AMERICAN INSTITUTE OF CPAs
ORAL STATEMENT PRESENTED TO

Internal Revenue Service
Public Hearing:
Proposed Regulations Concerning the Deduction for Qualified Business Income Under Section 199A of the Internal Revenue Code (REG-107892-18)
October 16, 2018

Good morning, my name is Troy Lewis and I am a sole tax practitioner and an associate teaching professor at Brigham Young University. I am testifying today on behalf of the American Institute of CPAs. I am currently the chair of the AICPA Qualified Business Income (or QBI) Task Force.

Before I start, I want to acknowledge and thank Treasury and the IRS for making 199A a priority and quickly issuing guidance. Hats off to you and your colleagues. You have accomplished a lot in a very short period of time.

The AICPA has submitted a detailed letter on the proposed regulations and my testimony today highlights some of the key issues from our written comments.

1. Qualification of rental real estate as a trade or business

First, let's talk about the qualification of rental real estate as a trade or business. The preamble of the proposed regulations defines a trade or business according to section 162(a). However, no uniform definition exists. The term "trade or business" is not defined in the Code, regulations, or other administrative guidance. Taxpayers are left to determine trade or business status on a case-by-case basis, sometimes with discrepancies even within the same industry. The courts have also struggled for a long time with drawing definitive lines on what constitutes a trade or business. This lack of clarity on the qualification of rental real estate will undoubtedly lead to inconsistent treatment.

To promote clarity and certainty in the rules, we recommend that rental real estate activity is considered a trade or business. Guidance could clarify whether there are specific circumstances in which rental real estate activities would not generate QBI. Otherwise, taxpayers will be left to pursue their own interpretation of the rules and the IRS will inevitably face unnecessary and time-consuming challenges in enforcement…

2. Recharacterization Rule

Our second key issue relates to the anti-abuse rules under the -5(c)(2) regs on specified service businesses.

The anti-abuse rules are designed to prevent the splitting of revenue, between related businesses, to qualify some of the group's income for the deduction. Administration and other support functions could be performed by a related entity with appropriate compensation being paid back to the non-SSTB. An example of this is when a non-specified business performs administrative functions, like payroll.

There are 2 rules – one dealing with situations where 80% or more of related party revenue is provided to the SSTB, and one dealing with situations where the revenue is less than 80%. The 80% or more threshold rule is overreaching and not necessary. It should be eliminated in the final guidance.

Generally, if a business provides property or services to an SSTB, it apportions the qualified and the non-qualified income. In some cases, the regulations do not allow a payroll processor to take a QBI deduction for services provided to outside clients. If a payroll processor provides 80% or more of its services to an SSTB, this otherwise qualified entity is automatically treated 100% as an SSTB as well.

We agree with the need for anti-abuse rules and having to separate out SSTB income from non-SSTB income. However income from a non-SSTB should not be unfairly recharacterized. Related party transactions should not qualify for QBI… but it also should not taint any outside income. The 80% or more rule that automatically recharacterizes all of the income limits the effectiveness of the QBI deduction. In the final regs we recommend removing the 80% threshold cliff rule and allowing the pro-ration rule to cover these transactions.

We also ask for clarification that the -5(c)(2) regs only apply to common owners that comprise the greater than 50% ownership test. As is, the operation of the rule appears to penalize the unrelated owners of a separate business. The income of unrelated owners from otherwise qualified businesses is recharacterized, even though they have no interest in the SSTB.

3. SSTB and Non-SSTB Lines of Business

Now let's talk a bit more about when businesses have both SSTB and non-SSTB lines of business.

The regulations provide an incidental rule when a business has a small amount of SSTB income. We appreciate that Treasury and the IRS recognized the need to minimize administrative burdens. However, the regulations are unclear as to what happens when the non-qualified income exceeds the incidental amount.

The regulations should allow businesses to separate their net income between qualified and SSTB activities. Applying a cliff effect to taxpayers who exceed the threshold would be unfair. It would also discourage natural business growth. We could easily apply the section 199 Small Business Simplified Overall Method. This method, which practitioners already use, would enable taxpayers to ratably apportion their costs and deductions between the different types of activities.

The law provides that taxpayers must calculate the QBI deduction based on each separate trade or business. The regulations interpreted this to mean that the books and records must be separable. We appreciate Treasury and the IRS's recognition of how businesses are formed and operate in the real world.

4. Aggregation Rules

Ok next, let's switch gears and talk about the aggregation rules for when taxpayers may treat multiple businesses as a single business.

Our first issue concerns siblings. Specifically, we recommend that businesses use existing attribution rules under sections 267 and 707 rather than creating a new family attribution rule. Congress intended section 199A to benefit businesses that are not organized as C corporations. Many of these businesses are family owned… and there is no reason to treat businesses owned primarily by the first generation and their children differently from a business owned by the children after the parents have transferred ownership. There is no reason to adopt a new family attribution standard and arbitrarily disadvantage businesses that are owned by siblings.

Our second ask involves multi-tiered passthroughs, referred to as RPEs in the regs. We recommend that aggregation be available at the RPE level. Allowing for RPEs to aggregate all the lower-tier businesses together would simplify its reporting process and result in a reduction in compliance costs.

5. Definition of QBI

Finally, I want to stress the importance of the details of how to calculate QBI.

For example, the IRS should confirm that certain deductions do not reduce a taxpayer's QBI, including the self-employed health insurance deduction, the 50% deductible portion of the self-employment tax, and a self-employed taxpayer's qualified retirement plan contributions.

These are details CPAs care about and need in order to properly calculate QBI.

Conclusion

As I mentioned earlier, we submitted a detailed comment letter that includes the issues I've shared with you, along with several other items. We hope you find our comments helpful as you work to finalize the regulations. Thank you for allowing me to testify today.