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IRS FAQs on Section 199A: Nasty? Helpful? Wrong?

Did you, or your tax advisor, use the wrong Section 199A rules when filing your tax return?

The IRS issued "final" regulations in January and then made a few changes before making them truly final in February.[1]

Most recently, on April 11 and then updated on April 22, the IRS expanded its Section 199A frequently asked questions (FAQs) from 12 to 33 questions and answers.[2]

And this should come as no surprise: some of the IRS answers are not in favor of you as a small-business owner.

We'll tell you three things you need to know, and help you decide whether you have to follow the IRS's website guidance on your 2018 federal income tax return.

Questions and Answers

The IRS often publishes FAQs on its website to help educate you on various tax law provisions.

Section 199A is no different: the IRS has been updating its FAQ website with additional questions and answers on the new qualified business income (QBI) tax deduction.[3]

We found three FAQs that help fill in some holes in the final Section 199A regulations.

FAQ 29: QBI Subtractions for Partnerships

The final regulations gave us three concrete tax items that reduce QBI:[4]

1. Self-employed health insurance deduction
2. One-half of self-employment tax deduction
3. Qualified retirement plan deduction

In the preamble to the final regulations, the IRS punted on stating whether or not the following three items reduce QBI:[5]

1. Unreimbursed partnership expenses

2. Interest expense to acquire partnership and S corporation interests

3. State and local taxes

But in FAQ 29, the IRS states:

To determine the total amount of QBI, the taxpayer must consider deductions not reported on Schedule K-1 that are related to the trade or business. This could include unreimbursed partnership expenses, business interest expense, the deductible part of self-employment tax, the self-employment health insurance deduction, and self-employed SEP, SIMPLE, and qualified plan deductions in addition to other adjustments.

In this FAQ on partnerships, the IRS hints at the following:

- Unreimbursed partnership expenses and business interest expense reduce QBI in some, if not all, circumstances.

- Traditional IRA contributions based on self-employment income don't reduce QBI (since the IRS didn't include them), while SEP, SIMPLE, and qualified plan deductions do reduce QBI.

FAQ 32: QBI in Final vs. Proposed Regulations

The proposed Section 199A regulations issued in August 2018 didn't explicitly list what business-related deductions reduce QBI. That guidance didn't come until the final regulations, as we discussed in IRS Issues Final Section 199A Regulations and Defines QBI.

The final regulations also state that you can rely on either the proposed regulations or the final regulations for tax year 2018.[6]

Some tax professionals mistakenly believed the permission to rely on the proposed regulations meant that you did not have to reduce QBI by the self-employed health insurance deduction, the one-half of self-employment tax deduction, and the qualified retirement plan deductions.

In FAQ 32, the IRS clearly says the answer is "no" to a different interpretation of QBI; all taxpayers must reduce QBI by the items listed above for tax year 2018.

The IRS's position is simple: the identical tax rule exists in both the proposed regulations and the final regulations. The difference: the final regulations give more clarity to the term "qualified items of income, gain, deduction, and loss."

According to this FAQ, the additional clarity creates no inconsistency between the proposed and final regulations. Therefore, for 2018 tax returns, you must reduce QBI by the above items.

FAQ 33 Has to Be Wrong

We really don't like this one.

FAQ 33 states that an S corporation shareholder who owns more than 2 percent may have to reduce QBI at both the entity (S corporation) and the shareholder (1040 tax return) levels for his or her self-employed health insurance deduction.

Example. Your S corporation has net pass-through income of $50,000 before health insurance. Your S corporation reimburses you $10,000 for health insurance premiums that you paid personally, and treats the reimbursement as wages to you, which reduces the pass-through income to $40,000. You then take a $10,000 self-employed health insurance deduction on your Form 1040.

Under this FAQ, your QBI is $30,000—you reduce it by both the wage expense and the self-employed health insurance deduction.

We don't agree with the double subtraction indicated in IRS FAQ 33, for three reasons:

1. The final regulations state that you reduce QBI "to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction."[7] Unlike the proprietorship, the S corporation reduces its business income by reimbursing or paying for the health insurance that it puts on the more than 2 percent shareholder's W-2.

2. Under Notice 2008-1, the self-employed health insurance deduction for the 2 percent S corporation shareholder requires that you include the insurance cost as shareholder wages.[8] The wages reduce QBI.

3. And income from the trade or business of being an employee is not QBI.[9]

Website Is Not an Authority

If you don't like the positions taken on the IRS's FAQ website, then there's one silver lining: FAQs don't constitute an authority for tax return positions.[10]

In fact, in what is highly unusual for FAQs, the IRS has a disclaimer at the bottom of this set of FAQs stating that you cannot use the FAQs as an argument in a court case.[11]

But keep this in mind: The IRS will likely take an FAQ position in an examination of your tax return. Be prepared with a solid argument as to why you are correct and the FAQ is not.

Takeaways

You can see from the recent FAQs discussed in this article why many 2018 tax returns claiming the Section 199A tax deduction may require an amended return.

For example, tax preparers who believed they could rely on the proposed regulations to avoid QBI adjustments for the self-employed health insurance deduction, the one-half of self-employment tax deduction, and the qualified retirement plan deductions will have to amend those returns.

On the partnership FAQ, you find the IRS suggestion that unreimbursed partnership expenses and business interest expense reduce QBI in some, if not all, circumstances. You also see that traditional IRA contributions based on self-employment income don't reduce QBI, while SEP, SIMPLE, and qualified plan deductions do reduce QBI.

And then you have FAQ 33, wherein the IRS appears to be calling for the S corporation owner of more than 2 percent of shares to subtract his or her self-employed health insurance from QBI twice. If that turns out to be the rule, you will first be rightfully outraged, and then will have to grudgingly amend the returns.

Client Letter on This Article for Use by Tax Pros. Click Here.

1 TD 9847, Federal Register, Vol. 84, No. 27.
2 FAQ-199A-4.22.2019.
3 https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs. In this article, we referenced the last review and update, on April 22, 2019. If there's a later review and update and you want the one we used in this article, see FAQ-199A-4.22.2019.
4 Reg. Section 1.199A-3(b)(1)(vi).
5 TD 9847, Federal Register, Vol. 84, No. 27, p. 2962.
6 TD 9847, Federal Register, Vol. 84, No. 27, p. 2952.
7 Reg. Section 1.199A-3(b)(1)(vi).
8 Notice 2008-1.
9 Reg. Section 1.199A-5(d)(1).
10 SBSE-04-0517-0030.
11 FAQ-199A-4.22.2019.