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Proper treatment of deduction for self-employed health insurance as it relates to partnerships - by Sandy Klein

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For many tax practitioners, the 2019 tax season was a compliance nightmare. The new rules about the deduction for Qualified Business Income (QBI), the new limitations on the deductibility of mortgage interest and the lack of guidance caused much confusion and consternation. Although the IRS issued guidance in February, 2019, several issues related to the application of the QBI rules to partnerships and S corporations remain unclear as we enter into the 2020 tax return filing season.

Among those issues is the proper treatment of the deduction for self-employed health insurance as it relates to partnerships. Generally, an active member of a partnership business eligible for the QBI deduction is entitled to a deduction, among other things, for health insurance either paid by the partnership on behalf of the partner or by the partner himself.

The final QBI regulations issued in February, 2019, provide that "Generally, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of section 199A and this section are otherwise satisfied. For purposes of section 199A only, deductions such as…the self-employed health insurance deduction under section 162(l)… are attributable to a trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction…"

Partnerships will often report the payment of a partner's health insurance premium as a guaranteed payment to the partner. The partner is also entitled to an "above the line" deduction for the amount of the health insurance paid by the partnership. In this case, the partnership's QBI is reduced by the amount of the health insurance premium by virtue of the guaranteed payment to the partner. When the partner deducts the health insurance premium, a literal reading of the Final Regulations would lead one to believe that the partner's QBI is being reduced twice by the health insurance, once at the partnership level and again at the partner level.

The IRS website contains a list of QBI FAQ's ("Tax Cuts and Jobs Act, Provision 11011 Section 199A – Qualified Business Income Deduction FAQs"). Question 33 addresses the treatment of the health insurance deduction by S corporations. The IRS response is that "Generally, the self-employed health insurance deduction under section 162(l) is considered attributable to a trade or business for purposes of section 199A and will be a deduction in determining QBI. This may result in QBI being reduced at both the entity and the shareholder level."

The IRS did not provide a Q&A on this topic dealing with the partnership treatment of health insurance but there is no reason to believe that partnerships would be treated any differently if they are deducting the health insurance as a guaranteed payment.

The above suggests that partnerships providing health insurance to their partners should treat the payments as distributions rather than guaranteed payments. Distributions will not reduce QBI at the partnership level resulting only in a reduction at the partner level. This may lead to other issues, however, in cases where there is a disparity in the amount of each partners' premium.

Some practitioners have suggested that the Final Regulations should be interpreted to mean that the health insurance premiums are not attributable to the partnership QBI, rather they are attributable to the guaranteed payment. Therefore, since guaranteed payments do not produce QBI, the health insurance premiums should not reduce QBI. It remains to be seen whether this interpretation of the Final Regulations will withstand an audit.

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