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Report No. 1415
April 8, 2019

The Honorable David J. Kautter
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Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable Charles P. Rettig
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1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
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1111 Constitution Avenue, NW
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Re: *Report No. 1415 – Report on Final and Proposed Guidance under Section 199A*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1415. This Report comments on final regulations under Section 199A, proposed regulations addressing the treatment of regulated investment companies under Section 199A and a proposed Revenue Procedure described in Notice 2019-07. This Report follows two prior reports we have submitted on Section 199A, one on March 23, 2018 and the other on October 19, 2018. We commend the Internal Revenue Service and the Department of the Treasury for the guidance issued under Section 199A.

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We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
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Report No. 1415

New York State Bar Association Tax Section

REPORT ON FINAL AND PROPOSED GUIDANCE UNDER SECTION 199A

APRIL 8, 2019

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I. Introduction

This Report[1] of the New York State Bar Association Tax Section (the "Tax Section") provides comments on (i) final regulations under Section 199A (the "Final Regulations"),[2] (ii) proposed regulations addressing the treatment of regulated investment companies under Section 199A (the "RIC Proposed Regulations"),[3] and (iii) a proposed Revenue Procedure described in Notice 2019-07,[4] in each case issued by the U.S. Department of the Treasury and Internal Revenue Service (collectively, "Treasury") on January 18, 2019.[5] We submitted two prior reports on Section 199A. The first such report, submitted on March 23, 2018 (the "First Prior Report"), made suggestions for Treasury to consider in promulgating regulations under Section 199A.[6] The second prior report[7], submitted on October 19, 2018 (the "Second Prior Report," and together with the First Prior Report, the "Prior Reports"), responded to and commented on the regulations under Section 199A proposed by Treasury on August 16, 2018 (the "Proposed Regulations" [8]).

This Report provides limited additional comments on the Final Regulations, the RIC Proposed Regulations, and Notice 2019-07, primarily addressing (i) certain areas to which Treasury requested additional comments or concepts that have been newly introduced in the Final Regulations or Notice 2019-07 and (ii) certain matters regarding the taxation of regulated investment companies ("RICs"). Because of the limited scope of this Report, we have not recited the background and statutory framework of Section 199A, but instead refer you to our Prior Reports.

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[1] This report may be cited as New York State Bar Association Tax Report No. 1415, "*Final and Proposed Guidance Under Section 199A*" (April 8, 2019). The principal drafters of this Report were James R. Brown, Adam Kool and Sara B. Zablotney, with contributions from Andrew Braiterman, Robert Barnett, Amanda Nussbaum, Richard M. Nugent, Deborah Paul, Elliot Pisem, and Michael Schler. The authors gratefully acknowledge the assistance of Chris Saki and Alexander Oveis in preparing this Report. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Qualified Business Income Deduction, T.D. 9847, 84 Fed. Reg. 2952 (Feb. 8, 2019).

[3] REG-134652, 84 Fed. Reg. 3015 (Feb. 8, 2019).

[4] 2019-09 I.R.B. 740.

[5] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury Regulations thereunder, unless otherwise indicated. A corrected version of the Final Regulations was released on February 1, 2019. References to the Final Regulations herein refer to the corrected version, unless otherwise noted.

[6] New York State Bar Association Tax Report No. 1392, *Report on Section 199A* (March 23, 2018).

[7] New York State Bar Association Tax Report No. 1403, *Report on Proposed Section 199A Regulations* (October 19, 2018).

[8] REG-107892-18, 83 Fed. Reg. 40884 (Aug. 16, 2018).

II. Summary of Principal Recommendations

A. General Recommendations

1. We recommend that the proposed safe harbor for rental real estate enterprises in Notice 2019-07 be clarified, particularly with respect to the operation of the 250-hour requirement and the Notice's use of the terms "residential" and "commercial" when describing real estate businesses.

2. We identify a number of approaches that might be applied to address the allocation of items among multiple trades or businesses where such items are not clearly allocable to a single trade or business.

3. We recommend that the rules applicable to aggregation for purposes of Section 199A be clarified to address the meaning of "group of persons" when articulating the overlapping ownership requirement for aggregation. We further recommend that Treasury consider permitting taxpayers to adjust groupings under Section 469 and Section 1411 to match groupings under Section 199A.

4. We make a number of recommendations regarding potential approaches to allocation of unadjusted basis immediately after acquisition ("UBIA") by partnerships at a time when the partnership's tax basis in qualified property is zero. Regardless of the approach taken with respect to this issue, we recommend Treasury consider anti-abuse provisions to avoid artificial reallocation of UBIA.

5. While we generally agree with the Final Regulations' approach to Section 734 and Section 743 adjustments, we note certain modifications and clarifications that may be appropriate with respect to properly adjusting UBIA when applying Section 743 concepts.

6. We note our agreement with Treasury's decision to permit carryover of UBIA in certain non-recognition transactions, but we suggest clarification (and potentially modification) of the treatment of cash and other property received in connection with such non-recognition transactions.

7. We reiterate our views from the Second Prior Report regarding Section 481 adjustments and similar items (such as deferrals of income pursuant to Section 108(i)) arising in a taxable year ending on or before December 31, 2017, for purposes of calculating qualified business income ("QBI") . We provide further explanation of the position in our Second Prior Report that items for which economic performance occurs after December 31, 2017, such as prepaid amounts deferred pursuant to Revenue Procedure 2004-34,[9] should generally not be excluded from QBI when taken into account for other U.S. federal income tax purposes.

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[9] 2004-1 C.B. 911.

B. Recommendations Related to RIC Provisions

We recommend that alternative approaches be considered for how to extend conduit treatment to qualified publicly traded partnership income ("QPTP Income") realized by a RIC.

III. Discussion

A. General Comments to Final Regulations

1. Notice 2019-07: Proposed Safe Harbor for Rental Real Estate Enterprises

In the Preamble to the Final Regulations, Treasury acknowledged a significant number of comments to the Proposed Regulations regarding whether certain real estate-related activities would be treated under Section 199A as a "qualified trade or business" within the meaning of Section 199A(d) (a "QTB"), the income of which could be eligible for the deduction under Section 199A.[10] In response, Treasury issued Notice 2019-07 (the "Notice"), which provides a safe harbor for certain rental real estate activities (the "Real Estate QTB Safe Harbor") in a proposed Revenue Procedure.[11] The Notice also requests comments on this proposed Revenue Procedure.

The Real Estate QTB Safe Harbor is proposed to apply to taxpayers who hold real estate (directly or through relevant pass-through entities ("RPEs")) for the production of rental income. In general, a "rental real estate enterprise" (as defined below) may be treated as a QTB if the following requirements are met:

(A) separate books and records are kept for each rental real estate enterprise,

(B) 250 or more hours of rental services (as defined below) per year are provided with respect to each enterprise in each year beginning prior to January 1, 2023, and for years beginning after December 31, 2022, in any three of five consecutive taxable years, and

(C) the taxpayer maintains contemporaneous records regarding the provision of such services for taxable years beginning after December 31, 2018.[12]

For these purposes, a "rental real estate enterprise" is an interest in real property held for the production of rents (and may consist of one or more properties but excludes "triple net leased" properties).[13] Taxpayers must either treat each enterprise separately, or all such enterprises in the aggregate (with the exclusion of real estate used by the taxpayer as a residence). Such treatment

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[10] 84 Fed. Reg. at 2955-56.

[11] 2019-09 I.R.B. 740.

[12] *Id.* at 741.

[13] *Id.*

is binding from year to year. Commercial and residential real estate must be treated as separate enterprises.[14]

"Rental services" for these purposes include (i) advertising to rent or lease real estate, (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 the real estate, (vii) purchase of materials, and (viii) supervision of employees and independent contractors.[15] These services may be performed by the owners of the rental property, or by employees, agents, or independent contractors of the owners.[16] The breadth of the definition of "rental services" is also uncertain. The proposed Revenue Procedure uses the term "includes," but does not specify whether "includes" is meant to be limiting or illustrative. Section 7701(c) provides that in the Code "includes" and "including" are illustrative. Because this is a safe harbor, we recommend clarifying that "including," in this specific context, is limiting.

First, we are not convinced that the 250-hour-per-year requirement reflects an adequate measure of the sorts of activities that Congress intended to benefit under Section 199A. For real estate enterprises of any moderate size, the threshold represents a relatively low hurdle for qualifying an enterprise as a QTB under Section 199A, considering the broad definition of "rental services." For example, under the provisions set forth in the Notice, a taxpayer with rental real estate that might not otherwise qualify as a QTB could simply engage a landscaping service or hire maintenance workers periodically, perhaps once or twice a month, and attain QTB treatment. Further, since the Notice provides that "supervision of employees and independent contractors" is a rental service and that rental services may be performed by employees, agents, and/or independent contractors of the owners, a taxpayer could generally expect to meet this safe harbor by hiring a small team of workers for less than one week per taxable year. On the other hand, for smaller, less sophisticated taxpayers, the Real Estate QTB Safe Harbor, would impose meaningful and burdensome record-keeping requirements instead of simplifying the ability to claim the Section 199A deduction. The "safe harbor" would practically benefit only larger, more sophisticated taxpayers, who arguably as a policy matter are less in need of such relief. In addition, because the Real Estate QTB Safe Harbor does not apply to triple net leased properties, there is still tremendous uncertainty whether the owner of, e.g., a large office building, can qualify for the Section 199A deduction if all or a portion of the space is rented under triple net leases, even if the owner provides substantial services with respect to common areas. We are uncertain whether these outcomes were intended by the Real Estate QTB Safe Harbor. We recommend that further consideration should be given to the Real Estate QTB Safe Harbor. In particular, requirements dependent on the size of the taxpayer (e.g. by number of properties or revenue) could be considered. We also recommend that, if the 250-hour-per-year test is retained, Treasury consider a minimum threshold or other requirements in order for a taxpayer to include hours spent providing services by an individual employee, agent, or independent contractor of an owner in the aggregate 250-hour-per-year calculation for an entire trade or business.

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[14] *Id.*

[15] *Id.*

[16] *Id.*

Second, we are concerned that the distinction between "residential" real estate and "commercial" real estate is ill-defined and does not reflect commercial realities of many real estate properties. This is a particularly difficult issue in the case of developments that are "mixed use." For example, a residential apartment building will often have commercial rental space on lower floors (e.g., medical offices, restaurants, storefronts, etc.). In addition, it is not clear how the proposed Revenue Procedure might apply to corporate housing, short-term and long-term vacation rental properties, and similar real estate holdings.

Accordingly, as an initial matter we recommend clarification of the meaning of these terms, perhaps based in part on existing guidance in other areas of the Code. For example, for purposes of Section 103, a "residential rental project" is property that is available for use by the general public, is not used on a transient basis, and has separate and complete facilities for living, sleeping, eating, cooking and sanitation.[17] Similarly, Treas. Reg. § 301.7701-13(j)(8) contains a definition of "residential real property" covering real property to be used by a "family consisting of one or more persons." Alternatively, under Section 168(e)(2)(A), property is not "residential rental property" unless 80 percent or more of its gross rental income for a taxable year is from non-transient living accommodations. Section 168(e)(2)(B) further provides that "nonresidential real property" is property described in Section 1250 that is not residential rental property or property with a shorter depreciable life than residential rental property under Section 168. While we do not have a strong view as to which of these approaches is most appropriate in the Section 199A context, we believe that adopting a clear standard will aid both taxpayers and the government in applying the final Revenue Procedure.

We also believe that clarification would be helpful with respect to "residential" and "commercial" real estate activities that could potentially be aggregated pursuant to Treas. Reg. § 1.199A-5. Because aggregation under Treas. Reg. § 1.199A-5 requires in the first instance that two sets of activities constitute separate trades or businesses, we believe the better view is that the aggregation rules of Treas. Reg. § 1.199A-5 should not affect the application of the Revenue Procedure (i.e., the Revenue Procedure should be applied to determine whether a QTB exists with respect to an activity before taking into account the aggregation rules of Treas. Reg. § 1.199A-5), but in any case we recommend clarification of the interaction between these sets of rules.

2. Allocation of Items Among Multiple QTBs

Treas. Reg. § 1.199A-3(b)(5) of the Final Regulations, which remains substantively unchanged from the Proposed Regulations, provides that if a taxpayer directly conducts multiple trades or businesses to which items (such as expenses) are properly attributable, the taxpayer must allocate such items among the trades or business to which they are properly attributable using "a reasonable method based on all the facts and circumstances." Treas. Reg. § 1.199A-3(b)(5) also provides that a different reasonable method may be used for different items, but must, with respect to each item, be consistently applied through successive tax years and clearly reflect the income and expenses of each trade or business; moreover, the overall combination of methods must also be reasonable based on all the facts and circumstances. The Preamble to the Final Regulations notes that Treasury declined to adopt suggestions regarding specific allocation methods that were

[17] Treas. Reg. § 1.103-8(b)(4)(i).

submitted in response to the Proposed Regulations, such as the cost allocation methods provided for in previous Treas. Reg. § 1.199-4(b)(2), as well as a suggested safe harbor threshold allowing a taxpayer to avoid direct tracing of items.[18] Treasury has requested additional comments with respect to these rules, as well as suggestions for potential safe harbors.[19]

In response to Treasury's request, we have further considered this issue. We believe that at a minimum, examples of "reasonable" methods should be provided to taxpayers, but that a robust anti-abuse mechanism should be included to avoid taxpayer manipulation of QBI. The Code and Treasury Regulations in other contexts have addressed similar issues. For example, in various parts of the Code, the allocation of certain items of income is based upon a formula that takes into account the ratio of gross income from certain sources over total gross income from all sources (e.g., certain dividends under Section 861(a)(2)(b)). Accordingly, in the First Prior Report, we noted that the Treasury Regulations issued under Section 861 through Section 864 appear to provide a logical framework for allocation of items across multiple trades or businesses under Section 199A, particularly given the cross reference to Section 864(c) in the definition of "qualified items" in Section 199A(c)(3).[20] We continue to believe that Treasury Regulations issued under Section 861 through Section 864 would provide a logical starting point for allocating items attributable to multiple trades or businesses.

However, to the extent helpful, we note several other options available to the government in crafting a rule to allocate items not clearly attributable to a single trade or business. For example, the Proposed Regulations under Section 163(j) offer a number of potential methods for allocating items of income and expense. Specifically, Prop. Reg. § 1.163(j)-10(b)(3) uses formulas based on the relative adjusted basis of assets in allocating certain dividends under Section 163(j). Similarly, Prop. Reg. § 1.163(j)-10(c)(1) generally allocates interest expense according to the relative adjusted basis of assets , whereas Prop. Reg. § 1.163(j)-10(b)(5)(ii) allocates certain items ratably in proportion to gross income. Finally, Prop. Reg. § 1.163(j)-10(c)(3)(ii) provides examples for the appropriate allocation of asset basis for an asset used in two or more trades or businesses: pro rata based on gross income generated, pro rata based on physical space used, or pro rata based on units of output. As a final example, under Section 512, salary expense may be properly allocated between a tax-exempt organization and an unrelated business in proportion to the approximate amount of actual time spent by the taxpayer with each activity.[21] While we reiterate our view that Treasury Regulations issued under Sections 861 through 864 likely provide an adequate starting point for allocating items across multiple trades or businesses, we believe each of the rules cited above may also provide an appropriate foundation for regulatory guidance.

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[18] 84 Fed. Reg. at 2965. Treasury noted that the allocation rules in Treas. Reg. § 1.199-4 were intended solely for expenses, in contrast to Treas. Reg. § 1.199A-3(b)(5), which governs "all qualified items of income, gain, loss, and deduction…."

[19] *Id.*

[20] First Prior Report at 18-19.

[21] Treas. Reg. § 1.512(a)-1(c). We further note that in the context of tax-exempt entities, similar allocation issues are being considered to address new Section 512(a)(6), which requires allocation among separate trades or businesses in which a tax-exempt entity is engaged. See Notice 2018-67, 2018-36 I.R.B. 409.

3. Aggregation Under Final Regulations

a) Overlapping Ownership Requirement for Aggregation

The Final Regulations generally maintain the approach of the Proposed Regulations with respect to permitted aggregation of QTBs for purposes of Section 199A. Thus, aggregation of multiple QTBs pursuant to the Final Regulations requires as an initial matter that 50 percent or more of each trade or business be owned by the same person or group of persons.[22] For these purposes, the Final Regulations clarify that the attribution rules of Section 267(b) and Section 707(b) apply.[23] As was the case in the Proposed Regulations, aggregation is limited to situations where this overlapping ownership exists for the majority of the taxable year, the trades or businesses in question are reported on the same taxable year, and the trades or businesses are sufficiently interdependent based on a three-factor test.[24] Aggregation is not permitted with respect to a specified service trade or business ("SSTB")[25]

The Preamble to the Final Regulations specifically rejects comments (including those comments from our Second Prior Report[26]) suggesting a minimum threshold of ownership in two RPEs before counting a given owner for purposes of measuring common ownership.[27] While we respect Treasury's decision not to adopt this minimum threshold, we note that as a technical matter, the language as drafted in the Final Regulations arguably permits two trades or businesses to be aggregated with minimal overlapping ownership. That is, in articulating the overlapping ownership requirement, Treas. Reg. § 1.199A-4(b)(1)(i) specifically requires that "[t]he same person or group of persons" own at least 50 percent of the two trades or businesses in question. The Preamble to the Final Regulations further glosses this requirement by stating:

> "[t]he ownership rule in the proposed regulations does not require that every person involved in the ownership determination own an interest in every business. The rule is satisfied so long as one person or group of persons holds a 50 percent or more ownership interest in each trade or business."[28]

We are concerned that the regulatory language, read together with the statements in the Preamble to the Final Regulations, could be interpreted to permit aggregation among two trades or business with little (or even no) overlapping ownership because it is not clear that the "group of persons" is

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[22] Treas. Reg. § 1.199A-4(b)(1)(i).

[23] *Id.*

[24] Treas. Reg. § 1.199A-4(b)(1)(ii), (b)(1)(iv), and (b)(1)(v).

[25] Treas. Reg. § 1.199A-4(b)(1)(iii).

[26] For example, we suggested as one possibility that anyone who owns less than 10 percent of the value of an enterprise could be excluded from the group of owners whose ownership is considered in testing whether the 50 percent common ownership threshold is satisfied. Second Prior Report at 45-46.

[27] 84 Fed. Reg. at 2966-67.

[28] 84 Fed. Reg. at 2967.

limited to persons who own interests in both QTBs. Thus, suppose that A owns 99% and B owns 1% of the capital and profits of PRS 1, which conducts QTB 1. Suppose that B also owns 1% and C owns 99% of the capital and profits of PRS 2, which conducts QTB 2. The language of the Final Regulations arguably permits grouping of QTB 1 and QTB 2 because the group that includes A, B, and C collectively owns 100% of both QTBs. We do not believe that this is the intended result under the Final Regulations, and accordingly we recommend that Treasury consider clarification of this point to avoid inappropriate aggregation of QTBs where minimal overlapping ownership exists. We note that a similar test applies under Section 707(b)(1)(B) with respect to two partnerships in which "the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests." Under Section 707(b), we believe that only overlapping owners are counted in measuring whether two partnerships are related, but there is no de minimis threshold, and it is possible that small amounts of overlapping ownership can result in partnerships being treated as related. If Treasury intends for results under the Section 199A aggregation rules to mirror results under Section 707(b), we believe that an example or other explicit confirmation of this intended result is appropriate.[29]

b) Section 199A Aggregation and Grouping Under Other Sections of the Code

In our Second Prior Report, we noted that taxpayers subject to Section 469 would potentially be required to maintain different groupings for Section 469 and Section 199A purposes.[30] Because Section 199A grouping standards are more restrictive than the standards under Section 469, we recommended that taxpayers be permitted to elect Section 199A groupings for Section 469 purposes.[31] Treasury requested additional comments concerning this proposal.[32]

We continue to believe that it would be appropriate for Treasury to issue guidance to allow taxpayers to group activities under Section 469 consistent with how they aggregate those activities under Section 199A. As we noted in the Second Prior Report, the Section 199A standard for aggregation is narrower than the grouping rules under Section 469, and thus, allowing taxpayers to group under Section 469 in a manner consistent with the aggregation of their activities under Section 199A would not compromise the policy goals of either statute. Additionally, we note that the Treasury Regulations under Section 1411 adopt the grouping rules under Section 469 for purposes of calculating net investment income tax with respect to multiple activities; accordingly, we also propose that Treasury consider issuing guidance that taxpayers may regroup their activities for purposes of Section 1411 consistent with the aggregation of their trades or businesses under Section 199A.

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[29] *See* McKee Nelson & Whitmire: *Federal Taxation of Partnerships & Partners*, ¶ 14.04[2][d], Example 14-18. Note that Section 304(a)(1) operates similarly, although it only takes into account stock ownership of actual transferors. Treas. Reg. § 1.304-5(b).

[30] Second Prior Report at 48-49.

[31] *Id.* at 49.

[32] 84 Fed. Reg. at 2966.

4. Unadjusted Basis Immediately After Acquisition

a) UBIA of Property with a Tax Basis of Zero

Treasury has requested comments as to whether a new regime is necessary to allocate UBIA in the case of a partnership with qualified property that does not produce tax depreciation during the taxable year.[33] In our Second Prior Report, we had suggested five possible regimes to allocate the UBIA of such qualified property: (i) rules based on the allocation of nonrecourse indebtedness under Treas. Reg. § 1.752-3, (ii) rules based on the application of the remedial method under Treas. Reg. § 1.704-3 where tax depreciation is exhausted, (iii) rules based on a hypothetical allocation of loss if the qualified property had a tax basis equal to UBIA, (iv) rules "freezing" the allocation of UBIA based on the final year in which tax depreciation was actually generated with respect to such property, and (v) rules allocating UBIA in proportion to depreciation deductions previously allocated to each partner.[34] We noted that any regime would need to be considered carefully in light of potential inappropriate tax planning.

On further reflection, and taking into account the rules actually adopted in the Final Regulations by Treasury with respect to UBIA, we recommend either the second or the third approach described above.

We think that rules based on an application of the remedial method under Treas. Reg. § 1.704-3 could be useful in addressing many of these problems. Under this approach, in the first taxable year in which a partnership has property with zero tax basis but positive UBIA, the partnership, solely for purposes of allocating UBIA could treat the property in question as if its basis were adjusted under Treas. Reg. § 1.704-1(b)(2)(iv)*(f)* and *(g)* to equal the UBIA of such property. Then under Treas. Reg. § 1.704-3(d)(2), the partnership would allocate hypothetical amounts of book depreciation. The regulations could provide that for purposes of this hypothetical calculation, the partnership could select any reasonable method (as provided in Treas. Reg. § 1.704-3(d)(2)) in a manner consistent with the approach that would apply in the case of remedial allocations in similar circumstances. Alternatively, the regulations could bind the partnership to use the same method previously used by the partnership with respect to the property. These hypothetical allocations would in turn govern the allocation of the property's UBIA. This approach hews to the intent of the statute, which requires UBIA to be allocated in proportion to "depreciation" allocations, but would add an additional administrative burden on the partnership.

Under the other approach we would recommend, the partnership could test in any year which partner(s) would be allocated loss if the property were sold for $0 with a tax basis equal to the property's UBIA and allocate the UBIA in proportion to such hypothetical loss allocations. This method arguably would have the effect of allocating the UBIA to the partner(s) with the greatest ongoing economic interest in the property giving rise to the UBIA.

We believe that the nonrecourse deduction approach, which would give taxpayers the flexibility to allocate UBIA in accordance with the allocation of any other reasonable item, is likely

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[33] 84 Fed. Reg. at 2958.

[34] Second Prior Report at 12-13.

to provide too much leeway for inappropriate shifts of UBIA among partners. A "freezing" of UBIA, while potentially administratively simple, does not properly account for the ability and likelihood of partners transferring interests and the possibility of manipulation of the allocation of UBIA in the final year(s) of a property's useful life to shift a Section 199A deduction to a particular partner. Rules allocating UBIA in proportion to depreciation deductions previously allocated to each partner would take care of the second concern with respect to "freezing" but would not easily take into account transfers of partnership interests. Whether Treasury ultimately adopts either of our recommended proposals or determines that another approach to allocation of UBIA in this context is preferable, we recommend that Treasury consider implementing an anti-abuse rule to limit the ability of taxpayers to artificially allocate UBIA for purposes of Section 199A.

b) Impact of Adjustments Pursuant to Sections 734 and 743 on UBIA

The Proposed Regulations generally provided that adjustments pursuant to Section 734 and 743 did not result in adjustments to a partnership's UBIA.[35] The Final Regulations reverse this result in the case of Section 743 adjustments, requiring an adjustment to UBIA applying the principles of Section 743, but assuming that the adjusted basis of all of the partnership's property is equal to the UBIA of such property.[36] However, the Final Regulations maintain the position of the Proposed Regulations in the case of adjustments to tax basis pursuant to Section 734, providing that an adjustment pursuant to Section 734 does not give rise to any adjustment to a partnership's UBIA in qualified property.[37] The Preamble further requests comments as to whether an entirely new regime to address UBIA adjustments independent of Section 734 or Section 743 may be appropriate.[38]

As we indicated in our Second Prior Report, we believe that adjustments to UBIA with respect to partnership transactions require careful balancing of technical precision and concerns regarding administrability.[39] Accordingly, we highlighted a number of approaches available to Treasury, including (1) maintaining the position of the Proposed Regulations that Section 734 and Section 743 adjustments are not taken into account in measuring UBIA, (2) adjusting UBIA upward or downward based on increases or decreases to tax basis pursuant to Section 734 or Section 743, or (3) creating an entirely new regime in which adjustments are made to UBIA independent of adjustments made pursuant to Section 734 or Section 743.

We believe that the position taken in the Final Regulations with respect to Section 734 and Section 743 adjustments represents one of a number of sensible outcomes with respect to this issue, and accordingly we support the approach taken in the Final Regulations. We note, however,

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35 83 Fed. Reg. at 40889.

36 Treas. Reg. § 1.199A-2(a)(3)(iv)(A).

37 Treas. Reg. § 1.199A-2(c)(1)(iii).

38 84 Fed. Reg. at 2960.

39 Second Prior Report at 14.

several technical concerns with respect to the application of Section 743 principles that we believe merit further consideration.

Specifically, the Final Regulations generally cap any adjustment to UBIA pursuant to Section 743(b) (the "excess Section 743(b) basis adjustment") at the "absolute value" of the relevant Section 743(b) basis adjustment (the "Absolute Value Cap").[40] It appears that the Absolute Value Cap may be designed to address a situation in which a downward adjustment to UBIA would result in UBIA adjustments that exceed tax basis adjustments. Example 2 in Treas. Reg. § 1.199A-2(a)(3)(iv)(D) specifically illustrates such a situation in which a downward adjustment to UBIA is limited by the Absolute Value Cap.

It is not immediately clear to us why the Final Regulations seek to harmonize changes to UBIA and adjusted tax basis in this manner. It is virtually certain that over time, UBIA and adjusted tax basis will diverge by virtue of ordinary course depreciation and amortization of assets used in a qualified trade or business, and as such it is not clear why avoiding this mismatch at the time of a Section 743 adjustment is necessary. Furthermore, we believe that the Absolute Value Cap described by the Final Regulations poses a number of technical issues that present difficult-to-justify results. We present a number of these technical issues below.

(i) Upward Section 743(b) Adjustment After Section 734 Adjustment

Because the Final Regulations do not permit adjustments to UBIA as a result of transactions described in Section 734(b), it is possible in certain cases that adjusted tax basis following Section 734(b) adjustments could exceed UBIA. The specific purpose served by the Absolute Value Cap in this context is unclear, as illustrated by the following examples:

> **Example 1**. At the beginning of Year 1, A, B and C each contribute $100 to PRS in exchange for a pro rata interest in PRS. PRS uses $180 to purchase Qualified Property A, and retains $120 for use as working capital. Qualified Property A is subject to ten-year straight-line depreciation.
>
> At the end of Year 1, PRS distributes $120 in cash to C in complete redemption of C's interest in PRS. Pursuant to Section 734(b)(1)(A) and Section 755, PRS adjusts the tax basis of Qualified Property A upward by $20 such that the adjusted tax basis of Qualified Property A is $182 (i.e., $180, less $18 of depreciation, plus $20 Section 734(b) adjustment).
>
> At the beginning of Year 2, when Qualified Property A has a fair market value of $240 and an adjusted tax basis of $182, D purchases A's interest in PRS for $120 in a transaction unrelated to the redemption of C's interest in PRS. D is entitled to an upward adjustment with respect to the assets of PRS under Section 743 equal to $29. Pursuant to Section 755, all $29 of the Section 743 adjustment is allocated to Qualified Property A such that with respect to D, Qualified Property A effectively has a tax basis of $120.

[40] Treas. Reg. § 1.199A-2(a)(3)(iv)(B).

> Applying the Final Regulations, if Section 743 and Section 755 principles are applied, substituting UBIA for adjusted tax basis, then the "excess Section 743 basis adjustment" before applying the Absolute Value Cap is $30, all of which would be allocated to the UBIA of Qualified Property A, effectively resulting in UBIA of $120 with respect to D. However, as a result of the Absolute Value Cap, the "excess Section 743 basis adjustment" is reduced to $29, effectively resulting in D having a UBIA with respect to Qualified Property A of $119, notwithstanding that D effectively has tax basis of $120 with respect to Qualified Property A.

It is not immediately clear to us why the results of Example 1 are necessary or justified. Rather, these results seem to penalize D for buying into a partnership that has assets to which a Section 734 adjustment had applied. It is not clear what the Absolute Value Cap achieves from either a technical or policy perspective on these facts.

(ii) Upward Section 743(b) Adjustment, Downward UBIA Adjustment

Issues with respect to the Absolute Value Cap are compounded where fair market value of a partnership's qualified property (i) exceeds adjusted tax basis, but (ii) is less than UBIA, as illustrated in the following example:

> **Example 2**. At the beginning of Year 1, E, F and G each contribute $100 to PRS2 in exchange for a pro rata interest in PRS2. PRS2 uses $180 to purchase Qualified Property B, and retains $120 for use as working capital. Qualified Property B is subject to ten-year straight-line depreciation.
>
> At the end of Year 3, Qualified Property B has a fair market value of $150 and an adjusted tax basis of $126. PRS2 has otherwise not had any net income or loss, and maintains the cash balance of $120. At the beginning of Year 4, H acquires E's interest in PRS2 for $90 at a time when PRS2 has in place an election pursuant to Section 754. H is entitled to an upward adjustment with respect to the assets of PRS2 under Section 743 equal to $8. Pursuant to Section 755, all $8 of the Section 743 adjustment is allocated to Qualified Property B.
>
> Applying the Final Regulations, if Section 743 and Section 755 principles are applied, substituting UBIA for adjusted basis, then the "excess Section 743(b) basis adjustment" before applying the Absolute Value Cap is a downward adjustment of $10. Under the principles of Section 755, this $10 downward adjustment would be allocated to Qualified Property B. However, the Absolute Value Cap applies, and this downward adjustment is reduced to $8 (i.e., the absolute value of the positive $8 adjustment).

Once again, it is not clear on these facts what goal the Absolute Value Cap serves to achieve. To the extent that the Absolute Value Cap is intended to harmonize adjustments pursuant to Section 743(b) and UBIA adjustments under Section 199A, it is difficult to see how the Absolute Value Cap furthers this policy where the Section 743(b) adjustment and the UBIA adjustment already apply in opposite directions (i.e., where the Section 743(b) adjustment is upward, whereas the UBIA adjustment is downward, or vice-versa). That is, it is unclear why limiting the downward

adjustment to UBIA to $8 is meaningfully different from permitting the downward adjustment to UBIA to be $10, given that the Section 743(b) adjustment to adjusted tax basis and the adjustment to UBIA were already driving in opposite directions. If in fact the Absolute Value Cap is intended to result in adjustments to UBIA that track Section 743(b) adjustments, an alternative that limits the divergence of UBIA adjustments and Section 743(b) adjustments may be to provide that (A) a positive adjustment to the UBIA of qualified property shall not exceed the greater of (i) zero and (ii) the total positive Section 743(b) basis adjustment with respect to qualified property, and (B) a negative adjustment to the UBIA of qualified property shall not exceed the greater of (i) zero and (ii) the total negative Section 743(b) basis adjustment with respect to qualified property.

Because the results in each of the examples above do not appear justified from a technical perspective, and because we are not able to determine a clear policy goal served by these results, we recommend that at a minimum Treasury consider clarifying the purpose of the Absolute Value Cap. In the event that the purpose of the Absolute Value Cap is simply to achieve the results contemplated by Example 2 in Treas. Reg. § 1.199A-2(a)(3)(iv)(D) in which a downward adjustment to UBIA is limited to avoid UBIA adjustments being greater than adjustments to tax basis, we recommend that (1) the policy justification for this result be made clearer, and (2) that the rule be modified in the manner described above to more narrowly address this specific situation to avoid the counterintuitive results reflected in the examples above.

c) Carryover UBIA in Certain Non-Recognition Transactions

In our Second Prior Report, we recommended that UBIA carry over to a transferee in connection with the transfer of a qualified trade or business in a non-recognition transaction described in Section 168(i)(7). The Final Regulations adopt a version of this approach. Under Treas. Reg. § 1.199A-2(c)(3)(iv), qualified property contributed by a partner to a partnership or a shareholder to an S corporation in a non-recognition transaction will retain its UBIA amount, "decreased by the amount of money received by the transferor in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction".

As an initial matter, we believe that the language of the Final Regulations should be clarified to apply not just to money paid, but also to the fair market value of other property received in connection with a Section 168(i)(7) transaction. We believe that this is likely a drafting oversight, but without this clarification, the rules applicable to "boot" in Section 168(i)(7) would effectively become optional for taxpayers willing to substitute property for cash as consideration in a transfer.

Turning to the conceptual approach contemplated by the Final Regulations, while we agree with the general concept of the carryover of UBIA, we are puzzled by the intended impact of adjustments for money paid or received in Treas. Reg. § 1.199A-2(c)(3)(iv). As drafted, it appears that the proposed adjustment potentially has no effect, because the amount of money received by the transferor and the amount of money paid by the transferee will always perfectly offset one another and net to zero. Consider the following example:

> **Example 3**. J operates a QTB as a sole proprietor, which holds an asset that is qualified property (Qualified Property X), which J purchased in 2011 for $10,000. The sole proprietorship owns no other assets other than self-created goodwill. K

operates a similar QTB through an S corporation, L. In 2019, when Qualified Property X has been fully depreciated for tax purposes, but has a fair market value of $2,500, J contributes the QTB held as a sole proprietorship, including Qualified Property X, to L in exchange for 80% of the stock of L and $2,500 cash in a transaction governed by Section 351. Under Treas. Reg. § 1.199A-2(c)(3)(iv), the UBIA of Qualified Property X of $10,000 would be decreased by the amount of money received by J ($2,500) or increased by the amount of money paid by the transferee to acquire the property (perhaps also $2,500).

Another way to read the provision is that the UBIA of Qualified Property X is decreased by the full $2,500 received by J (since UBIA is decreased by the amount of money received "in the transaction"), but is then only increased by the amount of the consideration allocated to Qualified Property X under the principles of Rev. Rul. 68-55[41] (since UBIA is increased by the amount of money paid "to acquire the property"). Under this Revenue Ruling, "boot" consideration is allocated among assets in accordance with their fair market values. Thus, if Qualified Property X were 1 percent of the value of the QTB held in sole proprietorship form, under this interpretation, the UBIA of Qualified Property X in the example above would be decreased by $2,500 (the amount of money received by J), but increased by $25, for a total carryover UBIA of $7,525. This has the effect of reducing UBIA by the full amount of cash boot received in respect of the transaction (even if primarily allocable to assets other than qualified assets). This approach, however, seems difficult to justify as a technical matter or as a matter of policy. It is not immediately apparent why 100 percent of the cash received by the transferor should be allocated to qualified property and result in a loss of UBIA, whereas only a fraction of the cash paid by the transferee should be allocated to qualified property to increase UBIA under the principles of Rev. Rul. 68-55.

Consistent with the Second Prior Report, we continue to believe that so long as qualified property remains with a QTB, the amount originally invested in that qualified property (i.e., its pre-contribution UBIA) generally should be conserved in the case of non-recognition transactions. Furthermore, incremental investment in qualified property should generate additional UBIA. This is the approach taken by the Final Regulations with respect to Section 1031 and Section 1033 transactions,[42] and we believe it is equally applicable in the case of Section 168(i)(7) transactions. Under such an approach, the UBIA of qualified property could be increased by the lesser of (1) appreciation, if any, in the qualified property (i.e., the excess of the fair market value of the contributed property as of the date of the exchange over the fair market value of the contributed property on the date of the acquisition by the taxpayer (i.e., its UBIA)) and (2) the sum of money and the fair market value of any property received in connection with the Section 168(i)(7) transaction.

The following example illustrates the application of these concepts:

Example 4. The facts are the same as in Example 3, except that the fair market value of Qualified Property X is $12,000 at the time of J's contribution to the S

[41] 1968-1 C.B. 140.

[42] *See* Treas. Reg. § 1.199A-2(c)(3)(ii)(B); Treas. Reg. § 1.199A-2(c)(3)(iii)(B).

corporation, and J owns no other assets with respect to its QTB other than Qualified Property X. J contributes Qualified Property X to L and receives S corporation shares and $2,500 in a transaction described in Section 351. Applying the rule described above, the UBIA of Qualified Property X is increased by $2,000 (i.e., the lesser of the $2,000 of appreciation and the $2,500 of money received in respect of Qualified Property X). Pursuant to Treas. Reg. § 1.199A-2(c)(2)(iv)(B), the $2,000 increase in UBIA is treated as separate qualified property that the S corporation placed in service on the date of the transfer.

While we believe that the proposed formulation is consistent with outcomes in the Final Regulations under Sections 1031 and 1033, we note that this formulation effectively allocates cash and other property to appreciation in an asset first. In particular, we note that Treasury could have considered approaches in which cash and other property is allocated pro rata between existing UBIA and appreciation, or approaches in which cash and other property is allocated first to existing UBIA and last to appreciation. Ultimately we do not express a view as to which of these approaches is preferable, and simply flag for Treasury's consideration that a number of approaches are available with respect to this issue. We do respectfully request some clarification of the existing regulatory language, which as we demonstrate in Example 3 raises questions as drafted.

In any case, if Treasury continues to believe that the approach taken in the Final Regulations is the correct outcome, we respectfully request examples that (1) confirm the effect of the Final Regulations, (2) apply the rule in different Section 168(i)(7) transactions (each of which may have different rules with respect to the allocation of boot), and (3) clarify the result where multiple properties are contributed.

5. Items Spanning Multiple Tax Years

Under Section § 1.199A-3(b)(1)(iii), Section 481 adjustments are taken into account for purposes of computing QBI only if the adjustment arises in taxable years ending after December 31, 2017. In our Second Prior Report, we suggested that there were other similar items that had the effect of shifting income from years prior to the enactment of Section 199A to years in which Section 199A is applicable that should receive the same treatment. In particular, we suggested that income from installment sales and deferred cancellation of indebtedness income under Section 108(i) arising prior to the effective date of Section 199A should not be included in the computation of QBI for purposes of Section 199A.[43] However, we suggested that items deferred under Revenue Procedure 2004-34 should be included in QBI regardless of when they arise.[44] Treasury has requested additional comments on this subject.[45]

We continue to support the recommendation in our Second Prior Report. In the case of each of installment sales and deferred cancellation of indebtedness income, the economic activity that gave rise to the income occurred in a year prior to the adoption of Section 199A. To give

[43] Second Prior Report at 36-37.

[44] Rev. Proc. 2004-34, 2004-1 C.B. 911; Second Prior Report at 36-37.

[45] 84 Fed. Reg. at 2961.

taxpayers the benefit of the Section 199A deduction by including such amounts in QBI confers a windfall on taxpayers that was probably not intended by the statute. However, items deferred under Revenue Procedure 2004-34 are different. These items relate to advance payments which are permitted to not yet be taken into income because the economic activity that relates to such payments (i.e., economic performance) has not yet occurred. Therefore, we think it is appropriate to include such amounts in QBI at the time that the relevant items are otherwise taken into account for U.S. federal income tax purposes.

B. Matters Regarding the Taxation of RICs

1. Background of RIC Conduit Treatment for Section 199A Deductions

Section 199A generally allows non-corporate taxpayers to deduct up to 20% of the aggregate amount of their "qualified REIT dividends"[46] and QPTP Income,[47] as determined at the partner or shareholder level in the case of partnerships and S corporations, respectively.[48] Section 199A does not specify how dividends from a RIC, to the extent such dividends are attributable to the RIC's qualified REIT dividends and QPTP income, should be treated for purposes of determining a Section 199A deduction, but it does grant authority to the Treasury Secretary to adopt regulations necessary to carry out the purpose of Section 199A, including in the case of "tiered entities."[49]

In its general explanation ("Blue Book"), the Joint Committee on Taxation states that Congress intends that RIC shareholders be permitted to treat dividends from a RIC as QPTP Income or qualified REIT dividends to the extent such RIC dividends are attributable to the RIC's QPTP Income or qualified REIT dividends, respectively.[50] Further, a discussion draft of the Tax Technical and Clerical Corrections Act by Ways and Means Committee Ranking Member Kevin Brady would provide by statute for this treatment in the case of RIC dividends attributable to qualified REIT dividends or QPTP Income.[51]

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[46] Qualified REIT dividends is defined in Section 199A(e)(3)

[47] Qualified PTP income is defined in Section 199A(e)(4) and Treas. Reg. § 1.199A-3(c)(3).

[48] Section 199A(b)(1)(B) and (f).

[49] Section 199A(f)(4)(B).

[50] General Explanation of Public Law 115-97, JCS-1-18 (Dec. 20, 2018). "Many individuals invest in REIT stock or interests in publicly traded partnerships indirectly through a regulated investment company (a 'RIC' or mutual fund). The RIC may receive amounts that would be treated as qualified REIT dividends of qualified publicly traded partnership income eligible for the Section 199A deduction in the hands of an individual RIC shareholder had that individual directly held the REIT stock or the interest in the publicly traded partnership. It is intended that in the case of an individual shareholder of a RIC that itself owns stock in a REIT or interests in a publicly traded partnership, the individual is treated as receiving qualified REIT dividends or qualified publicly traded partnership income to the extent any dividends received by the individual from the RIC are attributable to qualified REIT dividends or qualified publicly traded partnership income received by the RIC."

[51] Section 4(b)(5) of the proposed Tax Technical and Clerical Corrections Act states: "Section 852(b) is amended by adding at the end the following: '(10) Treatment by Shareholders of Qualified REIT Dividends and Qualified

The RIC Proposed Regulations permit RICs to report a dividend, to the extent attributable to a RIC's "qualified REIT dividend income,"[52] as constituting a "section 199A dividend"[53] and thereby permit a RIC's shareholders to treat those dividends in their hands as qualified REIT dividends.[54] The preamble of the RIC Proposed Regulations refers to this tax result as "conduit treatment."[55]

The RIC Proposed Regulations do not extend similar conduit treatment to QPTP Income. The preamble states, instead, that the Treasury Department and IRS seek public comments to assist in resolving several "novel issues with a view to developing regulations permitting conduit treatment for qualified PTP income" recognized by a RIC.

2. Rationale for Extending (or Not Extending) Conduit Treatment to QPTP Income

The statutory language of Section 199A gives no indication that Congress intended different treatment of REIT dividends and QPTP Income in determining the section 199A deduction by a RIC shareholders in respect of RIC dividends. To the extent there is evidence of Congressional intent, it points in the other direction. As noted above, both the Bluebook and proposed technical corrections bills support conduit treatment for both qualified REIT dividends and QPTP Income and do not distinguish between them with respect to their eligibility for conduit treatment.

The preamble to the RIC Proposed Regulations suggests two reasons for extending conduit treatment to qualified REIT dividends received by a RIC. First, doing so advances Subchapter M's objective of enabling small investors to pool their capital in a manner that allows them to

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Publicly Traded Partnership Income. – (A) In General. –A shareholder of a regulated investment company shall take into account for purposes of Section 199A(b)(1)(B) – (i) as a qualified REIT dividend the amount which is reported by the company (in written statements furnished to its shareholders) as being attributable to qualified REIT dividends received by the company, and (ii) as qualified publicly traded partnership income the amount which is reported by the company (in written statements furnished to its shareholders) as being attributable to qualified publicly traded partnership income of the company.'"

[52] Qualified REIT dividend income is defined in Prop. Treas. Reg. § 1.199A-3(d)(3)(v)

[53] A section 199A dividend is defined as any dividend or part of such a dividend that a RIC pays to its shareholders and reports as a section 199A dividend, to the extent derived from the aggregate amount of qualified REIT dividends includible in the RIC's taxable income for the taxable year less expenses properly allocable thereto. Prop. Reg. § 1.199A-3(d)(2)(i); Prop. Treas. Reg. § 1.199A-3(d)(3)(v).

[54] Prop. Treas. Reg. § 1.199A-3(d). In addition, the shareholder would have to satisfy certain holding-period requirements and not be under any obligation to make related payments. Prop. Treas. Reg. § 1.199A-3(d)(4)(i)-(ii).

[55] According to the preamble, the term "conduit treatment" reflects the fact that, under subchapter M, a RIC shareholder may treat a dividend received from the RIC "in the same (or a similar manner) as the shareholder would treat the underlying item of income or gain if the shareholder realized it directly."

obtain the benefits otherwise available only by direct investing.[56] Second, extending conduit treatment to qualified REIT dividends reduces economic distortions that would result from encouraging investors to invest directly in REITs instead of indirectly through RICs.[57] The preamble does not indicate why either of these reasons for conduit treatment might apply differently to qualified REIT dividends than to QPTP Income, if the QPTP Income earned by RICs is material.

The preamble instead indicates that the RIC Proposed Regulations did not extend conduit treatment to QPTP Income of a RIC because of the additional complexity that would potentially result from doing so. The preamble suggests that this resulting complexity would be potentially inconsistent with another of Subchapter M's objectives, which is simplicity of shareholder taxation. It identifies the following as sources of this potential complexity:

- How the SSTB rules under Section 199A(d)(2) would apply to RIC shareholders with varying income levels, since SSTB income from the publicly traded partnership ("PTP") could be QPTP Income for RIC shareholders with taxable income below the "phase-in range "[58] ("Non-Phased-In Shareholders") but not for shareholders with taxable income above the phase-in range ("Phased-In Shareholders");

- How loss carryforwards arising as a result of the rules prohibiting a PTP from netting losses from a SSTB against a non-SSTB would be reflected at the RIC shareholder level; and

- Whether and the extent to which non-U.S. shareholders and tax-exempt shareholders must treat QPTP income they receive through a RIC as income effectively connected with a U.S. trade or business for purposes of determining tax on non-U.S. persons under Sections 871(b) or 882 ("ECI Tax") or tax under Section 511(a)(1) on organizations described in Section 511(a)(2) ("UBIT").

The preamble requested comments addressing how these questions might be addressed, and in particular with regard to:

- Whether RICs have sufficient QPTP Income to warrant conduit treatment;

- How to provide conduit treatment for Non-Phased-In Shareholders and Phased-In Shareholders alike;

- How to treat losses of PTPs arising from SSTBs and non-SSTBs;

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[56] "Investing in RICs enables small investors to gain benefits, such as professional management and broad diversification, that otherwise would be available only to investors with more resources."

[57] "[I]n the absence of these supplemental proposed regulations, a market distortion is introduced by section 199A whereby direct ownership of REITs is tax-advantaged relative to indirect ownership of REITs through RICs."

[58] Phase-in range is defined in Treas. Reg. § 1.199A-1(b)(4).

- Whether SSTB items are sufficiently rare or incidental for PTPs that a conduit regime should exclude all SSTB items;

- Whether conduit treatment for QPTP Income can be disregarded for purposes of calculating the ECI Tax and UBIT at the RIC shareholder level; and

- How to apply conduit treatment for QPTP Income in a way that is consistent with the policy goal of preserving the overall simplicity of the tax treatment of investors in RICs while still achieving the policy goals of Section 199A and Section 199A(b)(1)(B) in particular.

3. Discussion of Issues with Extending Conduit Treatment to QPTP Income

In our view, extending conduit treatment to QPTP Income could be achieved without introducing undue complexity to shareholder-level taxation and therefore would be consistent with the tax policy objectives of Subchapter M. We acknowledge that permitting this treatment for shareholders would introduce RIC-level complexity, but we do not believe that such complexity would be inconsistent with Subchapter M's objectives.[59]

As suggested in the preamble, however, the merits of adopting rules to enable conduit treatment for QPTP Income depends on whether the benefits of doing so would be sufficiently great to justify the cost of introducing such complexity into Subchapter M. As also intimated in the preamble, if conduit treatment is generally extended for QPTP Income, the merits of alternatively requiring or permitting a RIC to take account of SSTB items in the measure of amounts treated as available to support RIC dividends eligible to be treated as QPTP Income in the hands of RIC shareholders ("QPTP Dividends") depends on the materiality of those SSTB items.

We have no view on those factual questions. For this reason, we are not making any recommendations about the extension of conduit treatment to QPTP Income or whether, if extended, conduit treatment should be required to disregard or permitted to take into account SSTB items. Instead, we have outlined how rules might be designed to permit (or require) such conduit treatment in a manner that addresses the issues identified in the preamble, including with respect to SSTB items.

As described in the preamble, the primary issues with extending conduit treatment to QPTP Income of a RIC fall into three categories: (1) how to report QPTP Dividends in amounts that are appropriate for Phase-In Shareholders as compared to Non-Phased In Shareholders, including after taking into account proper netting of losses, (2) how to require proper netting of PTP-related losses

[59] Consistent with this view, the preamble indicates concern only for shareholder-level complexity. While Subchapter M achieves significant simplicity with respect to shareholder taxation, RIC-level computations and compliance are quite complex and have become more so over time in order to reinforce a range of important other tax policies. The excise tax is among the most prominent examples of complexity that affects RIC-level tax compliance but not shareholder-level compliance.

across years and across "combined qualified REIT dividend income and QPTP Income,"[60] including after appropriately taking into account SSTB items, and (3) how to balance the complexity of adequately addressing the first two categories of issues against the potential benefit to shareholders given the limitations on a RIC's ability to invest in PTPs.

In our view, the simplest way to address the first category of issues would be to require a RIC to track items attributable to an SSTB separately from items not attributable to an SSTB and to permit a RIC either (1) to report QPTP Dividends in the same amount to all shareholders based on a measure of QPTP Income that disregards all SSTB items ("Simplified QPTP Reporting") or (2) to report two different amounts of QPTP Dividends ("Dual QPTP Reporting"), one that would pertain to Phased-In Shareholders based on a measure of QPTP Income that disregards SSTB items, and therefore is the same amount that would be reported under Simplified QPTP Reporting (the "Phase-In QPTP Dividend Amount"), and one that would pertain to Non-Phase In Shareholder that is based on a measure of QPTP Income that does not disregard SSTB items (the "Non-Phase-In QPTP Dividend Amount"). We agree with the implicit conclusion of the preamble that RICs should not be permitted to report QPTP Dividends for all shareholders based on a measure of QPTP Income that includes SSTB items, except perhaps when SSTB items are immaterial.

In specifying which of these reporting methods a RIC is permitted or required to use, the rules could, for example, (1) allow a RIC to elect annually to use Simplified QPTP Reporting or Dual QPTP Reporting, (2) allow a RIC to make a one-time election of either reporting method and permit it to change that election only with either IRS consent or upon specified changes in fact (such as a change in investment objectives approved by shareholder vote or an acquisition of the RIC by another RIC) or (3) prohibit or require a particular reporting method based on a specified level of materiality of QPTP Income and/or SSTB items, as determined either annually or over a rolling period. For shareholders, any approach could be either beneficial or detrimental, since the benefit or detriment of permitting or requiring QPTP Income and/or items of SSTB to be taken into account in measuring the amount available to support QPTP Dividends or section 199A dividends will depend on whether such items are negative or positive. For example, Simplified QPTP Reporting could be either beneficial or detrimental for Non-Phased-In Shareholders depending on whether the net SSTB items taken into account in the measure of QPTP are positive or negative.

In our view, how QPTP Dividend rules should handle the second category of issues (loss netting across categories of QPTP Income and across years) depends on which of these approaches to QPTP Dividend reporting is adopted. For example, if RICs are permitted to elect annually either Simplified QPTP Reporting or Dual QPTP Reporting, the required netting rules should focus on preventing RICs from (1) only taking into account SSTB benefits for Non-Phased-In Shareholders without taking into account SSTB detriments and (2) taking into account only QPTP-related benefits and not taking into account QPTP losses that would reduce combined qualified REIT dividend income and QPTP Income. By contrast, if the determination of the type of reporting permitted or required is tied to the materiality of QPTP Income or SSTB items, consideration

[60] Under Treas. Reg. §§ 1.199A-1(c)(1) and 1.199A-1(d)(1), the Section 199A deduction for QPTP Income and qualified REIT dividend income is capped at combined qualified REIT dividend income and QPTP Income to ensure that negative QPTP Income offsets qualified REIT dividend income.

should be given to how materiality should be taken into account across years and types of income or loss when mandating the netting of particular items.

The third category of issues (balancing complexity against shareholder benefit) might be handled one of two ways. The first would be for the government to determine the appropriate balance based on factual information it obtains about the extent and nature of PTP investments by RICs. Under this approach, the government could mandate either all RICs use the same approach (for example, mandated Simplified QPTP Reporting that caps section 199A dividends at combined qualified REIT income and QPTP Income) or mandate a particular approach for a given RIC based on objective materiality standards for the RIC's positive or negative QPTP Income and/or SSTB items. The second approach to balancing complexity against shareholder benefit would be to design rules that permit each RIC to make its own determination about appropriate balance. Under this approach, RICs would be permitted flexibility in reporting QPTP Dividends and section 199A dividends consistent with the objective of preventing a RIC from cherry picking its reporting method in a manner that would avoid taking into account negative QPTP Income or negative net SSTB items.

Allowing each RIC to choose its reporting method, so long as its choices are restricted in a manner to prevent abusive cherry picking, would maximize the likelihood of individuals benefiting from Section 199A while ensuring that RICs are not used to circumvent the limitations under Section 199A that apply to direct investments in PTPs and REITs. This approach also would permit RICs to change whether or how they report QPTP Dividends to shareholders so as to be able to respond more nimbly to changes in the materiality of their QPTP Income and SSTB items.

More specifically, this approach would allow a RIC each year to decide whether (or not) to pass through either or both of its QPTP Income and qualified REIT dividends and, in the case of QPTP Income, whether to measure the amount of its QPTP Income reportable to Non-Phase-In Shareholders by either taking into account or disregarding SSTB-related items. While this approach would allow a RIC to make these decisions differently from year to year, if in a year a RIC were to use a reporting method that is different than the method used in a prior year, this approach would require adjustments to the amounts reported in the current year (e.g., by taking into account amounts previously disregarded) so as to prevent shareholders from being taxed more favorably than they would have been taxed if the RIC has used consistent reporting for all years.

The following is an outline of how this approach might operate. Again, we are not recommending this approach but have provided these details of how it might work so that they can be more meaningfully evaluated.

1. Extend conduit treatment to QPTP Income by permitting a RIC's shareholders to treat as QPTP Income the RIC's dividends that the RIC has properly reported as QPTP Dividends,[61] which the RIC could elect to do (or not) annually and without

[61] In addition, the amount permitted to be so treated should be adjusted in the manner described in Prop. Treas. Reg. § 1.199A-3(d)(2)(ii) and (iii) (so as to account for potential excess designations in a manner that minimizes the likelihood of the RIC needing to issue corrected Forms 1099), subject to the satisfaction of the holding period requirements described in Prop. Treas. Reg. § 1.199A-3(d)(4)(ii).

regard to whether it has previously reported section 199A dividends with respect to its qualified REIT dividend income.

2. For this purpose, require the amount of a RIC's QPTP Income to be generally determined in the same manner as an individual determines his or her QPTP Income under Treas. Reg. § 1.199A-3(c)(3).[62]

3. Just as is the case when an individual determines his or her QPTP Income, require a RIC to (i) carryforward its "negative combined amount of qualified REIT dividend income and QPTP Income"[63] recognized in a year beginning after 2017 ("Negative Carryforward") and (ii) offset its combined amount of qualified REIT dividend income and QPTP Income in subsequent years by the amount of its unused Negative Carryforward.

4. If, in a year that the RIC reports QPTP Dividends, any portion of a RIC's QPTP Income or Negative Carryforward is attributable to an SSTB, permit the RIC to use either Simplified QPTP Reporting or Dual QPTP Reporting (without regard to whether the RIC has previously reported QPTP Dividends or which method it used in reporting such dividends).

5. If in a prior year a RIC used Simplified QPTP Reporting, then when determining amounts reportable under Dual QPTP Reporting for any subsequent year, require the Non-Phase In QPTP Dividend Amount for such year (as well as any Negative Carryforwards relevant to determine such amount) be reduced by any loss from an SSTB that (i) was previously disregarded in determining either the QPTP Income or a relevant Negative Carryforward under Simplified QPTP Reporting, (ii) would have resulted in a Non-Phase In QPTP Amount, if the RIC had used Dual QPTP Reporting in a year that it used Simplified QPTP Reporting, that would have been lower than the amount of QPTP Income used for such Simplified QPTP Reporting and (iii) has not reduced the Non-Phase In QPTP Dividend Amount for a year after the recognition of such loss (such SSTB-related loss being a "Dual Reporting SSTB Loss Carryforward").

6. If in a prior year the RIC used Dual QPTP Reporting, then when determining amounts reportable under Simplified QPTP Reporting for any subsequent year, require the RIC's QPTP Income for the current year (as well as any Negative Carryforwards relevant to determine such amount) be reduced by any loss from a SSTB in the current or prior year that (i) was previously not disregarded in determining the Non-Phase In Dividend Amount or a relevant Negative Carryforward, (ii) has not reduced the QPTP Income under Simplified Reporting for a year after the recognition of such loss and (iii) would reduce the Non-Phase

[62] For example, items of income or loss are disregarded in determining QPTP Income if the item is not effectively connected with a U.S. trade or business or, in the case of losses, are disallowed in the measure of taxable income.

[63] Treas. Reg. § 1.199A-1(c)(2)(ii) and (d)(3)(iii) specifies the measure of this carryover amount for individuals with taxable income below, or within, respectively, the phase-in range.

In Dividend Amount for the current year were the RIC to use Dual QPTP Reporting instead of Simplified QPTP Reporting (the amount of reduction being a "Simplified Reporting SSTB Loss Carryforward").

7. For purposes of determining the amount permitted to be reported as a section 199A dividend for a year, permit the RIC to disregard items of income and loss from PTPs and thereby base such reportable amount solely on the RIC's qualified REIT dividend income for such year, unless the RIC has in any prior year designated a QPTP Dividend and has a Negative Carryforward to the current year or negative QPTP Income for the current year such that the RIC's qualified REIT dividend income for such year is greater than its combined amount of qualified REIT dividend income and QPTP Income, as determined after taking into account such Negative Carryforward if any.

8. If a RIC has reported a dividend as a QPTP Dividend and either used Simplified QPTP Reporting in each year in which it reported a QPTP Dividend or has not recognized an item attributable to an SSTB that would potentially affect the amount of QPTP Income that it used to support a QPTP Dividend (including after taking into account Negative Carryforwards), require the amount of the RIC's section 199A dividend (i.e., the amount permitted to be treated as a qualified REIT dividend at the RIC shareholder level) to not exceed the lesser of its qualified REIT dividend income for the year or its combined amount of qualified REIT dividend income and QPTP Income as determined after taking into account any Negative Carryforward and disregarding in each such determination all items attributable to a SSTB ("Simplified REIT Dividend Reporting").

9. If a RIC has reported a dividend as a QPTP Dividend and used Dual QPTP Reporting in any year in which it reported a QPTP Dividend, require the amount of the RIC's section 199A dividend (i.e., the amount permitted to be treated as a qualified REIT dividend at the RIC shareholder level) to not exceed the lesser of its qualified REIT dividend income for the year or its combined amount of qualified REIT dividend income and QPTP Income for the year (after taking into account any Negative Carryforward), and require the RIC to report two alterative amounts of section 199A dividends ("Mandatory Dual REIT Dividend Reporting"):

    a. The first reportable amount may be relied on only by Phase-In Shareholders and is determined in the same manner as the amount reportable for Simplified REIT Reporting (the "Phase-In REIT Dividend Amount"), and

    b. The second reportable amount may be relied upon only by Non-Phased-In Shareholders and is based on QPTP Income and any Negative Carryforward that is determined by not disregarding items attributable to an SSTB (the "Non-Phased In REIT Dividend Amount"); provided, however, that if the RIC has used Simplified QPTP Reporting, such QPTP Income and any Negative Carryforward must take into account any Dual Reporting SSTB Loss Carryforward.

We recognize that the approach outlined above will not result in a RIC's shareholders being taxed the same as they would have been taxed if they had recognized directly their share of the RIC's QPTP Income. In particular, because RICs do not pass-through losses to their shareholders, a RIC might have a negative combined amount of qualified REIT dividend income and QPTP Income that reduces its taxable income and does not reduce the combined amount of qualified REIT dividend income and QPTP Income that its shareholders recognize directly (from investments outside of the RIC), thereby allowing the shareholders a larger Section 199A deduction than they would have obtained if they had recognized directly the RIC's negative combined amount of qualified REIT dividend income and QPTP Income.

In our view, however, this observation is not a reason to deny conduit treatment to QPTP Income. First, in the Blue Book and proposed technical correction bills, there is no indication that Congress is concerned about this issue. Second, the possibility of this result does not present a practical opportunity for abusive tax planning, since achieving this result would require shareholders to locate negative QPTP Income in their RIC investments while recognizing positive combined qualified REIT dividend income and QPTP Income directly. We do not believe that planning for loss recognition in this manner is practically possible. Third, since prior to disposition of a PTP investment any loss from the PTP would be suspended under the passive activity rules, negative QPTP income can result from only those PTP investments that result in an economic loss on final disposition, further reducing the potential for abusively planning into the recognition of negative QPTP Income inside of a RIC.

Finally, disregarding RIC-level negative QPTP Income at the shareholder level is consistent with the tax policy of not permitting RICs to pass through losses. There is no statutory basis to require or permit RICs to pass through negative QPTP Income, and doing either would be contrary to longstanding tax policy. The importance of this tax policy is emphasized by Congress' decision to make RICs the exclusive means of conduit treatment for publicly offered or traded investment funds registered under the Investment Company Act of 1940[64] and thereby preclude such funds from being classified as partnerships and thus able to pass through their losses.[65] The importance of this tax policy is also illustrated by the similar other ways that investing in a RIC potentially results in more taxpayer favorable treatment of RIC-level losses than if the RIC's shareholders had recognized their share of the RIC's losses directly.

Assume, for example, that a RIC's individual shareholder directly recognizes (from investments outside of the RIC) long-term capital gain of $100 and a short-term capital gain of $100, while the shareholder's indirect share of the RIC's long-term capital loss is $100, and its share of the RIC's short-term capital gain is $100. If the shareholder were to have recognized the RIC items directly, the shareholder would have been taxed on short-term gain of $200. Instead, since the long-term loss is recognized by the RIC, it is netted against the RIC's short-term capital gain in determining the amount of the RIC's investment company taxable income, thus leaving the

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[64] Statements of William McKee and Mark Kuller before the House Ways and Means Committee, June 9, 1986, reprinted in Master Limited Partnerships: Uses and Applications under the New Tax Code, 320 (1987).

[65] Statements of J. Roger Mentz, Assistant Secretary of Tax Policy, Department of Treasury, before the House Ways and Means Committee, June 9, 1986, reprinted in Master Limited Partnerships: Uses and Applications under the New Tax Code, 349 (1987)

shareholder's long-term capital gain to be taxed at the lower rate applicable to net capital gain, saving the shareholder $17 of income tax assuming the highest marginal income tax rates apply.

4. Treatment of QPTP Income under the ECI Tax and UBIT

Section 199A requires that the income, gain, deduction, and loss of a PTP be effectively connected with a U.S. trade or business in order to be taken into account in the measure of QPTP Income.[66] We do not believe, however, that permitting conduit treatment for QPTP Dividends, and thereby also permitting such amounts to be treated as effectively connected with a U.S. trade or business for purposes of determining a deduction under Section 199A, should result in QPTP Dividends being subject to ECI Tax or UBIT.

The statutory mandate for issuing regulations under Section 199A, including regulations to permit conduit treatment of QPTP Income, is limited to issuing only regulations "as are necessary to carry out the purpose of Section 199A, including regulations for its application in the case of tiered entities." The purpose of Section 199A does not include, in our view, the expansion of the ECI Tax or UBIT. Therefore, there might not be regulatory authority to permit or require conduit treatment in a manner that would expand the ECI Tax or UBIT. We do not believe that permitting conduit treatment for QPTP Income for purposes of Section 199A requires that for other tax purposes QPTP Dividends be treated as effectively connected with a U.S. trade or business. There are many examples of RIC conduit treatment being limited in relevance to particular taxpayers for particular purposes. The pass through of the dividends received deduction is relevant only to corporations. The pass through of qualified dividend income is relevant only to non-corporate shareholders, and the pass through of short-term gains and U.S. source interest is relevant only to non-U.S. shareholders.

Because Section 199A is specific to individuals and is relevant to them only insofar as they avail themselves of its deduction, permitting conduit treatment should be limited to the determination of only the deduction permitted under Section 199A. In the Blue Book and technical corrections bills, there was no suggestion that providing conduit treatment to permit a Section 199A deduction should also result in ECI Tax or UBIT. On the contrary, treating QPTP Dividends as subject to ECI Tax would potentially allow non-U.S. recipients of such dividends to offset them with losses effectively connected with a U.S. trade or business, a result that would seem to undermine the gross income tax treatment of RIC dividends under Sections 871 and 881 and gross withholding tax treatment under Sections 1441 and 1442.

Congress' intention for RIC dividends not to be subject to ECI Tax or UBIT is most clearly reflected in the design of the amendment to Section 851 that now permits RICs to invest in PTPs. Aware of the potential for RICs to be used by non-U.S. investors and tax exempt investors to avoid ECI Tax and UBIT on their indirect investments in PTPs through RICs, Congress limited this potential for tax avoidance by prohibiting a RIC from investing more than 25 percent of its assets in PTPs instead of imposing ECI Tax and UBIT on RIC dividends attributable to a RIC's PTP income.[67] The legislative record shows that this choice was deliberate: Congress determined that

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[66] Section 199A(c)(3)(A)(i)

[67] Section 851(b)(3)(B)(iii).

limiting a RIC's ability to invest in PTPs was a sufficient measure for reducing avoidance of ECI Tax or UBIT.[68]

[68] House of Representatives Report No. 108-548, 108th Cong., 2nd Sess., pp. 151–153. "Distributions from Publicly Traded Partnerships Treated As Qualifying Income of Regulated Investment Company (sec. 284 of the bill and secs. 851 and 469(k)) of the Code): … Nevertheless, the Committee believes that permitting mutual funds to hold interests in a publicly traded partnership should not give rise to avoidance of unrelated business income tax or withholding of income tax that would apply if tax-exempt organizations or foreign persons held publicly traded partnership interests directly rather than through a mutual fund. Therefore, the Committee bill requires that present-law limitations on ownership and composition of assets of mutual funds apply to any investment in a publicly traded partnership by a mutual fund. The Committee believes that these limitations will serve to limit the use of mutual funds as conduits for avoidance of unrelated business income tax or withholding rules that would otherwise apply with respect to publicly traded partnership income."