidance should provide that, for purposes of determining the amount deductible under section 199A(b)(2), the QBI and Form W-2 limitations are determined after the application of Treas. Reg. § 1.469-4(d)(5), regarding the grouping of activities conducted through partnerships and S corporations. A taxpayer should have an opportunity to aggregate or group separate legal activities together for purposes of applying the section 199A wage/investment limitations if the taxpayer’s activities are managed as one trade or business.

Similar to Treas. Reg. § 1.469-11(b)(3)(iii) and (iv), guidance should provide that upon the date of adoption of the aggregation rules, or upon the first year a taxpayer is eligible to claim a QBI deduction, the taxpayers are given an opportunity to re-group activities in light of this significant change in taxation for qualified trades or businesses.

Analysis

The ability to aggregate or group separate legal activities together will provide relief from a need to restructure where a family business has employees in a single entity, but the operating entities are separate. For example, a retailer might have one management holding company entity with executives and administrative staff, but each store front is in a separate legal entity underneath the management company. This example would allow for aggregating the QBI from the management business (with all of the Form W-2 wages) with the taxpayer’s other trades or businesses, in lieu of having to issue employees a Form W-2 from each entity.⁷ Secondly, it would prevent large family businesses with dozens, if not hundreds, of separate businesses (such as rental real estate projects) from having to calculate the deduction dozens, if not hundreds, of times for each shareholder. To the extent the upper tier partnership or S corporation groups these lower tier businesses into one or more appropriate economic units, the information reporting process is simplified.

Additionally, this recommendation should not cause any abuse of the section 199A deduction. If a holding company owns fifteen operating companies and one specified service business providing services only to the fifteen operating companies, the service business would have zero QBI after

⁷ Treas. Reg. § 1.199-2(a)(2) is not limited in its application to a related party employee leasing company.

aggregation. The adoption of grouping should also require a line-item segregation of items attributable to a specified service business. Owners with incomes over the thresholds would not include those amounts into their calculation whereas owners with incomes under the thresholds would include the amounts. We recognize that what constitutes a group for section 469 purposes is broader than a trade or business.⁸ However, the IRS has previously overcome the difference between section 469 activities and traditional trade or business activities in the section 1411 regulations.

Some businesses are not held through holding companies but are operated in a combination of holding companies and brother-sister pass-through entities. Individuals, estates and trusts are allowed to group those pass-through entities into appropriate economic units after the partnerships and S corporations have grouped the activities under Treas. Reg. § 1.469-4(d)(4). The same efficiencies exist in allowing section 199A to respect the taxpayers' section 469 groupings at the individual, estate or trust level as the rules provide for partnerships or S corporations.

Similar to sections 469 and 1411, Treasury should not interpret changes to the Code in a manner that necessitates changes in the legal structures and employment arrangements of businesses. Our interpretation is consistent with the ordering provisions, which appear to apply section 199A after taxable income (before section 199A) is determined. Taxpayers group their activities in accordance with section 469; those groupings should also apply for section 199A.

Additionally, the application of a separate legal entity standard is neither reasonable for taxpayer compliance nor efficient for IRS administration. Allowing taxpayers the opportunity to aggregate or group separate legal activities together for purposes of applying the section 199A will provide administrative relief to tiered entities and family businesses. For simplicity and consistency, Treas. Reg. § 1.469-4 standards should apply.

III. Deductible Amount of QBI for a Pass-through Entity with Business in Net Loss

Overview

Section 199A(c)(1) defines QBI as “the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.” Section 199A(c)(3)(ii) provides that “qualified items of income, gain, deduction, and loss” include any such item that is “included or allowed in determining taxable income for the taxable year.” A taxpayer that incurs net losses from his or her trade or business activities may face an increased administrative burden in determining the effect of the loss in computing the section 199A deduction (if any) for the taxable year that the loss originated, or for the year to which the taxpayer carried the loss.

Recommendations

The AICPA recommends that the IRS provide regulations that address the effect of losses in the application of section 199A. Specifically, taxpayers need:

1. Examples clarifying the mechanics of losses in section 199A, including:

⁸ See Treas. Reg. § 1.469-4(b)(1) and (2).

- a. Example to clarify that if the taxpayer has a loss carryover under section 199A(c)(2) for the taxable year, the taxpayer does not proceed to any other part of section 199A;
 - b. Example to clarify that a QBI loss is treated as incurred in a separate or notional qualified trade or business in the next year in order to illustrate how the taxpayer computes the section 199A(b)(2) deductible amounts in the following taxable year;
 - c. Example to clarify that a negative deductible amount for a qualifying trade or business does not carry over to the following taxable year; and
 - d. Example to clarify that no amounts are carried over to the following taxable year if the sum of the deductible amounts used to calculate a combined QBI in section 199A(b)(1)(A) is negative.
2. Clarification on how losses that are limited, suspended, and/or carried over pursuant to sections 704(d), 1366(d), 465, 469, and 461(l) are considered in computing section 199A(b)(2) deductible amounts, including:
 - a. Guidance that any items limited and carried over to a succeeding tax year by these sections are taken into account in the year in which the taxpayer includes the items in computing taxable income; and
 - b. Guidance that these items described above are included as QBI from the qualifying trade or business that originated the loss that was previously limited or suspended and not as a loss from a separate or notional qualifying trade or business that the loss carryover rule in section 199A(b)(2) contains.
 3. Alternative optional method to simplify the calculation for taxpayers with taxable income below the threshold amount, including:
 - a. Guidance that taxpayers with taxable income under the threshold amount should have the option of an alternative method to aggregate all items of income, gain, loss, and deduction from all of its qualifying trades or businesses to determine whether there is a loss carryover under section 199A(c)(2); and
 - b. Guidance that taxpayers should have the ability to use this alternative method to compute the section 199A(b)(2) deductible amounts and the combined QBI.

Specifically, taxpayers with taxable income under the threshold amount should have the option of an alternative method to aggregate all items of income, gain, loss, and deduction from all of its qualifying trades or businesses to determine whether there is a loss carryover under section 199A(c)(2). Additionally, these taxpayers should have the ability to use this alternative method to compute the section 199A(b)(2) deductible amounts and the combined QBI.

Analysis

1. Examples clarifying the mechanics of losses in section 199A.

Examples should illustrate that in accordance with section 199A(c)(2), the taxpayer must determine whether the aggregate of the QBI amounts results in a positive or negative number. If the amount is negative, the taxpayer must treat the negative amount as a loss from a qualified trade or business in the following taxable year. Additionally, if the sum of the deductible amounts used to arrive to a combined QBI in section 199A(b)(1)(A) is negative, examples should clarify what, if any, amounts are carried over to the following taxable year.

If the amount is a positive number, the taxpayer does not have a loss carryover in the taxable year and the taxpayer calculates the section 199A(b)(2) deductible amounts for each qualified trade or business. Since the deductible amount for each qualifying trade or business could result in a positive or negative amount, examples should clarify that a negative deductible amount (i.e., where the deduction itself is negative, after considering other applicable limitations) for a qualifying trade or business does not carry over to the following taxable year.

Example:

Company A, an S corporation with one individual shareholder B, is a domestic manufacturer that produces QBI. For the tax year ended December 31, 2018, Company A has a QBI loss of \$300,000, with Form W-2 wages of \$400,000. For the tax-year ended December 31, 2019, Company A has QBI income of \$800,000, with Form W-2 wages of \$50,000. Shareholder B is over the relevant taxable income threshold for the year ended December 31, 2019. Company A is the only applicable activity for shareholder B for the year.

Presumably, the \$300,000 QBI loss in 2018 carries forward to 2019 to offset the \$800,000 QBI income incurred in 2019, resulting in a net \$500,000 of QBI for 2019.

However, please clarify whether shareholder B has a QBI deduction of \$100,000 (20 percent of \$500,000). Under the facts above, would the section 199A deduction for shareholder B have an overall Form W-2 wage limitation of \$25,000 (or 50 percent of \$50,000 in wages from 2019), whereby the benefit of the \$400,000 in wages incurred in 2018 is disregarded?

- 2. Clarification on how losses that are limited, suspended, and/or carried over pursuant to sections 704(d), 1366(d), 465, 469, and 461(l) are considered in computing section 199A(b)(2) deductible amounts.*

Other sections in the Code may limit the taxpayer's ability to take into account losses or deductions for other purposes of the Code for a taxable year. Section 199A(c)(3)(ii) allows taxpayers to only include items of income, gain, loss, and deduction that are included or allowed in computing the taxable income for the year. Certain items from a taxpayer's trade or business have limitations due to the application of section 704(d) (limitation on allowance of partner's distributive share of partnership loss), section 1366(d) (limitation on allowance of shareholder's pro rata share of S corporation losses and deductions), section 465 (deductions limited to amount at risk), section 469 (passive activity losses), and section 461(l) (limitation of losses for taxpayers other than corporations). Additionally, taxpayers need guidance that include how the wage limitation applies when a business loss is only partially deductible (e.g., due to section 1366(d) loss limitations).

- 3. Alternative optional method to simplify calculation for taxpayers with taxable income below the threshold amount.*

Treasury and IRS should allow certain taxpayers, with taxable income below the threshold amount, to have the option to apply a simplified alternative method to calculate the QBI deduction. The

threshold amount defined in section 199A(e)(2)⁹ is used to determine whether any items of income, gain, deduction, or loss from a specified service trade or business result in QBI or a loss carryover for the taxpayer. The threshold amount is also used to determine whether the limitations provided in section 199A(b)(2)(B) apply in determining the section 199A(b)(2) deductible amounts. If the taxpayer's taxable income is under the threshold amount, all of the items related to a specified service trade or business are treated as QBI. Therefore, we suggest that the regulations provide an optional (by election or via form and instructions) method that a taxpayer with taxable income below the threshold amount can use to aggregate all items related to its qualifying trades or businesses to determine whether there is a loss carryover under section 199A(c)(2) and to compute the section 199A(b)(2) deductible amounts and combined QBI.

IV. Qualification of Wages Paid by an Employee Leasing Company

Overview

Under section 199A(b)(2), the amount of the deductible QBI is limited to the lesser of 20 percent of the taxpayer's QBI with respect to the qualified trade or business, or the greater of 50 percent of the Form W-2 wages *with respect to* (emphasis added) the qualified trade or business, or the sum of 25 percent of the Form W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property. This limitation is not applicable if the taxpayer's taxable income is below a certain threshold amount each year (section 199A(b)(3)(A)) and the limit is phased-in for taxpayers with taxable income above the threshold amount up to \$50,000 (\$100,000 in the case of a joint return) (section 199A(b)(3)(B)).

Recommendation

The AICPA recommends that Treasury and IRS provide that a trade or business includes, in its Form W-2 wage limitation, the qualifying wages paid by an employee leasing company in addition to the qualifying wages paid to its common law employees. Specifically, taxpayers and tax preparers need guidance that the phrase: "with respect to," under section 199A(b)(2)(B)(i), includes Form W-2 wages paid by a leasing company, whether independent or related, if such wages are paid to employees that perform services on a substantially full-time basis to a trade or business that generates QBI.

Analysis

The wage limitation is presumably intended to deny or at least significantly reduce the QBI deduction to trades or businesses that do not generate employment and related payroll costs. Many trades or businesses are serviced not by employees directly paid by the same business entity but rather by either an independent employee leasing company, a so-called Professional Employer Organization (PEO), or in a related employee leasing company owned identically or nearly identical to that of the operating business (collectively, a PEO). A company outsources employee management tasks, human resource functions, payroll, employee benefits and training among other responsibilities to the PEO. PEOs are established for legal risk mitigation of employment issues,

⁹ For 2018, "the term 'threshold amount' means \$157,500 (200 percent of such amount in the case of a joint return)."

securing the ability to lower related payroll costs associated with plan administration, worker's compensation insurance coverage and providing the ability of the business to offer superior employee work benefits. In this co-employment relationship, the PEO becomes the employer for tax reporting purposes. Legally, employees working for the leasing company are employees of the PEO even though they may exclusively work for the QBI related trade or business. The trade or business will often report no employees on its payroll because the entire payroll relationship is handled through a PEO.¹⁰

This guidance should include similar language to that provided in Treas. Reg. § 1.199-2(a)(2). The term W-2 wages means all remuneration for services performed by an employee for his or her employer with limited exceptions under section 3401(a). However, Treasury and IRS should restrict the Form W-2 limitation to amounts *properly allocable* (emphasis added) to the qualified trade or business of the taxpayer for purposes of the QBI deduction (section 199A(b)(4)(B) and (c)(1)).

Example:

Company A, an S corporation, is a domestic manufacturer that produces QBI. Company A leases 10 employees, who work exclusively for and under the direction of Company A, from PEO B. Company A has no qualified property.

For tax-year ended December 31, 2018, Company A has QBI of \$500,000 and no wages paid directly to employees. However, PEO B paid Form W-2 wages of \$400,000 to the 10 employees with respect to Company A.

Company A would calculate its QBI by multiplying \$500,000 by 20 percent to arrive at a tentative \$100,000 QBI deduction. Since the leased employees worked exclusively for, and were under the primary direction or control of Company A, the Form W-2 wage limitation is \$200,000 (\$400,000 times 50 percent). Company A's QBI deduction is \$100,000.

V. Application of Section 199A to an Owner of a Fiscal Year Pass-through Entity Ending in 2018

Overview

The effective date of section 199A is for taxable years beginning after December 31, 2017. Section 199A applies to owners of pass-through entities, rather than at the entity-level. Thus, it appears that an owner of a fiscal year pass-through entity uses entity information that is normally used in calculating taxable income for 2018, even though that entity information includes months prior to January 1, 2018.

¹⁰ Approximately 2.7 to 3.4 million worksite employees are employed through a PEO. Such estimates do not include leasing of employees through a related entity. See National Association of Professional Employer Organizations (NAPEO) report on "[Key Findings of An Economic Analysis: The PEO Industry Footprint](#)," released September 2015.

Recommendations

The AICPA recommends that Treasury and IRS clarify that the section 199A deduction applies to all of the income that an owner receives on a Schedule K-1 of a fiscal year pass-through entity (i.e., partnership or S corporation) ending in 2018.

Analysis

It is critical for individual taxpayers to have immediate clarification on the application of section 199A to owners of fiscal year pass-through entities ending in 2018. The QBI deduction applies to individual taxpayers (rather than to partnerships and S corporations) for tax years beginning after December 31, 2017, and individual owners of such entities need guidance that the entity's choice of fiscal year does not impede the ability of owners to obtain the benefit of section 199A for their 2018 individual tax year.

For example, a partnership with a July 31, 2018 fiscal year end provides Partner A with a Schedule K-1 for the year ended July 31, 2018 which Partner A uses to calculate their 2018 tax return. Our understanding of the statute and effective date is that Partner A should include all of the income from the fiscal year end Schedule K-1 to calculate the QBI deduction on his or her 2018 tax return.

VI. Availability of Deduction for Electing Small Business Trusts (ESBTs)

Overview

The Joint Explanatory Statement of the Committee of Conference notes that “[t]he conference agreement provides that trusts and estates are eligible for the 20-percent deduction under the provision.”

An Electing Small Business Trust (ESBT) under section 1361(e) is a type of trust that is an eligible shareholder of S corporation stock. Special rules governing the taxation of ESBTs are set forth in section 641(c). Section 641(c)(2)(C) lists the only items of income, loss, deduction or credit to take into account for the S portion of ESBTs.¹¹ The list includes “items required to be taken into account under section 1366.”

Recommendations

The AICPA recommends that the IRS provide guidance clarifying that the section 199A deduction is a section 1366 item deductible by an ESBT.

Analysis

Congress intended section 199A to include trusts and estates.¹² The previous version of the legislation specifically excluded trusts and estates in the provision, and this exclusion was removed

¹¹ Treas. Reg. § 1.641(c)-1(b)(2) defines the S portion of an ESBT as “the portion of the trust that consists of the S corporation stock and that is not treated as owned by the grantor or another person under subpart E.”

¹² The Joint Explanatory Statement of the Committee of Conference, page 40, “provides that trusts and estates are eligible for the 20-percent deduction under the provision.”

in Pub. L. 115-97. Since an S corporation is one of the main types of entities that may generate QBI and considering that an ESBT is one of the few types of trusts allowed to own S corporation stock, Congress likely intended to allow ESBTs to benefit from section 199A.

Section 199A(f) provides that in the case of a partnership or S corporation, the section should apply at the partner or shareholder level. It provides that “each partner or shareholder shall take into account such person’s allocable share of each qualified item of income, gain, deduction, and loss.”

Section 1366 provides that the shareholder takes into account a pro rata share of the “corporation’s items of income (including tax-exempt income), loss, deduction, or credit.”

Treasury Reg. § 1.641(c)-1(d)(2)(i) notes that “[i]n general, the S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion.”

As the section 199A deduction is attributable to the QBI generated by the S corporation, the section 199A deduction appears as a section 1366 item that is allowed by ESBTs under section 641(c)(2), in accordance with Congress’s intent. Regulations explicitly providing this guidance should clarify this issue.



AMERICAN INSTITUTE OF CPAs
Request for Guidance Regarding
IRC Section 199A Deduction for Qualified Business Income of Pass-Through Entities
(Pub. L. No. 115-97, Sec. 11011)

Developed by the AICPA Qualified Business Income Task Force

Item #	Topic	Description of Item	IRC Section
AICPA Priority Requests for Immediate Guidance (Submitted in February 21, 2018 Comment Letter)			
1.	Definition of Section 199A Qualified Business Income	<ul style="list-style-type: none"> • The AICPA recommends that Treasury and IRS provide the following items: <ol style="list-style-type: none"> 1. Guidance that a trade or business is identified at the activity level, rather than entity level, whereby a taxpayer with multiple types of activities should have the ability to segregate qualified and nonqualified business income from services. 2. Guidance that defines what constitutes a business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners in the interpretation of section 1202(e)(3)(A). 3. Guidance that provides a gross receipts safe harbor whereby nonqualified income generated by a trade or business is deemed as QBI for each taxable year if the nonqualified gross receipts are 5 percent or less of the total combined qualified and non-qualified gross receipts from the same trade or business. 4. Guidance that income from a qualified trade or business is eligible for the QBI deduction when earned by a passive shareholder/partner. 5. Guidance that rental real estate is included in the definition of qualified trade or business under section 199A. 6. Guidance on what activities are included in the definition of specified service trade or business under section 199A. <ol style="list-style-type: none"> a. Specify that precedents established in section 448 apply to section 1202(e)(3)(A), where appropriate. b. Specify that specified service trade or businesses do not include: <ol style="list-style-type: none"> i. Valuation; ii. Appraisals; iii. Billing/accounts management; and iv. Software solution development and sales. 	199A

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2.	Aggregation Method for Calculation of QBI of Pass-through Businesses	<ul style="list-style-type: none"> • The AICPA recommends Treasury and IRS should invoke, in part, the regulation promulgation authority provided in section 199A(f)(4) to adopt a method of aggregation for calculating QBI for pass-through businesses. For example, guidance should provide that, for purposes of determining the amount deductible under section 199A(b)(2), the QBI and Form W-2 limitations are determined after the application of Treas. Reg. § 1.469-4(d)(5), regarding the grouping of activities conducted through partnerships and S corporations. A taxpayer should have an opportunity to aggregate or group separate legal activities together for purposes of applying the section 199A wage/investment limitations if the taxpayer’s activities are managed as one trade or business. • Similar to Treas. Reg. § 1.469-11(b)(3)(iii) and (iv), guidance should provide that upon the date of adoption of the aggregation rules that taxpayers are given an opportunity to re-group activities in light of this significant change in taxation for qualified trades or businesses. 	199A
3.	Deductible Amount of QBI for a Pass-through Entity with Business in Net Loss	<ul style="list-style-type: none"> • The AICPA recommends that the IRS provide regulations that address the effect of losses in the application of section 199A. Specifically, taxpayers and tax preparers need: <ol style="list-style-type: none"> 1. Examples clarifying the mechanics of losses in section 199A, including: <ol style="list-style-type: none"> a. Example to clarify that if the taxpayer has a loss carryover under section 199A(c)(2) for the taxable year, the taxpayer does not proceed to any other part of section 199A; b. Example to clarify that QBI loss is treated as incurred in a separate or notional qualified trade or business in the next year in order to illustrate how the taxpayer computes the section 199A(b)(2) deductible amounts in the following taxable year; c. Example to clarify that a negative deductible amount for a qualifying trade or business does not carry over to the following taxable year (since the deductible amount for each qualifying trade or business could result in a positive or negative amount); and d. Example to clarify that no amounts are carried over to the following taxable year if the sum of the deductible amounts used to calculate a combined QBI in section 199A(b)(1)(A) is negative. 2. Clarification on how losses that are limited, suspended, and/or carried over pursuant to sections 704(d), 1366(d), 465, 469, and 461(l) are considered in computing section 199A(b)(2) deductible amounts, including: <ol style="list-style-type: none"> a. Guidance that any items limited and carried over to a succeeding tax year by these sections are taken into account in the year in which the taxpayer includes the items in computing taxable income; and b. Guidance that these items described above are included as QBI from the qualifying trade or business that originated the loss that was previously limited or suspended and not as a loss 	199A

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		<p>from a separate or notional qualifying trade or business that the loss carryover rule in section 199A(b)(2) contains.</p> <p>3. Alternative optional method to simplify the calculation for taxpayers with taxable income below the threshold amount, including:</p> <ul style="list-style-type: none"> a. Guidance that taxpayers with taxable income under the threshold amount should have the option of an alternative method to aggregate all items of income, gain, loss, and deduction from all of its qualifying trades or businesses to determine whether there is a loss carryover under section 199A(c)(2); and b. Guidance that taxpayers should have the ability to use this alternative method to compute the section 199A(b)(2) deductible amounts and the combined QBI. 	
4.	Qualification of Wages Paid by an Employee Leasing Company	<ul style="list-style-type: none"> • The AICPA recommends that the IRS provide that a trade or business includes, in its Form W-2 wage limitation, the qualifying wages paid to its common law employees in addition to qualifying wages paid by an employee leasing company. Specifically, taxpayers and tax preparers need guidance that the phrase: “with respect to,” under section 199A(b)(2)(B)(i), includes Form W-2 wages paid by a leasing company, whether independent or related, if such wages are paid to employees that perform services on a substantially full-time basis to a trade or business that generates QBI. 	199A
5.	Fiscal Year Pass-through Entities Ending in 2018	<ul style="list-style-type: none"> • The AICPA recommends that Treasury and IRS clarify that the section 199A deduction applies to all of the income that an owner receives on a Schedule K-1 of a fiscal year pass-through entity (i.e., partnership or S corporation) ending in 2018. 	199A
6.	Availability of Deduction for ESBTs	<ul style="list-style-type: none"> • The AICPA recommends that the IRS provide guidance clarifying that the section 199A deduction is a section 1366 item deductible by an ESBT. 	1361(e)
Additional QBI Definition Concerns			
7.	Phase-out Range	<ul style="list-style-type: none"> • Example of how to calculate the QBI for a service business where taxable income is in the phase-out range (the double phase-out problem). 	199A
8.	Calculation	<ul style="list-style-type: none"> • Clarification that when computing the 20 percent deduction under section 199A, whether the calculation is based on the Schedule K-1 income from the S corporation or the net amount of the Schedule K-1 income after subtracting the interest expense deduction from the Schedule E. <ul style="list-style-type: none"> ○ For example, a taxpayer borrows money to purchase an S corporation. The S corporation is in an active trade or business. Taxpayer has historically deducted the interest expense as trade or business interest expense on Schedule E. In 2018, the client has the following items: <ul style="list-style-type: none"> ○ Schedule K-1 from S corporation with income of \$1 million 	199A

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		<ul style="list-style-type: none"> ○ Schedule E interest expense deduction of \$100,000 ○ When computing the 20 percent deduction under section 199A, clarification whether it is based on the \$1 million Schedule K-1 income or the \$900,000 after the \$100,000 interest expense deduction (or whatever portion is deductible). <p>Note: This question also is addressed in the section 163(j) limitations.</p>	
9.	QBI Income Character	<ul style="list-style-type: none"> ● Clarification of the calculation of QBI when flowing through multiple tiered entities. ● Clarification of whether QBI income retains character through a flow through structure that includes non-QBI income. 	199A
10.	Passive Loss Activity	<ul style="list-style-type: none"> ● Clarification on how the QBI deduction is calculated in a year in which a passive loss activity is recorded and a loss is suspended. Additionally, clarification on how the QBI deduction is calculated in a subsequent year in which a prior year suspended passive loss is released. 	199A
11.	Investment Items, Gains	<ul style="list-style-type: none"> ● Clarification on whether the list of “investment items” excluded from qualified income includes unrecaptured section 1250 gain. ● Clarification of the determination of items effectively connected with a business, e.g., section 1245 gains and losses, retirement plan contributions of partners and sole proprietors, the section 162(l) deduction and one-half of self-employment tax. <p>Note: This issue refers to types of income.</p> <ul style="list-style-type: none"> ● Clarification on what “gain” is included in QBI income, such as: <ul style="list-style-type: none"> ○ Gain from sale of fixed assets ○ Ordinary depreciation recapture ○ Section 1231 gain ○ Gain on sale of goodwill (self-created or purchased or both) 	162(l), 199A, 1231, 1245, 1250
12.	AMT	<ul style="list-style-type: none"> ● Clarification on determining the QBI deduction amount, if both/or either the regular taxable income and/or the AMT taxable income is used in calculating limitations and exclusions for QBI. <ul style="list-style-type: none"> ○ Clarification on whether these limitations and exclusions for QBI apply if a majority of income is from capital gains. ○ Under prior rules, one would determine taxable income, and AMT taxable income, and then determine the tax on each to compare. Need clarification on whether the same rules apply. ○ Section 199A(f)(2) makes clear that qualified business income should not reflect minimum tax adjustments. Even though section 199A(f)(2) applies, the minimum tax is involved at the partner/shareholder level. Need clarification on the partner level application. 	199A

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13.	Real Estate Investment Trust	<ul style="list-style-type: none"> Confirm that Real Estate Investment Trust (REIT) dividends passed through from Regulated Investment Companies (RICs) (mutual fund/ETF) and common trust funds do not qualify for the QBI deduction. 	199A
14.	Reasonable Guaranteed Payments	<ul style="list-style-type: none"> Clarification that the reasonable compensation standard will continue to not apply to a partner's guaranteed payments. 	199A
15.	Reasonable Compensation	<ul style="list-style-type: none"> Clarification regarding the reasonable compensation definition. Clarification on how reasonable compensation tests are applied for shareholders with income from multiple related pass-through entities. Clarification on how reasonable compensation affects QBI. Clarify whether shareholder wages and greater than 2 percent S Corporation owners' Form W-2 wages/reasonable compensation are included or excluded or backed out of Form W-2 gross wages for purposes of the 50 percent limitation. Clarification that the reasonable compensation standard will continue to not apply to a Schedule C taxpayer's business income. 	199A
16.	Calculation	<ul style="list-style-type: none"> Clarification on whether the QBI deduction is taken at the Charitable Remainder Trust (CRT) level, or whether QBI creates a separate class within the category/class system. 	199A
17.	Calculation	<ul style="list-style-type: none"> Clarification on whether the deduction under section 7518(c)(1)(A) for Capital Construction Funds (CCFs) reduces QBI. 	199A
18.	Basis Calculation	<ul style="list-style-type: none"> Clarification on whether a beneficiary who inherited qualified property receives a step up (or down) in basis for purposes of the limitation based on the FMV of the property at the decedent's date of death. In other words, clarify whether "acquisition" refers to when the beneficiary received the assets or when the decedent acquired the assets. 	199A
19.	"Carry on"	<ul style="list-style-type: none"> Clarification regarding "carried on" and whether an owner of an entity under Subchapter K or Subchapter S must carry on a trade or business or the entity must "carry on" the trade or business. 	199A
20.	Brokerage Services	<ul style="list-style-type: none"> Clarification on the meaning of the term "brokerage services" in section 1202(e)(3)(A). 	199A, 1202
21.	Athletics	<ul style="list-style-type: none"> Clarification whether the term "athletics" in section 1202(e)(3)(A) is applied to a sports team as a qualified business or is applied to the income of an individual independent contractor athlete. Clarification on whether endorsement income of an athlete is a specified trade or business based upon an individual's skill or reputation. 	199A, 1202
22.	Cannabis Business	<ul style="list-style-type: none"> Clarification whether the section 199A QBI deduction allowed to an individual in a cannabis business. 	199A

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		<ul style="list-style-type: none"> Note: Section 280E states “No deduction or credit shall be allowed for any amount <i>paid or incurred</i> during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances ...” The section 199A QBI deduction is not <i>paid or incurred</i>. Also, the purpose of the section 199A QBI deduction is to lower the tax rate for owners. 	
Additional Wage/W-2 Concerns			
23.	Statutory Employees	<ul style="list-style-type: none"> Clarification whether QBI includes statutory employees (section 3121(d)(3)). Statutory employees receive Forms W-2, but they report the income on a Schedule C with expenses. 	199A
Additional Asset Base Test Concerns			
24.	Basis Calculation	<ul style="list-style-type: none"> Clarification on how to determine the tangible asset base for the alternative test (section 199A(b)(2)(B)(ii)). Clarification of the unadjusted basis of assets held as of 1/1/18 and how to calculate that unadjusted basis (including for information that is provided to owners of fiscal year entities). Clarification on whether the unadjusted basis includes property placed in service prior to enactment or only new additions. Clarification regarding the unadjusted basis of assets subject to bonus depreciation. Clarification regarding the unadjusted basis of property subject to section 743(b) basis adjustments. Clarification whether “qualified property” includes assets expensed under section 179. Clarification whether “qualified property” includes assets expense under section 263. Clarification regarding capital improvements and section 754 step up property as part of basis. Clarification regarding whether step up or down in basis under section 1014 would apply for the individual inheriting the property 	179, 199A, 263, 743(b), 754, 1014
Additional Entity Specific Concerns			
25.	Suspended Losses Coordination	<ul style="list-style-type: none"> Clarification on the application of various limitations and how they interplay. Clarification of the application and interaction of all the limitations. Clarification on whether a net operating loss is a business loss for section 199A purposes. Clarification on how this limitation applies to tiered partnerships or S corporations that are partners in partnerships. 	190, 199A, 461, 465, 469, 704(d), 1366

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26.	Section 707(a)	<ul style="list-style-type: none"> Modification of the rules of section 707(a) (regarding transactions between a partnership and a partner not acting in a partner capacity) for purposes of applying section 199A. The statute calls for regulations. (Section 199A(c)(4)(C)) 	199A, 707(a)
27.	Partnership Audit Regime	<ul style="list-style-type: none"> Clarification on how section 199A is applied under the partnership audit regime. Clarify whether the 20 percent deduction is allowed to the entity if the entity pays the tax. Clarify whether the taxpayer is allowed to adjust section 199A accordingly if push-out is elected. 	199A
28.	Anti-abuse Rules, Step-up Basis at Death	<ul style="list-style-type: none"> Clarify that the anti-abuse rules under section 199A(f) will not apply in determining the basis in qualified property under section 199A(b)(2)(B) received from a decedent under section 1014(a). Confirm that the person entitled to a section 743(b) adjustment due to section 1014(a) considers the adjustment for purposes of determining the basis in qualified property under section 199A(b)(2)(B). 	199A, 1014
29.	Standardized Reporting for QBI Deduction, Individuals and Trusts	<ul style="list-style-type: none"> Standardization of the reporting for Forms 1065 and 1120 to provide to individuals and trusts to streamline and simplify the flow of information needed to determine the QBI deduction. 	199A