AGGREGATE VS. ENTITY THEORY AFTER TCJA

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Report No. 1387
February 2, 2018

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The Honorable David J. Kautter
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Re: *Request for Immediate Guidance under Sections 864(c)(8) and 1446(f)*

Dear Messrs. Kautter and Paul:

The New York State Bar Association Tax Section (the "Tax Section") is submitting this letter[1] to request immediate guidance under Sections 864(c)(8) and 1446(f) (collectively, the "Provisions") of the Internal Revenue Code of 1986, as amended (the "Code"), which were added to the Code pursuant to P.L. 115-97 (the "Act") on December 22, 2017.

[1] The principal drafters of this letter were Robert Cassanos and Michael Shulman with contributions from Stanley A. Barsky, Kimberly S. Blanchard, Charles W. Cope, Ze'ev Deutsch, Tim Devetski, Phillip J. Gall, Rafael Kariyev, Michael Karlin, Abraham Leitner, Michael Miller, Erika W. Nijenhuis, Harsha Reddy, Tyler Robbins, David R. Sicular, Michael Schler, Eric B. Sloan, Karen G. Sowell, Chaim Stern, and Gordon E. Warnke. This letter 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.

As discussed below, while the Provisions raise numerous technical and interpretative issues that should be addressed through regulations, there is a pressing need for immediate guidance regarding the Provisions, particularly in light of the current requirement to withhold tax under Section 1446(f) in connection with the transfer of certain partnership interests and the effect of Section 864(c)(8) on the structuring of certain transactions. Such guidance would allow affected transactions to proceed in a workable manner while the government considers how to address the broader set of issues raised by the Provisions.

I. Background

Section 864(c)(8) provides that gain or loss recognized by a nonresident alien individual or foreign corporation from the sale, exchange or disposition of a directly or indirectly held partnership interest generally is treated as effectively connected with the conduct of a U.S. trade or business to the extent that such gain or loss does not exceed the gain or loss such person would have recognized as effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the transfer. Section 1446(f) provides that a transferee of such a partnership interest generally must withhold tax equal to 10% of the amount realized upon the disposition of a partnership interest if any gain on the transfer of such interest would be treated as effectively connected with the conduct of a U.S. trade or business under Section 864(c)(8). If the transferee fails to withhold the correct amount of tax under Section 1446(f), the obligation to collect is shifted to the partnership, which is required to withhold from distributions to the transferee partner any amount required to be, but not, withheld by the transferee.

The enactment of Section 864(c)(8) was intended to override the result in *Grecian Magnesite Mining Co. v. Commissioner*, 149 T.C. No. 3 (July 13, 2017) ("*Grecian Magnesite*"), and to codify the holding in Revenue Ruling 91-32, 1991-1 C.B. 107. In *Grecian Magnesite*, the Tax Court held that gain recognized on a sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business generally does not constitute income that is effectively connected with a U.S. trade or business ("ECI"). In *Grecian Magnesite*, the court rejected the position of the Internal Revenue Service (the "Service") in Revenue Ruling 91-32 that gain or loss recognized by a foreign person upon its disposition of a partnership interest generally constitutes effectively connected gain or loss to the extent of the foreign person's distributive share of unrealized gain or loss of the partnership attributable to effectively connected property of the partnership.

The Provisions, however, go well beyond a codification of Revenue Ruling 91-32. Most notably, Section 1446(f) imposes a new withholding regime on transfers of partnership interests after December 31, 2017. As a result, partnership interest transfers occurring in 2018 are potentially subject to withholding tax without the benefit of much-needed guidance on the scope and manner of this new withholding regime.

Section 864(c)(8) also differs in certain important respects from the holding in Revenue Ruling 91-32 and is ambiguous in many respects. Moreover, Revenue Ruling 91-32 itself raised numerous interpretative questions, resulting in substantial commentary from practitioners, the issuance of a prior report by the Tax Section[2] and the initiation of a project at the Department of the Treasury ("Treasury") and the Service regarding the implementation of the ruling.[3] Most of these questions continue to apply to the application of Section 864(c)(8).

In response to concerns expressed by taxpayers and practitioners, Treasury and the Service issued Notice 2018-8, 2018-4 I.R.B. (Jan. 2, 2018), which suspended all withholding in connection with the sale or other disposition of publicly traded partnership ("PTP") interests under Section 1446(f) until regulations or other guidance under such section are issued. Notice 2018-8 also requested comments on whether a temporary suspension of Section 1446(f) withholding for partnership interests other than PTP interests is needed and what additional guidance may be needed to assist taxpayers in applying the Provisions.[4]

Part II of this letter recommends that immediate guidance be provided on certain critical issues in order for the withholding regime under Section 1446(f) to operate in a workable manner until more detailed guidance can be issued or, alternatively, that withholding be delayed until guidance is issued. Part III of this letter makes recommendations for immediate guidance under Section 864(c)(8) (regardless of whether withholding under Section 1446(f) is delayed) in order to clarify certain matters that could meaningfully affect the structuring of current transactions. Finally, in Part IV of this letter, we provide a brief summary of a number of other important issues raised by the Provisions that should be addressed through guidance.

II. Recommendations Regarding Section 1446(f)

Although Section 1446(f) is currently in effect for partnerships that are not PTPs, applying its provisions as written in a sensible manner has proven to be challenging in a number of circumstances. In particular, the manner in which Section 1446(f) was drafted leaves many interpretative gaps. Ideally, guidance to address such gaps should be prompt but also thorough and workable. Given the need for thought and care in handling many of the difficult issues that arise under the statute, there is some tension between the goals of speed and thoroughness/workability. Accordingly, we recommend that the Service consider extending to all partnerships the delay in implementation of Section 1446(f) currently in effect for PTPs until practical guidance can be issued if Treasury and the Service conclude that they cannot provide workable guidance in a very short time frame.

The following two examples illustrate some of the many challenges withholding agents currently face in implementing the withholding regime under Section 1446(f) without further guidance.

[2] *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on Guidance Implementing Revenue Ruling 91-32* (Jan. 21, 2014).

[3] *See* Joint Treasury, IRS 2013-2014 Priority Guidance Plan.

[4] We understand that Treasury and the Service are presently crafting a procedure to implement Section 1446(f) withholding for PTPs and that this procedure may place the responsibility for withholding on the broker of the transferor of the partnership interest. In light of this ongoing process, we are not commenting further on issues specific to PTP withholding in this letter.

Example 1: Open-ended domestic fund classified as a partnership for U.S. federal income tax purposes ("PRS") periodically redeems interests of holders, each of whom has provided PRS with a Form W-9 certifying its status as a U.S. person. PRS has a U.S. trade or business ("USTB"), which constitutes less than 1% of its gross assets. As drafted, PRS apparently must either obtain affidavits from each redeeming partner or withhold 10% of the amount realized on the disposition by such redeeming partner because it is not clear that a Form W-9 is considered an "affidavit" for this purpose (and notwithstanding the fact that less than 1% of PRS's assets are used in a USTB).

Example 2: A foreign person ("FP") is a partner in a foreign partnership ("FPRS") that to the best knowledge of FP does not have a USTB. FP wishes to sell its partnership interest to another foreign person. Under the statutory provision, although there is in fact no withholding obligation, there is no practical procedure for the buyer in this transaction to avoid the requirement to withhold because there is no reasonable cause exemption. Even if FPRS were willing to certify that it has no USTB assets, the statute does not permit a buyer to rely on such certification to avoid withholding.

We make below two alternative recommendations concerning the effective and orderly implementation of Section 1446(f), given the lack of guidance. Specifically, we recommend that either (i) Treasury and the Service issue immediate guidance that addresses the most pressing issues regarding the manner in which withholding under Section 1446(f) is to be conducted or (ii) if workable guidance cannot be issued in a very short period of time, the application of withholding for all partnership interests be delayed until regulations or other guidance is issued. We believe that at a minimum such "workable guidance" should address the issues set forth in this letter with respect to both Section 864(c)(8) and Section 1446(f). We note that there are many other important interpretative issues to be addressed, some of which are briefly summarized in Part IV below.

A. <u>Alternative 1: Provide Immediate Guidance Allowing for Orderly Application of Withholding Rules until More Detailed Guidance Is Provided</u>

We recommend that the government provide immediate and temporary guidance (until further guidance is issued) that would provide basic and needed direction so that withholding may be done in a reasonable manner in advance of broader guidance being issued. As described below, we believe that such immediate guidance should provide that (i) no withholding is required if the effectively connected assets of the partnership do not constitute a substantial portion of the partnership's total assets, (ii) a transferee may rely on certification provided by the underlying partnership to determine whether withholding is required, (iii) a transferee of a partnership interest generally may rely on a Form W-9 to certify the U.S. status of the transferor, and (iv) nonrecognition transactions (with certain appropriate carve-outs) are exempt from withholding.

1. <u>No Withholding Where the Partnership's Effectively Connected Assets are Less than a Specified Percentage of the Partnership's Total Assets</u>

The statute by its terms appears to require withholding of 10% of the entire amount realized by a seller of a partnership interest if the seller recognizes any gain on the sale and there is even a dollar of gain that would be treated as ECI on a sale of partnership assets. The fact that withholding is required with respect to amounts not attributable to USTB assets can result in the withholding of tax in an amount that is grossly disproportionate to the amount of tax that will ultimately be due. Although Section 1446(f)(3) allows taxpayers to make an application to the Service to reduce the amount required to be withheld, there is presently no procedure in place to obtain such relief. Moreover, even if there were, such relief would have to be given on a case-by-case basis and, in any event, would in many cases be unnecessarily costly and burdensome to both taxpayers and the Service, particularly where the value of USTB assets held by the underlying partnership is relatively small.

Section 1446(f)(6) provides the Secretary with regulatory authority to provide exceptions from the requirement to withhold. We believe that this authority should be utilized to create an exception from the requirement to withhold in connection with the transfer of a partnership interest where the value of the partnership's USTB assets is less than a specified percentage of the value of the partnership's total assets. An application for relief from withholding should still be available under Section 1446(f)(3) to cover situations where the exception does not apply but the amount of tax due will be less than the amount required to be withheld.

For purposes of identifying a model for interim guidance, we considered the withholding regime for FIRPTA (the Foreign Investment in Real Property Tax Act of 1980), which generally provides that gain realized on the disposition of a U.S. real property interest ("USRPI") is considered effectively connected income, which in certain cases requires withholding upon the transfer of an interest in a partnership that holds a USRPI. Withholding under the FIRPTA regime is required upon the transfer of a partnership interest only if (i) 50% or more of the value of the gross assets of such partnership consists of USRPIs and (ii) 90% or more of the value of the gross assets of the partnership consists of USPRIs plus any cash or cash equivalents (the "50%/90% rule"). *See* Treas. Reg. §§ 1.897-7T(a) and 1.1445-11T(b). This is a ready-made rule that is familiar to both taxpayers and the Service, which could be adopted for Section 1446(f) by substituting USTB assets for USRPIs. We note that this standard would allow for withholding tax to be avoided even on the transfer of an interest in a partnership substantially more than half of whose assets consist of USTB assets. In that regard, the rule could be modified, if desired, to use only the 50% prong for purposes of Section 1446(f). Under this approach, withholding under Section 1446(f) would be required only if 50% or more of the value of the partnership's gross assets consists of USTB assets. With or without such a "de-coupling," using Section 1445 principles, at least on a temporary basis, would have certain benefits. First, as noted above, the framework for such an exception is already in place in the FIRPTA context and is familiar to both the Service and practitioners. Thus, using the framework in this context would allow for a smoother implementation of the new withholding regime than if a completely new approach were adopted. Second, using this framework for the new withholding regime might allow for easier coordination between the different withholding regimes under Section 1445 and Section 1446(f). For example, income and loss with respect to USRPIs often are effectively connected with a U.S. trade or business.

If the 50% threshold is lowered for this interim guidance, we recommend that the principles and procedures of the 50%/90% test be used. In considering which threshold to use, we would note the following factors: (i) the calculations required are extremely complex and burdensome; (ii) the higher the threshold, the more readily certification may be obtained; and (iii) a higher threshold serves to mitigate to a greater extent the difficulties of complying with the "amount realized" requirement discussed below.

Whether a 50% threshold is adopted, or a lower threshold is used, consideration should be given to integrating the procedures under Section 1445 relating to transfers of partnership interests with those under Section 1446(f) so that the two procedures can work in tandem even if the thresholds are different (*e.g.*, the Section 1446(f) regime should allow the use of the same forms and certification procedures as the Section 1445 withholding regime), although for the reasons set forth above, it would be preferable if the procedures were the same, at least for the immediate future.[5]

2. <u>Allow Transferees to Rely on Certifications</u>

Section 1446(f) does not by its terms permit certification as to the underlying partnership's USTB assets to be given or relied on by any person (either the transferee or the partnership itself) to avoid withholding under Section 1446(f). The absence of a reliable certification process can place transactions at risk since in many cases the buyer can only avoid liability by withholding and allowing the seller to file for a refund, which in many cases will be unduly burdensome since the amount of the tax may not have a strong relationship to the amount of withholding.

Section 1445 permits a transferee of a partnership interest to rely on certification from the underlying partnership to determine if the partnership satisfies the 50%/90% test. We recommend that discretionary certification by a partnership equivalent to that permitted for purposes of the 50/90% test under the FIRPTA regime be permitted to allow transferees to determine whether the underlying partnership is under the applicable threshold for USTB assets (as described in Part II.A.1 above) for purposes of determining whether withholding is required.

We note, however, that because Section 1446(f) imposes secondary liability on the partnership to withhold from distributions to the transferee if the transferee fails to withhold, partnerships may be reluctant or unwilling to provide such a certification because relieving the transferee of withholding responsibility causes the partnership to be potentially liable for any underwithholding if the certification were ultimately determined to be incorrect. This dynamic is part of a larger challenge created by the Provisions, which is that the proper calculation of whether tax is due under the Provisions, and the amount of any such tax, will require the underlying partnership to provide detailed information to the transaction parties (including the liabilities allocable to the transferred interest, the amount of net gain inherent in the partnership's USTB assets and the portion of any such gain allocable to the interest), each of which (except for the first) is a purely hypothetical calculation. The overall construction of the statute and, in particular, the potential secondary liability of the partnership for any under-withholding may make efforts of the affected parties to comply with the Provisions without undue burden or inefficiency more difficult precisely because the partnership (which is best positioned to provide accurate information) is incentivized not to cooperate in this process. To address this issue, the secondary withholding

[5] In this regard, we note that Section 1446(f) provides no direction on the timing or manner of remitting amounts withheld under that provision. Immediate guidance should address this by either directing withholding agents to use the same withholding remittance procedures set forth in Section 1445 or requiring the remittance of any tax withheld under Section 1446(f) no earlier than 30 days after guidance addressing such procedures is issued. In addition, Sections 1445 and 1446(f) should be coordinated to prevent the possibility that withholding of tax under both provisions may be required, for example, in the case of the transfer of an interest in a partnership whose assets principally consist of USRPIs but that also holds non-USRPI assets that comprise a USTB.

liability could be relieved in cases where the partnership provides a certification or other information under penalties of perjury and such certification or information was prepared reasonably and was consistent with the partnership's tax reporting.

Certification issues may also arise when partnerships make cash distributions to continuing partners. In that case, assuming the distribution is not part of a disguised sale of a partnership interest and there is no alteration in the distributee partner's share of Section 751(b) property, the distribution generally does not result in gain except to the extent that the amount of the distribution exceeds such partner's basis in its partnership interest. Such gain is treated as gain from the sale or exchange of the partnership interest of the distributee partner. Section 864(c)(8) requires a sale, exchange or disposition of a partnership interest in order to potentially characterize gain or loss as effectively connected with a U.S. trade or business; Section 1446(f) requires a disposition of a partnership interest in order to potentially impose a withholding obligation. Accordingly, to the extent a partnership cash distribution does not exceed the distributee partner's basis, there should be neither a substantive tax nor a requirement to withhold. The foregoing should be confirmed through immediate guidance.

Even though withholding should not be required where a cash distribution does not exceed the distributee partner's basis, the partnership may not have knowledge of sufficient facts to determine such partner's outside basis. As a result, because a partner's basis may be less than the partnership would expect as a result of facts not within the knowledge of the partnership, the partnership may decide to withhold on all distributions of cash (including operating cash flow distributions in the ordinary course) in order to avoid potential exposure to transferee liability if a cash distribution were found to exceed the distributee partner's basis. Accordingly, we recommend that, for purposes of Section 1446(f), a partnership be allowed to rely on its books and records to determine which portion, if any, of a distribution is in excess of a partner's basis, provided it does not know or have reason to know that such partner's basis is not accurately determined by such information. A partnership also should be allowed to rely for purposes of the withholding tax determination under Section 1446(f) on a certification received from a distributee partner as to such partner's basis, provided that the partnership does not know or have reason to know that the certification is incorrect. A partnership that meets either standard should be relieved of any liability for underwithholding. Failure to promulgate such a rule could result in partnerships with USTBs withholding on all cash distributions to foreign partners to avoid withholding liability.

> *Example*: PRS is engaged solely in a USTB. Based on its books and records, PRS determines that FP has a tax basis of $10X in its PRS interest, after taking into account FP's distributive share of income and loss for the current and prior periods and all prior distributions to FP. PRS makes a distribution of $8X of cash to FP. No withholding should be required in this case because PRS has determined, based on information within its control, that there has been no amount treated as gain from the sale or exchange of FP's interest. If, however, unbeknownst to PRS, FP's basis was in fact only $6X, FP would recognize $2X of gain, characterized as ECI under Section 864(c)(8). Nevertheless, because PRS did not know or have reason to know that the cash distribution exceeded FP's basis, PRS should be relieved of any liability for underwithholding with respect to the $2X of gain.

3. Treatment of Form W-9 as a Nonforeign Affidavit for Purposes of Section 1446(f)(2)

Section 1446(f)(2) provides that no withholding is required if the transferor furnishes to the transferee an affidavit stating, under penalty of perjury, the transferor's U.S. taxpayer identification number and that the transferor is not a foreign person. In many cases, the exception has limited efficacy, however, by placing undue compliance burdens on partners, partnerships and other withholding agents. For instance, in the case of domestic partnerships that periodically redeem the interests of their partners, all of the partners may be U.S. persons and have certified that fact under penalty of perjury on a Form W-9. However, if the partnership cannot rely on a Form W-9 to eliminate its withholding liability, the partnership will be required to either obtain separate affidavits from each of its partners (which may prove burdensome) or withhold with respect to each redemption, despite the fact that such redemptions are not subject to tax by virtue of Section 864(c)(8).

The Form W-9 requirements (*i.e.*, provision of a U.S. taxpayer identification number and certification that the person providing the Form W-9 is a U.S. citizen or other U.S. person, both under penalty of perjury) match the requirements set forth in the exception for a nonforeign affidavit. While the Form W-9 would therefore appear to meet the substantive requirements of Section 1446(f)(2), any uncertainty in this regard could frustrate the purpose of the exception. Thus, to achieve the intended objective of the nonforeign affidavit exception without requiring duplicative and burdensome documentation requirements, we recommend Treasury and the Service issue guidance that confirms that a duly certified Form W-9 is an acceptable certification for purposes of Section 1446(f)(2).

4. Provide for No Withholding in the Case of Nonrecognition Transfers

For the reasons discussed in Part III.A below, we believe that Section 864(c)(8) should not be interpreted to override nonrecognition treatment (except where recognition treatment is necessary in order to prevent the permanent elimination of gain through the use of a nonrecognition provision). We recommend that immediate guidance provide that, in the case of any partnership interest transfer that is eligible for nonrecognition treatment, other than a form of transfer that is specifically identified in such guidance, no withholding under Section 1446(f) is required. If desired, the transferor could be required to provide certification of nonrecognition treatment to the transferee and also to notify the Service.

B. Alternative 2: Delay Withholding on Transfers of Non-Publicly Traded Partnership Interests

We believe that, in the absence of guidance addressing the issues discussed in Alternative 1 and Part III below, implementation of the withholding tax regime under Section 1446(f) should be delayed until such guidance is released. As it currently operates, the application of the statutory withholding provision is overinclusive and imposes an undue burden on withholding agents. Without immediate guidance addressing the issues raised in this letter or a temporary delay in withholding, many partnership interest transfers may be delayed or abandoned in light of the many uncertainties associated with the Provisions.

In addition, we note that in many if not almost all cases, partners in non-traded partnerships which have a U.S. trade or business are already subject to "regular" withholding under Section 1446, and so are already in the U.S. tax filing system. This may reduce the risk to the U.S. tax system of a short-term delay in the implementation of Section 1446(f) withholding. Extending the delay set forth in Notice 2018-8 to the application of withholding under Section 1446(f) to all partnership interests would give practitioners and other interested parties the opportunity to identify issues and propose solutions and would provide the government with time to consider such comments in drafting guidance that is reasonable, workable and thorough. Such a delay would have no effect on the amount of U.S. tax ultimately owed by the foreign partner by virtue of Section 864(c)(8). We note, however, that even if withholding of tax under Section 1446(f) is delayed, it is critical that immediate guidance still be issued clarifying the application of Section 864(c)(8) to nonrecognition transactions and treaties, as discussed in Part III below.

III. Recommendations Regarding Section 864(c)(8)

A. Interaction of Section 864(c)(8) with Nonrecognition Provisions

By its terms, Section 864(c)(8) does not purport to override nonrecognition provisions, and instead merely characterizes gain or loss as effectively connected. Nevertheless, some practitioners have suggested that the statute could be read as requiring gain recognition in connection with a partnership interest transfer, even where a nonrecognition provision otherwise applies. We believe that the statute only characterizes gain or loss as effectively connected gain or loss and is not intended to change the determination of whether gain or loss is recognized. This view is consistent with the approach taken in Revenue Ruling 91-32, which provided a rule for characterizing recognized gain or loss, and did not itself require the recognition of gain or loss.

Given the apparent confusion on this point, however, we think it is important for immediate guidance to confirm that, except as provided in regulations (or other published guidance), the Provisions do not apply to transactions otherwise eligible for nonrecognition treatment. In this regard, we note that Section 864(c)(8)(E) provides the Secretary with regulatory authority in appropriate cases to require the recognition of gain or loss upon the transfer of a partnership interest even where nonrecognition treatment would otherwise be available. We briefly discuss below in what circumstances it might be appropriate for this authority to be used to override nonrecognition treatment.

One approach in evaluating whether Section 864(c)(8) should override a particular nonrecognition provision would be to align, where possible, the treatment of partnership interest transfers with the treatment of comparable transfers of U.S. branches holding the same assets (the "Branch Consistency Approach"). Under this approach, a nonrecognition provision would continue to apply to a foreign person's transfer of a partnership interest to the extent that a transfer of the partnership's underlying assets in a comparable transaction would be eligible for nonrecognition treatment. The focus of this approach would be on whether the gain that would have been subject to U.S. tax if the partnership interest at issue were sold is preserved in a manner that will continue to be subject to U.S. tax, such that there is no erosion of the U.S. tax base.[6]

[6] A special rule might be necessary for a limited class of transactions, for example those involving certain provisions of Subchapter K where there is no ready analogy to a branch transaction, but no base erosion is present.

Another approach would be to provide that gain inherent in the foreign partner's interest that would be taxable under Section 864(c)(8) upon a sale would be triggered unless the interest is exchanged in a nonrecognition transaction for an interest that would be subject to U.S. tax in the hands of the transferor upon a subsequent sale to at least the same extent (the "Transferor Gain Approach"). Under this approach, the focus would be on ensuring that the foreign partner cannot escape U.S. tax with respect to its partnership interest even if the amount of income and gain that will ultimately be subject to U.S. tax has not changed and even if the identical transaction would not have been taxable had it been an asset transfer, rather than an interest transfer.

We consider below three types of nonrecognition transactions involving partnership interests and the extent to which it may be appropriate for any guidance to override nonrecognition treatment.

> *Section 721(a) Contributions*. FP contributes its interest in PRS1 to PRS2 in a transaction qualifying under Section 721(a). Assume PRS1 has a USTB. A contribution by a foreign person of the assets of a U.S. branch to a partnership generally does not give rise to the recognition of gain or loss. The same rule should apply in this case because Section 704(c) generally causes any pre-contribution gain or loss with respect to the PRS1 interest to be allocated to FP. Thus, using either approach outlined above, Section 864(c)(8) should not override nonrecognition treatment in this case.
>
> *Section 351(a) Contributions*. FP holds an interest in PRS, which it contributes to a newly formed U.S. corporation ("Corp") in a transfer qualifying for nonrecognition treatment under Section 351(a). A contribution by a foreign person of the assets of a U.S. branch to a corporation generally qualifies for nonrecognition treatment under Section 351(a), except with respect to the assumption of certain liabilities. Thus, under the Branch Consistency Approach, nonrecognition treatment should be available to the extent that, due to having a carryover basis of the PRS interest, Corp (whether it is domestic or foreign) will ultimately be taxed on (or otherwise take into account) all of the pre-contribution built-in gain in the PRS interest. Under the Transferor Gain Approach, however, even though the gain otherwise would remain subject to U.S. taxation in a modified form of ownership, the contribution would be taxable to FP because, after the contribution, FP would not be subject to U.S. tax on a subsequent disposition of its stock in Corp (unless Corp is a United States real property holding corporation). Appropriate adjustments would need to be made to the basis of Corp's assets to reflect the gain recognized.
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> *Section 731(a) Distributions*. FP and a U.S. person ("USP") hold interests in PRS. PRS has a USTB and also holds non-USTB assets. In a transaction ordinarily qualifying as a nonrecognition transaction, PRS distributes the non-USTB assets to FP in complete redemption of its interest in PRS. In such a case, while USP remains fully subject to tax, FP has gone from partially subject to U.S. tax (because it indirectly held a share of the USTB through PRS) to not being subject to U.S. tax because it no longer holds any interest in PRS. In such case, under either approach, nonrecognition treatment may not be appropriate. Nevertheless, depending on the factual circumstances (*e.g.*, where the parties have a strong business purpose for causing FP to be redeemed for non-USTB assets), there may be

situations where nonrecognition may still be appropriate. We believe further study is warranted to determine the circumstances in which it is necessary to override the nonrecognition rule in Section 731, as we believe the determination may not be susceptible to a hard and fast rule.

The foregoing examples are intended to illustrate that the application of many nonrecognition provisions to transfers of interests in partnerships with a USTB do not create the potential for inappropriate results, but that there are circumstances where an override of otherwise-applicable nonrecognition provisions may be appropriate. Given the number of potential fact patterns and the complexity of these issues (as illustrated above), in an effort to provide near-term guidance, we recommend that any guidance confirm that the Provisions do not override nonrecognition provisions except as provided in future guidance, perhaps with a carve-out at least for transactions that would have the effect of causing gain that would have been subject to U.S. tax to no longer be subject to U.S. tax. If desired, the Tax Section would be happy to provide more detailed analysis and recommendations on this issue.

B. Interaction of Section 864(c)(8) and Treaty Provisions

The application of U.S. income tax treaties to transactions described in Section 864(c)(8) should be clarified. In particular, Treasury and the Service should confirm whether (i) Section 864(c)(8) is intended to override treaty provisions and other reciprocal agreements, given that such agreements are nowhere mentioned in the section, and (ii) the approach taken in Revenue Ruling 91-32 (Situation 3) will apply to the application of Section 864(c)(8).

In Revenue Ruling 91-32 (Situation 3), a foreign partner was eligible for the benefits of an income tax treaty which provided that gain recognized by a resident of the treaty partner from the disposition of movable property was exempt from U.S. tax except to the extent such gain is from the disposition of assets of a permanent establishment in the United States ("USPE"). The ruling then held that gain from the disposition of the foreign partner's partnership interest will be subject to U.S. tax only to the extent such gain is attributable to unrealized gain of the partnership's assets attributable to the partnership's USPE. We recommend that guidance confirm this approach, including nontaxation in cases where the relevant partnership has no USPE. In addition, we recommend that the withholding rules be coordinated to reflect this conclusion (for example, for purposes of calculating the threshold amount to determine if withholding is required).[7] We note that the interaction of treaties and the Provisions is a complex topic that will likely require further study and guidance.

[7] We also recommend that such guidance permit an exemption from withholding tax under Section 1446(f) to the extent that the treaty eligibility of the transferring partner will cause the gain from the sale to be fully exempt from U.S. tax (or the portion of the partnership's assets attributable to a USPE is less than the threshold percentage for withholding described above). *Cf.* Treas. Reg. § 1.1446-2(b)(2)(iii) (in determining the amount of effectively connected taxable income of a partnership subject to withholding tax under Section 1446(a), such income does include income or gain exempt from tax by operation of a U.S. income tax treaty or reciprocal agreement).

IV. Other Issues to be Addressed

The issues addressed above are only a small subset of the significant issues raised by the Provisions. Other issues that Treasury and the Service should consider promptly addressing in subsequent guidance include:

- the fact that the mechanical application of Section 864(c)(8) may result in the taxation of the same items of unrealized gain in USTB assets more than once in the case of partial transfers of a partner's interest or multiple transfers of the same partnership interest,

- the effect, if any, of special allocations of income, gain, loss or deduction on the application of Section 864(c)(8), including the intended effect of the flush language following Section 864(c)(8)(B),

- how to make determinations necessary to apply the Provisions when partnership interest transfers occur during the middle of a tax accounting period,

- the manner of determining the source of effectively connected gain or loss recognized under Section 864(c)(8),

- the interaction of the Provisions with the FIRPTA tax and withholding regime of Sections 897 and 1445,

- the interaction of the Provisions with the partnership audit rules of the Bipartisan Budget Act of 2015,

- the application of the Provisions to tiered partnership arrangements,

- the effect of a shift in a foreign partner's share of USTB assets in a transaction not otherwise resulting in the recognition of gain or loss,

- the application of Section 1446(f) where proceeds are received by a partner in connection with a transaction treated as a disguised sale of a partnership interest,

- whether the secondary liability of a partnership to withhold tax under Section 1446(f) where the transferee failed to do so continues to apply after the transferee transfers the acquired interest to another party,

- the manner in which tax should be withheld under Section 1446(f) in the case of transfers of PTP interests,

- the manner in which a partnership with a USTB may confirm that tax has been withheld on a transfer of a partnership interest in order to eliminate its secondary obligation to withhold on distributions to the transferee, and

- definitional issues with respect to the defined terms provided in Section 1446(f), including the fact that (i) the "transferor" and "transferee" as used in Section 1446(f), by virtue of its cross-reference to Section 1445, appear to be limited to the persons who transfer or receive a "U.S. real property interest" (rather than the partnership interest) and (ii) a "qualified foreign pension fund" is apparently permitted to avoid withholding by providing a nonforeign affidavit (even though such a fund would still be subject to tax on a partnership interest transfer).

The Tax Section would be happy to issue a more detailed report addressing some or all of the issues listed above. We note that certain of these issues (such as the definitional issues under Section 1446(f)) may be more properly addressed through technical corrections.

* * *

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

Respectfully submitted,

Karen G. Sowell

Karen Gilbreath Sowell
Chair

cc:

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Report No. 1392
March 23, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
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Washington, DC 20220

The Honorable David J. Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
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The Honorable William M. Paul
Principal Deputy Chief Counsel and
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Internal Revenue Service
1111 Constitution Avenue, NW
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Re: *Report No. 1392 on Section 199A Deduction*

Dear Messrs. Kautter and Paul:

I am pleased to submit Report No. 1392 adressing Section 199A of the Internal Revenue Code of 1986, as amended (the "**Code**"), which was added to the Code pursuant to P.L. 115-97 (the "**Act**") on December 22, 2017. As discussed in the Report, Section 199A raises numerous technical and interpretative issues that should be addressed. In particular, we believe that there is an immediate need for guidance with respect to (1) the identification of a "specified service trade or business," (2) the determination as to whether a given set of activities constitutes a single trade or business or multiple trades or businesses for purposes of Section 199A (including activities conducted through one or more pass-through entities), (3) the application of Section 199A's netting principles where a taxpayer is engaged in multiple "qualified trades or businesses," and (4) the measurement of "W-2 wages" for purposes of calculating certain limitations on the Section 199A deduction.

Given the scope of Section 199A, and in light of our uncertainty regarding Congressional intent with respect to the resolution of several of the technical ambiguities within the statute, this Report generally refrains from offering firm recommendations on the issues identified for immediate guidance. Rather, this Report notes a number of alternative approaches that could be considered by Treasury and the Service in crafting regulations under Section 199A. For example, with respect to the identification of a "specified service trade or business," the Report notes that Treasury and the Service may consider (i) "safe harbor" lists clarifying the status of certain trades or businesses, (ii) certain mechanical tests as the basis for a presumption, or (iii) certain principles in constructing a regulatory standard. Similar approaches are taken with respect to the identification and separation of multiple "qualified trades or businesses" and the application of the Section 199A netting rules. At the conclusion of the Report we have identified other technical areas in need of guidance, and where possible have offered firmer recommendations where we believe a given result is clearly warranted by the statutory framework of Section 199A.

If further elaboration on any of the points addressed in this Report would be useful to Treasury and the Service, we would be happy to provide additional commentary upon request.

Respectfully submitted,

Karen G. Sowell

Karen G. Sowell
Chair

Enclosure

Cc:

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Report No. 1392

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 199A

March 23, 2018

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The New York State Bar Association Tax Section (the "***Tax Section***") is submitting this report[1] to request immediate guidance under Section 199A of the Internal Revenue Code of 1986, as amended (the "***Code***"), which was added to the Code pursuant to P.L. 115-97 (the ***"Act"***) on December 22, 2017. As discussed below, while Section 199A raises numerous technical and interpretative issues that should be addressed through regulations, there is a pressing need for immediate guidance regarding certain aspects of the guidance that go directly to whether taxpayers may access the benefits of Section 199A, and if so, how those benefits are calculated. This guidance is needed sooner rather than later so that taxpayers may pay accurate estimates of taxes owed and make appropriate choice of entity and planning decisions for business ventures.

I. Background

Section 199A generally allows a non-corporate taxpayer an income tax deduction equal to up to 20% of its qualified business income (***"QBI"***) from pass-through businesses. The provision is of limited duration, and does not apply to taxable years beginning after December 31, 2025.[2] The deduction is based on a mechanical, if relatively complex calculation, as follows:

- First the taxpayer determines whether it (a) recognized QBI, either directly through operation of a sole proprietorship or indirectly through owning an equity interest in an entity classified as a partnership or S corporation, (b) received dividends from a REIT or cooperative or (c) recognized income with respect to an interest in a publicly traded partnership.

- QBI is generally the net amount of qualified items of income, gain, loss and deduction with respect to a "qualified trade or business" (***"QTB"***).[3] There are netting and loss carryforward provisions, which raise uncertainties in the case of multiple trades or businesses, discussed in further detail in Section II.C, below.

- A QTB is generally defined as any trade or business other than (i) a specified service trade or business (***"SSTB"***) or (ii) the trade or business of providing services as an employee; provided that taxpayers with income less than a threshold amount ($415,000 for joint filers and $207,500 for individual filers) are not subject to the SSTB exception.

- An SSTB is generally defined as a trade or business (i) which is described in Section 1202(e)(3)(A)[4], without regard to the words "engineering, architecture", or (ii) which

[1] The principal drafters of this report were Sara B. Zablotney, Adam Kool, Amanda Nussbaum, Lee Allison, and Brad Borden, with substantial contributions from Dario Arezzo, Stanley Barsky, Andy Braiterman, James R. Brown, Robert Cassanos, Phillip Gall, Rafael Kariyev Matthew Lay, Elliot Pisem, Michael Schler, Joel Scharfstein, David H. Schnabel, Eric Sloan, Martin Shenkman, Michael A. Shulman, Karen G. Sowell, Jonathan Talansky, and Willard Taylor. This letter 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] Section 199A(i).

[3] Section 199A(c).

[4] All Section references herein are to the Code unless otherwise indicated.

involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.[5] Uncertainties with respect to the QTB definition and the SSTB definition are discussed in greater detail in Sections II.A and II.B, below.

- The Section 199A deduction is calculated as the sum of (1) the lesser of (A) the "combined qualified business income" (***"Combined QBI"***) amount of the taxpayer or (B) 20% of the excess (if any) of (i) the taxpayer's taxable income over (ii) the sum of the taxpayer's net capital gain, plus the taxpayer's aggregate qualified cooperative dividends and (2) the lesser of (A) 20% of the taxpayer's aggregate qualified cooperative dividends or (B) the taxable income (reduced by the net capital gain) of the taxpayer, for the taxable year, with a cap of the taxpayer's taxable income.[6]

- Combined QBI is itself a complex calculation and is equal to the sum of (1) for each QTB, the lesser of (A) 20% of the taxpayer's QBI with respect to such trade or business or (B) the greater of (i) 50% of the W-2 wages with respect to such trade or business or (ii) the sum of 25% of the trade or business' W-2 wages and 2.5% of the "unadjusted basis" immediately after acquisition of "qualified property" of such trade or business and (2) 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year. The W-2 wage/basis limitations are phased in to apply only to taxpayers with income above a threshold amount ($415,000 for joint filers and $207,500 for individual filers). The deduction, and the components of the limitation, are to be determined at a partner or member level in the case of a partnership or S corporation.[7] Uncertainties with respect to these calculations are discussed in further detail in Section II.D, below.

- The deduction is only applicable, broadly, to income that would be treated as effectively connected income for a foreign person.[8]

II. Request for Guidance Regarding Section 199A

A. Guidance Regarding the Scope of a "Qualified Trade or Business" and a "Specified Service Trade or Business"

As a threshold matter, taxpayers involved in pass-through businesses whose income exceeds the threshold amount need immediate guidance regarding whether they are engaged in QTBs or SSTBs. Section 199A(d)(2) specifically prohibits high-income taxpayers from receiving the Section 199A deduction with respect to income from an SSTB. As described more generally above, an SSTB is either (i) a trade or business described in Section 1202(e)(3)(A), but without regard to the words "engineering" and "architecture" and substituting "owners or employees" for

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[5] Section 199A(d).

[6] Section 199A(a).

[7] Section 199A(f).

[8] Section 199A(c)(3).

"employees" or (ii) a trade or business involving certain investment management activities. Thus, the definition of an SSTB would read:

> Any trade or business--
>
> > (A) involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees, or
> >
> > (B) which involves the performance of services that consist of investing and investment management, trading or dealing in securities (as defined in Code section 457(c)(2)), partnership interests, or commodities (as defined in Code section 175(e)(2)).

The first part of this definition raises several uncertainties:

- The scope of the enumerated categories of SSTBs. As further discussed below, we recommend that Treasury and the Service look to Section 448 and the Treasury Regulations thereunder (as suggested in the Conference Report accompanying the Act (the ***"Conference Report"***[9]) for a framework for guidance.[10]

- The general application of the reputation or skill clause to other trades or businesses, which we believe turns, in part, on how broadly Congress intended the Section 199A deduction to be available. Because of our uncertainty regarding Congress' intent on this subject, and the limited duration of the provision, we recommend that Treasury and IRS in the short term publish a list of business types that are meant to be SSTBs (or meant not to be SSTBs), together with a clear articulation of the criteria that will be used to judge non-enumerated trades or businesses.[11] We have proposed a few possible frameworks for Treasury and the Service's consideration.

- Whether the last clause of the first part of the definition (the ***"reputation or skill clause"***) could be read to cause persons engaged in the specifically excluded trades or businesses of architecture and engineering to nonetheless be deemed to be engaged in an SSTB. Though it is possible that Congress intended engineering and architecture businesses to be *per se* QTBs, it is not clear that the statute as drafted achieves this result.

1. Uncertainties Regarding Enumerated SSTB Categories

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9 H. Rep. No.115-446 (2017).

10 *Id.* at 215-16.

11 Including, as discussed below, engineering and architecture.

In unpacking the statutory language addressing SSTBs, the first question raised relates to the scope of the enumerated categories of SSTBs. While in some instances the categories are relatively obvious (e.g., in the case of a doctor with a private general practice or a lawyer with a law firm), other categories are less obvious. For instance, the "health care" industry is potentially an enormous category that could encompass a wide variety of activities and services, including research, laboratory testing, payment processing, billing analysis and similar services. This is equally true in the legal arena (e.g., form document publishers, process servers, etc.). In addition, many businesses that are not otherwise service-oriented in nature may include a consultancy aspect (e.g., a widget manufacturer could well have a consulting arm regarding best practices for widget implementation; software developers often have consultants who customize and implement solutions for specific customers). Clear guidance regarding how to interpret these categories would be extremely welcome to taxpayers.

The Conference Report[12] in several footnotes to the description of the Senate's version of Section 199A suggests that the Senate, at least, viewed Section 448 and the Treasury Regulations thereunder as a good analogue for interpreting these categories. Section 448 addresses the circumstances under which a "qualified personal service corporation" can use the cash method of accounting.[13] The Conference Report notes (in the first sentence of footnote 44) that the list of trades or businesses that are not QTBs is similar to the list of "service" trades or businesses provided in Section 448(d)(2)(a) and Treasury Regulation Section 1.448-1T(e)(4)(i), and notes with specific approval these Treasury Regulations' delineation of (i) services in the field of health being limited to the actual provision of medical services, rather than related services[14] and (ii) services in the field of performing arts being limited to the activities of actual performing artists (and not their managers, agents or broadcasters of their performances).[15] The same Treasury

12 Conference Report at 216.

13 For these purposes, a qualified personal service corporation is defined in part as "any corporation…substantially all [95 percent] of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting…" and substantially all (95 percent) of the stock of which is owned by employees (including former employees) who performed the permitted services. Their estates or beneficiaries may be shareholders but only for two-year period.

14 However, we note that cases and private letter rulings interpreting the scope of the field of health under the Section 448 "function" test, apparently influenced by the broad scope of the term "medical care" under Code Section 213, tend to find that the test is met by the provision of services directly related to patient oriented medical care such as the provision of ultrasound services (*Reza Zia Ahmadi v. Commissioner*, Tax Court Summary Opinion 2017-39 (June 14, 2017)); an emergency ambulance service (PLR 9309004 (November 23, 1992)); physical therapy (PLR 9222004 (January 8, 1992)); and the provision of portable x-rays and EKG's to nursing home patients (FSA 1999-919). This "patient care" distinction seems consistent with the limited guidance in the form of private letter rulings that exists in the context of Section 1202. *See*, *e.g.*, PLR 201436001 (September 5, 2014) (a pharmaceutical company researching, testing, and manufacturing drugs but not providing patient services not disqualified under Section 1202(e)(3)); PLR 201717010 (a laboratory testing patient samples and producing reports for healthcare providers not disqualified under Section 1202(e)(3), discussed in greater detail *infra* at footnote 22). While we acknowledge that private letter rulings cannot be cited as precedent, we include examples from relevant private letter rulings to demonstrate the Service's past views on the interpretation of these analogous provisions.

15 *See* Conference Report, footnote 45 (at 216) and Treas. Reg. § 1.448-1T(e)(4)(iv). As further color, the Service has held that the services performed by a director of motion pictures are not the performance of

Regulations include a fairly robust definition of what constitutes services as a "consultant" for these purposes, complete with examples.[16]

We recommend these Treasury Regulations under Section 448 as an excellent starting point for defining the specifically listed categories of SSTBs. The rules (sensibly in our view) emphasize the direct provision of services rather than the application of capital or of institutional intellectual property. However, the purposes of and included categories of trades or businesses within the provisions are different, and it is not clear to us that the same policy considerations would apply in all circumstances in making determinations under Section 199A. Therefore, we believe modifications and additions to Section 448 authorities will be necessary. In particular, clear guidance regarding "adjacent" activities to enumerated SSTBs (e.g., process serving, producing and directing content, laboratory testing, billing and collection, etc.) is needed. We recommend that Treasury and the Service clearly address the treatment of these adjacent business types in any guidance.

2. The Reputation and Skill Clause

In addition, taxpayers need guidance regarding the scope of the reputation and skill clause of the SSTB definition.[17] There are many categories of trades or businesses where the reputation and skill of the owner is the critical factor contributing to the success of the business. Indeed, in some sense, all successful businesses rely on the reputation and skill of owners and employees, and determining whether this or some other asset is the business' "principal" asset presents a difficult factual inquiry.[18] On the one hand, the reputation and skill clause could be read very

services in the field of performing arts for the purposes of Section 448. *See* PLR 9416006 (January 4, 1994). With respect to other fields enumerated on the list of Section 448(d)(2)(A), the Service (and a Tax Court decision) has tended to take a narrow view of the services that fall within the enumerated fields of the 'function" test. For example, soil and concrete testing is not encompassed by "engineering" services (*Alron Engineering and Testing Corp. v. Commissioner,* 2000-335 Tax Court Memorandum (November 1, 2000)); appraisal and valuation services are not "consulting" services as no advice or counsel (as required by the applicable regulation) is provided to clients (PLR 200606020 (February 10, 2006)), interior, graphic and lighting design for a building is not included within "architectural" services (PLR 9602013 January 16, 1996)); "claim staking" is not included within "engineering" services (PLR 9232009 (May 5, 1992)); medical billing of insurance claims for doctors and patients is not included within "health" services (PLR 8927006 (March 31, 1989)); the provision of training and educational courses is not included within "consulting" services (PLR 8913012 (December 27,1988)); and a lobbyist's services are not included within "consulting" services (PLR 8902005 (September 29,1988)). On the other hand, under a *Chevron* analysis, a court upheld the inclusion of surveying and mapping as "engineering" services in regulations (despite separate state law classification for licensure purposes) consistent with their inclusion in the legislative history of the provision (*Kraatz Craig Surveying, Inc., v. Commissioner,* 134 T.C. 167 (April 13, 2000)). Similarly, tax preparation and bookkeeping services are included within "accounting" services (*Rainbow Tax Service, Inc., v. Commissioner*, 128 T.C. 42 (March 8, 2007)). If a similar policy should apply in the context of SSTBs, clarification of these sorts of distinctions would be helpful in regulations, rather than leaving taxpayers feeling the need to seek a private letter ruling.

16 *See* Treas. Reg. §1.448-1T(e)(4)(iv).

17 Section 448 does not contain a similar analogue.

18 For instance, a local bakery, while producing a product, might also be viewed as having its principal asset as the reputation or skill of its its owners or employees who make the baked goods. Equally, a restaurant's success may depend on the skill and reputation of its chef and servers, though they also provide a product for

narrowly, in which case it is unclear what businesses, if any, the clause was meant to target, other than enumerated SSTBs. On the other hand, the reputation and skill clause could be read extremely broadly, with potential to subsume the vast majority of businesses that utilize service providers, whether the business is service-oriented or not. If interpreted broadly, the clause could cause businesses to become SSTBs as and if they become more successful (or QTBs as the business becomes more successful yet and less dependent on personal expertise rather than institutional goodwill), meaning that a taxpayer would need to make difficult decisions each year regarding the qualification of the business based on its success.

As further explained below, it is unclear what policy goals Congress was trying to achieve in crafting this particular formulation of SSTB. As such, we are unsure what regulatory approach to suggest to Treasury and the Service. The Conference Report does not provide any illumination as to Congress' intent, and there is no other meaningful legislative history. Therefore, other than broad statements made to the press, there is little information from which taxpayers can divine which businesses were meant to be treated as QTBs, eligible for the Section 199A deduction, and which businesses were meant to be SSTBs. Above all, we recommend that Treasury and the Service do promulgate guidance further interpreting this standard to help to give taxpayers needed certainty. We have outlined a few possible approaches guidance could take (though none of these approaches is a consensus recommendation). If any of the approaches we suggest is a path the Treasury and the Service would like to consider, we are happy to draft an additional report carefully considering that approach.

a. *Reputation and Skill Clause, In General*

A logical place to look for a framework is under existing Section 1202. However, the guidance under this section is limited, and may not inform the language in its Section 199A form. In *John P. Owen v. Commissioner*,[19] the Tax Court examined whether Mr. Owen, whose business was insurance brokerage, was entitled to benefits under Section 1202 with respect to the sale of his interest in a corporation conducting such business. The corporation in *Owen* had extensive training programs and sales structures, but primarily relied on the services of independent contractors (including Mr. Owen) in conducting its business. While the Tax Court acknowledged that the business' success was due to Mr. Owen's efforts, it found that the principal asset of the company in question was the training program and sales structure rather than Mr. Owen's services. While this might be read to suggest that there is a concept of "institutional goodwill" or intellectual property as applied by individual employees that differs from the reputation or skill of employees,

consumption. Other examples (though this list is entirely non-exhaustive) include barbers and beauty salons, sellers of eponymous brands of consumer goods, interior decorators, gardeners and lawn care providers, call centers, staffing agencies, journalists, agents for writers, real estate agents, home builders, personal trainers, hotel managers, plumbers, electricians, auto repair shops, carpenters, tutors, and interpreters.

19 T.C. Memo 2012-21.

query whether this is a useful precedent in the Section 199A context, where the activities of "owners" are also taken into account in determining eligibility.[20]

Separately, the reasoning of the Service in Private Letter Ruling 201436001[21] may provide some additional hints regarding how the Service, at least, historically viewed Section 1202(e)(3), and by analogy, how the Section 199A should be interpreted. In that ruling, the issue was whether a corporation that provided products and services in connection with the pharmaceutical industry was a qualified trade or business under Section 1202(e)(3)(A). The corporation worked with clients to assist in the commercialization of experimental drugs, specifically conducting clinical tests (including related manufacturing and research). In its business it used physical assets (such as manufacturing and clinical facilities) and its intellectual property assets (including its patent portfolio). In relevant part, the Service ultimately found that the business was not disqualified under Section 1202(e)(3), reasoning that a business was disqualified only if it was primarily engaged in performing services for customers. The fact that a business has a service component is not enough; rather the service component must be the primary business of the corporation.[22]

Without citation to any specific authority to support its interpretation, the Service stated the following in the ruling:

> Section 1202(e)(3) excludes various service industries and specified non-service industries from the term 'qualified trade or business'. Thus, a qualified trade or business **cannot be primarily** within service industries, such as restaurants or hotels or the providing of legal or medical services. In addition, section 1202(e)(3) excludes businesses where the **principal asset of the business is the reputation or skill of one or more of its employees**. This works to exclude, for example, consulting firms, law firms and financial asset management firms. **Thus, the thrust of [Section] 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services,**

20 Additionally, this discussion likely constitutes *dicta*, as the conclusion under Section 1202(e)(3)(A) was not dispositive in the ultimate resolution of the case, which turned on the active business requirement of Section 1202(c).

21 September 5, 2014.

22 As described above in footnote 14, the ruling also found that the company was not engaged in a "health care" business. The ruling specifically found the following: "Company is not in the business of offering services in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry within the meaning of [section] 1202(e)(3)…"

> **whether those services are the providing of hotel rooms[23], for example, or in the form of individual expertise (law firm partners).** [emphasis added].

But these authorities do not necessarily add up to an administrable standard of broad application in the Section 199A context. And because of the uncertainty regarding Congress' intention in choosing this particular standard, we are unable to come to a consensus as to a single particular standard to recommend. However, we have the following suggestions for potential approaches:

1. Whatever metric Treasury and the Service adopt in interpreting the reputation and skill clause, there is broad consensus around a recommendation for Treasury and the Service to publish a list of business types that are either clearly QTBs or clearly SSTBs for the purposes of Section 199A (this could be a per se rule or a rebuttable presumption). We suggest that the Principal Business Activity Codes (found, e.g., at the back of instructions for IRS Form 1065 and for IRS Form 1120S) are an excellent starting place and cover a wide range of business types. Using that list, Treasury and the Service could give needed certainty to many taxpayers. This list will necessarily be incomplete, and we therefore believe that it will need to be backstopped by another standard (either one of the standards suggested below or something else).

2. One possible metric for making this determination (and for crafting the backstop) is an activity-based standard as described in the ruling above. Under this standard, businesses providing value to customers in the form of products (including certain kinds of intangible property, e.g., certain software), no matter the reputation and skill of the owners and employees, would qualify for the deduction. This standard would appear effective in that it excludes businesses involving manufacturing, distribution and retail from SSTB status, which seems to be consistent with Congress's intent in crafting Section 199A. This standard, however, appears to capture businesses such as hair care, nail care, tutoring and foreign-language interpreting as SSTBs, and it is unclear whether these businesses were intended to be eligible for the Section 199A deduction. It is also less effective in providing a clear classification of businesses like plumbing, HVAC services, ride sharing services, etc. where there is a strong services component that is more "commoditized."[24] We are unsure which of these business types Congress intended to grant Section 199A deductions for high income taxpayers.

3. We could imagine a balance sheet test that compares the value of assets other than goodwill and workforce in place to the value of such goodwill and workforce in place. This standard

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23 However, note that operating a hotel and restaurant is subject to a specific exclusion under Section 1202(e)(3)(E), so arguably the "reputation and skill" clause alone was not enough to bring these businesses within the scope of businesses excluded from the benefits of Section 1202.

24 One possible way to distinguish these businesses would be to look to whether the business required state licensure or certification. Because states can widely vary in what they require in terms of such requirements, we do not recommend this approach as a bright-line rule as we do not believe that the federal tax law should treat similarly situated taxpayers differently based on a particular state's decision that for consumer protection purposes or otherwise a particular business type requires a license or certification.

would reach similar businesses as described in the second approach, and leaves the same questions regarding "commoditized" service businesses. However, such a test could easily lead to strange and unintuitive results, and may be difficult to apply in the case of small businesses that do not maintain audited financial statements.[25] It also may not always be possible to untangle such goodwill from a business' other intellectual property (e.g., trademarks). In addition, because valuation (particularly of intangible assets such as goodwill and workforce in place) is relatively subjective, we think that such a standard would both be ripe for abuse, and could potentially set Treasury and the Service up for years of audit litigation. Finally, a standard for "principal" asset (e.g., what percentage of total assets make something the "principal" asset?) would be extremely difficult to implement in practice if appropriate adjustments are to be made, for example, for working capital, passive investments made in connection with the business, and asset balances that may be easily manipulated by taxpayers to achieve a better result under Section 199A.

4. We also have considered whether some other sort of mechanical test could be developed to create a two-way rebuttable presumption regarding the classification of a business as a QTB or an SSTB. For instance, we can imagine a test based on the ratio of (A) the sum of employee wages and payments to independent contractors and/or owners,[26] to (B) gross receipts of the business. We would suggest subtracting payments to "back office" employees and/or independent contractors and/or owners (those who do not routinely interact with customers or provide skills used by those who do interact with customers) from (A). If this ratio is high, there could be a rebuttable presumption that the business' principal asset is providing "skilled" employees and therefore an SSTB. If the ratio is low, then the presumption would be that the business would be a QTB. We have reached no conclusions regarding the correct metrics for this sort of approach. If Treasury and the Service believe that this sort of standard would best express Congressional intent, we can consider it further and submit another report.

5. Finally, we have considered a standard based on whether the trade or business involves the provision of highly skilled services. The primary benefit of this standard is that it harmonizes the meaning of the reputation and skill clause with the list of enumerated SSTBs, each of which involve the provision of services by professionals who either received a substantial amount of training (e.g., health care professionals such as doctors, lawyers and accountants), or who have otherwise achieved a high degree of skill in a given field (e.g., professional athletes or performing artists). The primary drawback of the standard is that it does not offer bright-line results, and as such similarly situated taxpayers may take differing positions in situations as to whether the level of training or development required to perform the service makes the person "highly skilled." While examples may

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25 At least one commentary on Section 199A has suggested that a general concept of "workforce in place" does not exist in the context of at-will employees in a manner that is relevant for purposes of the reputation and skill clause. Martin Sullivan, *Economic Analysis: Do Skills and Reputation Nix the Passthrough Deduction?*, TAX NOTES (Mar. 5, 2018). We disagree with this line of argument, and, whatever the standard under the "reputation and skill" clause is, this likely was not intended.

26 We recognize that properly accounting for sole proprietorships and partnerships that do not make guaranteed payments in respect of services may be difficult under this standard.

be used to offer guidance in some cases as to the meaning of "highly skilled" in this context, the standard itself could have substantial ambiguity, failing to give taxpayers needed certainty.

These approaches are not exclusive. We could imagine that more than one approach could be applied to help reach the intended result. If it would be helpful, we are happy to draft a more detailed report that further develops the above or considers the best way to implement any approach selected by Treasury and the Service.

b. *Architects and Engineers*

One final ambiguity with respect to the reputation and skill clause is how it applies to architects and engineers. Congress clearly intended to allow at least some architects and engineers to be treated as engaged in QTBs, as it did specifically carve architecture and engineering out of the enumerated categories of SSTBs. However, Congress did not equally carve architects and engineers out of the reputation and skill clause. As currently drafted, the clause can be fairly read to apply to architects and engineers. Under that reading, many (or most) such businesses would likely be treated as SSTBs in practice, whatever standard for applying the reputation and skill clause is chosen. We are not sure whether this is what Congress intended, and the limited legislative history does not further elucidate Congress' intent. Persons engaged in such businesses will need clarity quickly as to their treatment under Section 199A. As a result, we suggest that consideration be given as to what guidance Treasury and the Service can provide to this class of businesses and whether further Congressional action is needed to clarify the effect of the provision.

B. <u>Multiple Trades or Businesses</u>

In addition to questions regarding how individual trades or businesses will be classified for Section 199A purposes, there are difficult questions where a taxpayer is (or purports to be) engaged in multiple trades or businesses, either through a single person or multiple entities. We believe that guidance is most urgently needed to (i) identify and properly classify multiple businesses and (ii) properly allocate expenses and income among activities conducted by a single entity.

1. Multiple Trades or Businesses

The application of the QTB and SSTB rules discussed above is uncertain where a taxpayer is engaged (directly or indirectly) in multiple trades or businesses. For example, Section 199A is silent as to whether (and to what extent) a taxpayer's income with respect to an SSTB might "taint" or otherwise impact a separate qualified business that could otherwise support a deduction under Section 199A, including in cases where SSTB income is earned through the same entity as QBI. These uncertainties compound when a taxpayer owns interests (whether directly or indirectly) in multiple flow-through entities, some of which conduct SSTBs, and some of which conduct QTBs.

As an example, suppose A and B are full-time physicians operating a medical practice through Partnership AB. Partnership AB owns Building X. Half of Building X is utilized by the medical practice of Partnership AB, and half of Building X is rented to an unrelated business. A independently owns Building Y, which A rents to unrelated commercial tenants. Under these facts, how many trades or businesses should A be treated as engaged in for purposes of Section 199A? How should the business activities of Partnership AB be attributed to A? Does the medical practice cause the rental income from Building X to be treated as income from an SSTB? If so, could this result be changed if A and B were to restructure their business to hold building X through a separate entity?

In considering these uncertainties, we have identified a number of existing rules under the Code that could provide a suitable foundation for guidance under Section 199A. Each is explained briefly below:

- Some principles of Sections 446 and/or 469 could be used as a basis for guidance as to the determination of whether multiple trades or business exist.
- In applying Section 199A to flow-through entities, "aggregate" principles should apply to treat the owners of the flow-through entities as engaged in the trades or businesses in which the flow-through entity is engaged.
- As an anti-abuse measure, we recommend consideration of a presumption that two persons are engaged in the same trade or business where (A) such persons are related (e.g., partnerships with substantially the same partners), and (B) one or both persons derives a substantial portion of its gross income from the other.

These recommendations are described in further detail below.

a. *Definition of "Trade or Business"*

Section 199A requires that the taxpayer be engaged in a trade or business (directly or through a flow-through entity). We believe that "trade or business" should be interpreted for purposes of Section 199A in the same manner as under Section 162. We believe that the statute clearly contemplates that a single person may be engaged in multiple trades or businesses, whether or not conducted through separate entities. Section 199A(b) appears to require a taxpayer to separately identify and track its trades or businesses.[27] Section 199A(f)(1)(A)(i) requires Section 199A to be applied at the partner or S corporation shareholder level. Section 199A(f)(1)(A)(ii) requires each partner or shareholder to take into account each qualified item of income, gain, deduction or loss. These two provisions seem to be slightly in tension with each other. In the entity context, we believe that these rules are best read to mean that (i) whether a business is qualified or not is determined at the entity level, but (ii) the separate items attributable to the business are passed through to the owners to determine, for any particular owner, the amount of the deduction available to it. However, we do not believe that a taxpayer should be permitted to achieve different results under Section 199A by splitting a business that might constitute an SSTB into multiple businesses in a manner that does not reflect economic reality, whether through the interposition of entities or otherwise.

In addition, where a taxpayer is clearly engaged in two separately identifiable trades or businesses under the chosen standard, we do not think that the fact of one of those trades or businesses is an SSTB should "taint" another trade or business that is a QTB. However, where the taxpayer's trade or business includes some SSTB elements along with QTB elements that perhaps

[27] Computational issues associated with this separate tracking are discussed *infra* at Section II.C.

do not rise to the level of a separate trade or business under the chosen standard, the essential character of that identified trade or business will have to be determined under the standard chosen as described above in II.A.

i. Section 446 Authorities.

In the first instance, we recommend that rules similar to those under Section 446(d) be adopted to define when a taxpayer may separately identify a trade or business conducted directly by it. This provision permits a taxpayer engaged in more than one business to use different accounting methods for each trade or business. Under Treasury Regulation Section 1.446-1(d), two trades or businesses must be "separate and distinct" for a taxpayer to be eligible to use different methods of accounting for the businesses. As an example, Treasury Regulation Section 1.446-1(d) suggests that a personal service business and a manufacturing business may be "separate and distinct" in certain cases. For these purposes, trades or businesses will not be treated as separate and distinct unless a "complete and separable set of books and records" is maintained for each trade or business.[28]

The rules described in Treasury Regulation Section 1.446-1(d) have been the subject of a number of judicial decisions. In *Peterson Produce Co. v. United States*,[29] for example, the court analyzed whether the sale of feed for livestock and poultry and the raising of broiler chickens constituted two separate and distinct trades or businesses. Pointing to the functional integration and interdependence of the two businesses based on the specific facts of the case, the court held that the two activities failed to meet the "separate and distinct" standard described in Treasury Regulation Section 1.446-1(d). In contrast, *Burgess Poultry Market Inc. v. United States*, in an unpublished opinion,[30] a district court held that the processing and selling of broiler chickens was a "distinct and separate" trade or business from farm-raising baby chicks, in this case because (i) the taxpayer kept separate books and records for each business, (ii) the taxpayer had different employees for each business, (iii) the businesses were geographically separated, and (iv) the divisions transacted on an arm's length basis, and, in fact, the processor had third party sources of chickens which constituted 60% of its supply. Additional case law and IRS authority provide further guidance regarding the "separate and distinct" standard in Treasury Regulation Section 1.446-1(d).[31]

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28 We note that Section 446 and the Treasury Regulations promulgated thereunder are designed to achieve a clear reflection of a taxpayer's income from a timing perspective. While we believe that the tools used by Congress, Treasury and the IRS to achieve a clear reflection of income in the Section 446 context can be useful in the Section 199A context as well, we acknowledge that given the distinct policy considerations driving Section 199A and Section 446, not every aspect of the Section 446 authorities will be relevant for purposes of Section 199A.

29 205 F. Supp. 299 (W.D. Ark. 1962).

30 14 A.F.T.R.2d (RIA) 5036 (E.D. Tex. 1964).

31 *See, e.g.*, *W.W. Enters.*, T.C. Memo 1985-313 (making of loans to employees did not constitute a separate and distinct trade or business where loans were to be repaid through bonuses paid to employees from corporation's business); *J.F. Stevenhagen Co.*, T.C. Memo 1975-198 (same); *Bennett Properties Co.*, 45 B.T.A. 696 (1941) ("The operation was unlike its established business and activities, and it had the right to keep its accounts relating to such new operations without regard to the method of keeping its accounts for

The principles of Section 446(d) and Treasury Regulation Section 1.446-1(d) may be helpful to Treasury and the Service in considering guidance under Section 199A with respect to multiple trades or businesses conducted by a single taxpayer. In particular, we believe that the gatekeeping function served by Section 446(d) and Treasury Regulation Section 1.446-1(d) may be recreated in the Section 199A context through guidance that would permit a taxpayer to separate income streams from an activity that arguably constitutes a QTB from another that constitutes an SSTB only where the two businesses are truly distinct from one another.

We note, however, that the rules of Section 446(d) are less helpful with respect to issues posed by tiered and brother-sister flow-through entities. A legal entity that is a separate taxpayer is permitted to select its own method of accounting, which in some cases may incentivize business owners to reorganize or otherwise structure their business affairs to achieve an attractive income tax result. In addition, an approach that is too narrowly focused on entities would not appear to appropriately take into account relatively common structures where activities of a trade or business (such as property ownership, employee services, banking functions, etc.) are isolated in separate entities, some which may have somewhat different ownership (whether for regulatory reasons or otherwise) but all of which are under common control. As further discussed below, we believe that certain existing concepts under Section 469 may be helpful in this regard.

ii. Section 469 Authorities

Section 469[32] restricts taxpayers' ability to deduct certain trade or businesses losses that arise with respect to passive activities. Specifically, where a taxpayer does not "materially participate" in an activity, trade or businesses losses generated by that activity are deemed "passive activity losses." Such passive activity losses are generally available only to offset passive activity income. A taxpayer engaged directly or indirectly in multiple trades or businesses may "materially participate" in certain trades or business for purposes of Section 469, but not in others.

Treasury Regulations issued under Section 469 address questions arising with respect to multiple trades or businesses through a "grouping" approach. Specifically, Treasury Regulation Section 1.469-4 contains a set of rules in which a taxpayer is generally entitled to treat two or more trade or business activities as a single activity if the activities constitute an "appropriate economic unit." The regulations apply a facts and circumstances test for determining whether two activities constitute an "appropriate economic unit," with the greatest weight being given to five factors:

1. Similarities and differences in types of trades or businesses;

2. The extent of common control;

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the earlier business."); *Stern*, 14 B.T.A. 838 (1928) (operation of retail stores and coal land sales constitute separate and distinct trades or businesses); Chief Counsel Advice 201430013 (July 25, 2014) (two businesses carrying on different activities in different locations with limited shared employees treated as "separate and distinct" for purposes of Treas. Reg. § 1.446-1(d)).

32 It is perhaps worth noting that the House specifically contemplated using Section 469 principles in its (very different) version of Section 199A. *See* Conference Report at 211.

3. The extent of common ownership;

4. Geographical location; and

5. Interdependencies between or among the activities.

When it comes to flow-through entities, Treasury Regulation Section 1.469-4(a) provides for an "aggregate" approach in which a taxpayer's activities include activities conducted through a partnership or S corporation. In applying the grouping rules to flow-through entities, Treasury Regulation Section 1.469-4(d)(5)(i) contemplates a two-step process in which (i) first, a flow-through entity determines groupings for purposes of Section 469 and (ii) second, each of the owners of the flow-through entity applies the Section 469 grouping rules with respect to his or her allocable share.

First, we suggest that aspects of Section 469's approach to identifying and separating "activities" may prove useful for identifying and separating trades or businesses in the Section 199A context. In particular, the five factors used in Treasury Regulation Section 1.469-4 to determine whether a trade or business constitutes an "appropriate economic unit" may also be helpful in measuring whether a taxpayer's activities should be treated as a single trade or business or as multiple separate and distinct trades or businesses. For example, under this standard, a taxpayer engaged in both (1) the SSTB of offering legal advice in Los Angeles, California and (2) the trade or business of renting commercial real estate to unrelated parties in Kansas City, Missouri may apply these factors and find that the two income streams should be treated as separate trades or businesses. On the other hand, a medical doctor who rents an x-ray machine owned in his individual capacity to his wholly-owned SSTB in which he provides medical care may not be able to treat the two trades or businesses as separate and distinct. The answer would be the same no matter the number and type of flow-through entities interposed between the owner and the activity.

Section 469's approach to identifying and separating activities also provides a sensible answer as to whether an SSTB could somehow "taint" and deny a taxpayer a deduction with respect to otherwise qualified business income. So long as QBI is generated from a separate trade or business, income earned with respect to an SSTB conducted, directly or indirectly, by the taxpayer should not limit eligibility for the Section 199A deduction with respect to the QTB. We believe this is a sound result that is consistent with the policies underlying Section 199A.

Notwithstanding the usefulness of these five factors, we believe that wholesale adoption of Section 469 standards in the Section 199A context may provide an inappropriate windfall in some cases. In particular, because grouping is elective under Section 469, and because multiple groupings may be permitted on the same facts,[33] full adoption of Section 469 standards may prove overly permissive, resulting in taxpayers Congress intended to exclude gaining access to the Section 199A deduction. Accordingly, we recommend Treasury and the Service consider carefully whether and to what extent any sort of elective grouping should be allowed under Section 199A. For administrability purposes, it may be more appropriate to limit regrouping at the taxpayer level to limited related party contexts, and it will be important for the government to have an anti-abuse

[33] *See, e.g.*, Treas. Reg. § 1.469-4(c)(3), Example 1.

backstop to prohibit taxpayers from attempting to artificially separate out QTBs that are integral to SSTBs.

We also believe that Section 469's "aggregate" approach to flow-through entities could provide a helpful basis for measuring whether multiple trades or businesses exist.[34] By treating each partner or S corporation shareholder as engaged in the business activities of the entity, Section 469 significantly limits the ability of taxpayers to affirmatively structure the same trade or business (or the same collection of trades and businesses) in a manner that produces different results. We believe this should be a high priority for Treasury and the Service in crafting guidance under Section 199A, as it does not appear that Congress intended the availability of Section 199A to turn on the form through which a taxpayer owns his or her interest in a trade or business.

Importantly, however, Section 469 does not apply a pure "aggregate" approach when applying its grouping concepts. Instead, Treasury Regulation Section 1.469-4(d)(5)(i) contemplates that a grouping determination should be made at the entity level. We believe a similar requirement in the Section 199A context may be appropriate. By forcing an entity-level determination as to which activities constitute a trade or business, the government ensures some level of consistency among partners or shareholders. Such an approach may yield more accurate tax reporting, as an entity in many cases may have better access to information regarding its trade or business activities as compared to its owners. After making this entity-level determination, each individual taxpayer would be required under similar principles to determine whether income with respect to the trades or businesses conducted by the entity are merely components of another trade or business in which the taxpayer is engaged so that the government is not disadvantaged in more complex cases.

iii. Other Standards for Identifying and Attributing Trades or Businesses

Though Section 446 and Section 469 provide a good existing framework to consider future guidance, there are other places in the Code that attempt to identify trades or businesses. These may provide additional tools for Treasury and the Service to identify when an entity, or group of entities, has properly separated and identified separate businesses, or where, instead, it has non-economically separated the functions of a single integrated business (e.g., an SSTB) to obtain or maximize a Section 199A deduction.

We think it is worth considering an anti-abuse standard that applies relatedness standards (e.g., Section 267(b), Section 707(a), or definitions of "expanded affiliated group" such as are contained in Sections 1471(e)(2) or 7874(c)(1)) to serve as the basis for a presumption regarding the relationship of trades or businesses conducted by two entities. For example, Treasury and the Service might consider a rebuttable presumption for purposes of Section 199A that two partnerships bearing the relationship described in Section 707(b) are engaged in the same trade or business in the event that either partnership derives a substantial amount of revenue from the other.

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34 Section 469's aggregate approach is also consistent with the attribution of businesses from partnerships to non-U.S. persons under Code Section 875(1). Because Section 864(c) principles are used to determine whether a business is a "qualified trade or business", and because application of Section 864(c) necessarily takes Section 875(1) into account, applying this principle has some support in the statutory text.

Applied to the facts of our example above, if Partnership AB were to attempt to separate its real estate assets from its medical practice, a rebuttable presumption that the real estate assets and medical practice are part of a single trade or business would apply.

Certain standards under Section 355 might also be useful. One example is the "secondary business" concept from Treasury Regulation Section 1.355-2(d)(2)(iv)(C), which applies in the context of the "device" requirement of Section 355 and asks if one business' "principal activity is to serve the business of" a distributing or controlled corporation. Such a test could be applied in the Section 199A context to determine whether two sets of activities are truly separate or instead constitute a single trade or business for Section 199A purposes. Alternatively, the Section 355 "expansion" doctrine in the "active trade or business" context may also be considered.[35] Such a test would ask whether under Section 355 standards, two sets of activities would be treated as separate trades or businesses, or whether one would be an "expansion" of the other. However, because these two tests are generally designed in the Section 355 context to address two or more sets of activities that by themselves constitute trades or businesses, we do not recommend that these principles be imported wholesale into the Section 199A context, but instead note these standards may serve as a baseline for Treasury and the Service in crafting regulations.

Once a trade or business has been appropriately identified, we believe that the better answer under the statute is that the items from the business retain their character as relating to QBI through tiers of ownership.[36] However, if Treasury and the Service were to determine that an SSTB at one level of ownership somehow "taints" income from a QTB at another, it should draft clear rules regarding the standards that would apply, because taxpayers would need to be able to take appropriate precautions before investing in any business that may be an SSTB.

b. *Measurement of QBI in a Multiple Business Case*

In a case where a single taxpayer is found to be engaged in multiple trades or businesses, the calculation of QBI for each business is itself potentially uncertain. QBI is defined in Section 199A(c)(1) as a net calculation of "qualified items" with respect to a QTB.[37] "Qualified items," in turn, is defined by reference to Section 864(c). The calculation excludes specified investment items, including capital gains and losses, dividend (or dividend equivalent) income, interest income (other than interest income properly allocable to a trade or business), certain commodities and foreign currency income, income from notional principal contracts, annuity income that is not received in connection with the trade or business and any item of deduction or loss properly allocable to any of the foregoing.[38] Whether an item is attributable to a particular business (whether a QTB, an SSTB, or an excluded investment activity) may be relatively obvious for many items (e.g., if a Section 446 type approach is selected, then items on the separately stated balance

[35] *See* Treas. Reg. §1.355-3(b)(3)(ii).

[36] Section 199A(f)(1); Section 199A(f)(4).

[37] Section 199A(c)(1).

[38] Section 199A(c)(3)(B). We think that this specifically excludes any items exempt from ECI under Section 864(b)(2) that are not already specifically excluded, but this could be clarified.

sheet should generally be allocated to that business). However, allocations for other items (such as overhead, interest on debt borrowed against all of the taxpayer's assets, depreciation on assets used in both businesses) are less obvious. Allocations, for example, could be in proportion to the gross income of the businesses, the relative fair market value of the businesses, or a tracing approach, all of which have benefits and potential detriments. Given the cross reference to Section 864(c) in Section 199A(c)(3)'s definition of "qualified items," Treasury Regulations issued under Section 861 (which provides rules for the calculation of U.S.-source income) seem to be a logical place to look for a regulatory framework.[39]

In the partnership context, a further question arises regarding the treatment of guaranteed payments in respect of capital where a single partnership is engaged in multiple businesses. Section 199A appears to treat guaranteed payments in respect of capital as QBI eligible for the deduction.[40] So, for instance, assume Partnership X, which is engaged in a single QTB, has two equal partners, A and B. Assume that A is entitled to a guaranteed payment in respect of capital of $800. Before taking into account the guaranteed payment, Partnership X has net income of $600 (so an overall net loss of $200). It appears in this example that A would have QBI of $700 (and be allocated 50% of any W-2 wages and unadjusted basis in assets). If X had two businesses, there would be a further question as to how the $800 guaranteed payment should be allocated as between those businesses. We believe the same principles for allocating expenses among businesses as described above should govern the allocation of the deduction for the guaranteed payment.[41]

C. Calculations with Respect to Multiple Businesses

As mentioned above, Section 199A clearly contemplates that a taxpayer may be engaged in multiple QTBs (directly, or indirectly through a partnership or S corporation). However, Section 199A does not contain clear guidance regarding whether and to what extent income from multiple QTBs should be aggregated and netted for purposes of the deduction.

1. Background

Section 199A clearly provides that loss from a particular QTB offsets income with respect to that same QTB. This rule is contained in the definition of "Qualified Business Income" itself -

[39] We note that such an approach was used under regulations issued pursuant to old Section 199. *See* Treas. Reg. § 1.199-4(d) (describing the "Section 861 method"). We further note that any such approach would need to be harmonized with the "identification" approach (discussed above) that is selected for measuring the number of trades or businesses in which a taxpayer is engaged.

[40] This follows from the statute's reference to Section 864(c) as the standard. Guaranteed payments for services are specifically excluded from the definition of QBI under Section 199A(c)(4).

[41] We also note that Treasury and the Service could consider applying concepts similar to those found in Treas. Reg. § 1.469-7, which provides special rules for determining the extent to which self-charged interest (including guaranteed payments for the use of capital) is subject to the Section 469 passive loss limitation rules.

described as the "***net amount*** of qualified items of income, gain, deduction and loss with respect to any qualified trade or business of the taxpayer [emphasis added]."[42]

A much more complex and uncertain mechanism addresses the netting of income and losses from different QTBs. Section 199A appears to envision a four-step process:

- **Step #1:** As noted above, Section 199A(c)(1) begins by measuring the net QBI with respect to each of the taxpayer's QTBs. Section 199A(c)(2) provides that if the net QBI with respect to all trades or businesses of the taxpayer is less than zero, such amount shall be treated as a loss from a QTB in the succeeding taxable year.

- **Step #2:** After measuring net QBI, Section 199A(b)(2) measures the tentative "deductible amount"[43] with respect to each QTB, calculated as the lesser of (A) 20% of the taxpayer's QBI with respect to such trade or business or (B) the greater of (i) 50% of the W-2 wages with respect to such trade or business or (ii) the sum or 25% of the trade or business's W-2 wages and 2.5% of the unadjusted basis in qualified property.[44]

- **Step #3**: Following calculation of the tentative deductible amount with respect to each QTB, Section 199A(b)(1) calculates the Combined QBI amount, which is the sum of (A) each QTB's tentative deductible amount, and (B) 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

- **Step #4**: Section 199A(a) grants a deduction to the taxpayer that is generally based on this Combined QBI amount, subject to a number of limitations and additions discussed above in Part I.

As we discuss below, the details of these mechanics are ambiguous and incomplete, requiring technical guidance. In particular, we note the following ambiguities needing urgent guidance.

- First, it appears that net losses from an unprofitable QTB are intended to reduce net income from profitable QTBs on a year by year basis, with any overall net loss from all QTBs carried forward to subsequent years.[45] However, this conclusion is not free from doubt in light of ambiguities in the statutory language.

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[42] Section 199A(c)(1).

[43] Though this term is used in the statute, the actual deduction is subject to the limitations described in Part I.

[44] Section 199A(b)(2). Note that the discussions in this Section generally assumes that the taxpayer's income exceeds the applicable threshold amount defined in Section 199A(e)(2).

[45] We use the terms "profitable" and "unprofitable" throughout this Section. Unless otherwise indicated, "profitable" is meant to refer to a QTB in which gross items of income and gain exceed gross items of loss and deduction. "Unprofitable" in turn is meant to refer to a QTB in which gross items of loss and deduction exceed gross items of income and gain.

- Second, assuming that some form of netting applies between net income from profitable QTBs and net loss from unprofitable QTBs, when does this netting occur in the process described above (which generally depends on whether the "deductible amount" calculated under Section 199A(b)(2) can be negative for purposes of applying Section 199A(b)(1))?

- Third, does the same rule or another rule apply with respect to loss carryforwards described in Section 199A(c)(2)?

- We believe that the loss use and carryforward rules described in Section 199A(c)(2) are intended to apply solely for purposes of calculating the amount of the deduction under Section 199A, and that Section 199A(c)(2) and the "net QBI" rule should not be read to actually change the application and limit the use of tax losses for general U.S. federal income tax purposes.

Each of these ambiguities is discussed in turn below.

a. *Current Year Netting Under Section 199A*

The statute itself is unclear whether net losses from an unprofitable QTB are intended to reduce net income from profitable QTBs on a year by year basis. There is support for both a "netting" and a "no netting" approach in the statute and legislative history, although we believe on balance a "netting" approach best reflects the drafters' intent with respect to Section 199A.

The ambiguity arises because Section 199A(c)(2) mandates carryforward of net losses "with respect to qualified ***trades or businesses*** of the taxpayer" [emphasis added], suggesting that all QTBs are aggregated for purposes of measuring the loss carryforward.[46] However, the statutory mechanics for measuring the Section 199A deduction with respect to profitable QTBs seem to contemplate a business-by-business calculation, without any explicit reference to netting. Read literally, the statute arguably measures net losses from QTBs on an aggregate basis taking into account net income and loss from all QTBs, while net income from QTBs is arguably measured on a business-by-business basis.

Such a literal reading would lead to inconsistent and counterintuitive results that we do not believe Congress intended. Particularly helpful in shedding light on this apparent inconsistency in the statute is the Conference Report discussion of netting, which includes an example clarifying the application of Section 199A where a taxpayer has an overall net loss across multiple QTBs.[47] In the example, a taxpayer has QBI of $20,000 from QTB A and a $50,000 loss from QTB B in Year 1. The example concludes that the taxpayer is not permitted a deduction under Section 199A for Year 1 and has a loss carryforward of $30,000 into Year 2.[48] This example strongly suggests

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46 Section 199A(c)(2). This is in contrast to Section 199A(b), which appears to operate on a business by business basis.

47 Conference Report at 29.

48 *Id*. ("For example, Taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Taxpayer has qualified

that Congress intended net income from profitable QTBs to be offset by net loss from unprofitable QTBs in measuring whether a taxpayer is entitled to a deduction under Section 199A in a given tax year.

The example does not deal with a scenario where the taxpayer has net income across its QTBs. Assume in the example above, the loss from QTB B was only $5,000. In that case, there would be no loss carryforward. Under a netting approach, the taxpayer's deduction for Year 1 would take into account the loss from QTB B. However, if a "no netting" approach is adopted, the taxpayer would get a deduction based on $20,000 of QBI, with no carryforward of the loss to reduce future deductions. This seems plainly incorrect.

We accordingly recommend that Treasury and the IRS confirm in guidance that in applying Section 199A(b), a taxpayer's net income from one QBI is offset by the taxpayer's net loss from another QBI on a year by year basis.

b. *How Netting Rules Interact with Limitations on Section 199A Deduction*

i. <u>Netting In General</u>

If the Treasury and the IRS accept netting of income from profitable QTBs against losses from unprofitable QTBs, the next question to be answered is when and how precisely that netting takes place under the statute.

Example 1. A taxpayer has three QTBs: one (QTB X) that pays $500,000 of W-2 wages, and two (QTB Y and QTB Z) that pay no W-2 wages.[49] If the taxpayer has $1 million of income each from QTB X and QTB Y, and $600,000 of losses from QTB Z, how should netting be applied? Should the $600,000 of losses reduce the potential Section 199A deduction by $120,000 (i.e., 20% of $600,000), or should the $600,000 be spread pro rata among each of QTB X and QTB Y, such that the potential Section 199A deduction is reduced by $60,000 (i.e., 20% of one-half of $600,000).

There are two potential approaches to addressing this uncertainty in our view.[50] We believe that these approaches can apply equally with respect to net losses from an unprofitable QTB in a

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business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the deduction for Year 2, Taxpayer reduces the 23 percent deductible amount determined for the qualified business income of $70,000 from qualified businesses A and B by 23 percent of the $30,000 carryover qualified business loss."). The example in the Conference Report was technically given in the context of explaining the Senate proposal, which is why the example refers to a 23% deduction rather than a 20% deduction. However, no material changes were made to the statutory text of Section 199A(c)(2) between the Senate proposal and the final bill, and so we believe the example to be informative in understanding Section 199A(c)(2) as finally enacted.

[49] For simplicity, these examples ignore the alternative calculation under Section 199A(b)(2)(B)(ii).

[50] A "tracing" approach is also theoretically possible, particularly with respect to loss carryforwards. However, we do not believe that a tracing approach does the best job of implementing the statutory language (e.g., Section 199A(c)(2) implies the exact opposite of tracing). A tracing approach would give rise to needless complexity, and there would be questions regarding the fate of any traced losses when a taxpayer exits a particular business.

current year and with respect to net loss carryforwards from prior years described in Section 199A(c)(2).

ii. Pre-Limitation Netting

The first approach to netting we call "Pre-Limitation Netting." Under this approach, netting of gains from profitable QTBs against losses from unprofitable QTBs is taken into account before any limitations on the Section 199A deduction based on W-2 wages or unadjusted basis in qualified property. Thus, the netting is effectively done when calculating QBI for each QTB in Section 199A(b)(2)(A).

The benefits of Pre-Limitation Netting are twofold. First, Pre-Limitation Netting is more consistent with the approach taken to calculating net losses for the purposes of the carryforward under Section 199A(c)(2). That is, under Section 199A(c)(2) it is clear that the amount of an overall loss for purposes of the carryforward rules is measured by solely looking to qualified items of income, gain, loss or deduction and without regard to W-2 wages or unadjusted basis in qualified property. Pre-Limitation Netting thus offers some amount of symmetry when the situation is reversed and net income from profitable QTBs exceeds net losses from unprofitable QTBs.

Second, Pre-Limitation Netting arguably offers fairer results to taxpayers. As discussed in greater detail below, the alternative to Pre-Limitation Netting effectively results in net losses from an unprofitable QTB being used to reduce first the net income from profitable QTBs that have paid W-2 wages or have made capital expenditures with respect to qualified property. Pre-Limitation Netting, however applies without regard to limitations based on W-2 wages or basis in qualified property. Additionally, Pre-Limitation Netting may deliver fairer results across tax years if a taxpayer's income from each QTB is constant, but W-2 wages and unadjusted basis in qualified property fluctuate. This is because Pre-Limitation Netting applies consistently across all QTBs based on net income, rather than effectively allocating losses disproportionately to QTBs that are paying more W-2 wages or investing in more qualified property.[51]

The primary weakness of Pre-Limitation Netting is that Section 199A(b)(2)(A) by its terms does not offer any guiding principle as to how net loss from unprofitable QTBs should be spread across the taxpayer's profitable QTBs. While we believe a pragmatic and reasonable approach would be to allocate net loss from unprofitable QTBs against the taxpayer's profitable QTBs proportionally based on the net income of each profitable QTB, other allocation methods may be considered by the Treasury or the IRS.[52]

As an illustrative example, if Pre-Limitation Netting were applied to Example 1 above, the taxpayer would use his or her $600,000 of net loss from unprofitable QTB Z to reduce equally the $1 million of net income from profitable QTB X and the $1 million of net income from profitable QTB Y. Thus, each of QTB X and QTB Y would be treated as having $700,000 of net income for

[51] We think that there is some evidence that Congress intended these provisions to encourage job/wage creation and capital investment. If that is true, then it seems inconsistent to apply the netting rules in a manner that disproportionately negatively effects such businesses.

[52] For instance, there may be concerns that taxpayers would time income or losses in different QTBs to maximize the deduction in particular years.

purposes of applying Section 199A(b)(2)(A), and taxpayer would be entitled to a deduction under Section 199A of $140,000 (i.e., $700,000 x 20%).

iii. Post-Limitation Netting

The alternative to Pre-Limitation Netting is an approach in which net losses from unprofitable QTBs are taken into account only after the Section 199A limitations based on W-2 wages and unadjusted basis in qualified property are applied ("Post-Limitation Netting"). Post-Limitation Netting would be achieved by applying the statutory calculation of Section 199A(b)(2) to each trade or business of the taxpayer and then netting the results.

As discussed above, the statutory formula under Section 199A(b)(2) requires a calculation of the lesser of:

> (A) 20% of the taxpayer's QBI with respect to such QTB or
>
> (B) the greater of (i) 50% of the W-2 wages with respect to such trade or business or (ii) the sum or 25% of the trade or business's W-2 wages and 2.5% of the unadjusted basis of qualified property.

For profitable QTBs, this formula may result in the Section 199A deduction being capped due to insufficient W-2 wages and/or unadjusted basis in qualified property. However, for unprofitable QTBs, the taxpayer would always simply multiply his or her net loss with respect to the QTB by 20%, because while QBI can apparently be less than zero, W-2 wages and unadjusted basis in qualified property can never be less than zero.

The primary benefit of this approach is that it arguably is more consistent with the plain language of Section 199A(b)(2), which suggests that the limitations based on W-2 wages and unadjusted basis in qualified property should be applied on a business-by-business basis. Indeed, it is very clear that if all of a taxpayer's QTBs generate net income in a given taxable year that the limitations should not be aggregated or otherwise split between QTBs. Post-Limitation Netting is fundamentally just an extension of this concept that takes into account net losses from unprofitable QTBs and does not require Treasury or the Service to impute allocation principles into the statute to measure how losses from an unprofitable QTB should otherwise be taken into account.[53]

The drawbacks of Post-Limitation Netting are the inverse of the benefits to Pre-Limitation Netting described above. Thus, one potential drawback of Post-Limitation Netting is that it results in somewhat inconsistent netting concepts within Section 199A. That is, netting for purposes of measuring an overall loss from QTBs under Section 199A(c)(2) across all trades or businesses clearly does not take into account W-2 wages or unadjusted basis in qualified property, but netting for purposes of measuring overall income from QTBs under the Post-Limitation Netting approach

[53] We note, however, that the concept of netting income from profitable QTBs against losses from unprofitable QTBs requires at least some level of deviation from the plain statutory text of Section 199A. Accordingly, once netting is accepted as a concept, the benefit of adhering tightly to the plain language of the remainder of the statute may be diminished.

would effectively take these limitations into account. It is not clear why such an inconsistency is justifiable as a policy matter, and so it is unclear whether Congress intended such an inconsistency.

The second drawback of Post-Limitation Netting is that it has the effect of allocating net loss from unprofitable QTBs disproportionately to profitable QTBs that have paid W-2 wages or invested in qualified property. This effective allocation to QTBs paying W-2 wages or investing in qualified property occurs because Section 199A(b)(2) by its terms would eliminate some or all of the potential net income from profitable QBIs that did not pay W-2 wages or invest in qualified property. After these limitations have been imposed on profitable QTBs, all that is left to be reduced are the profitable QTBs in which the taxpayer has in fact paid W-2 wages or invested in qualified property.

Returning to our illustrative example, if Post-Limitation Netting were applied to Example 1 above, the taxpayer would apply Section 199A(b)(2) separately with respect to each QTB. Thus, the statutory formula when applied to QTB X would yield $200,000 (because 20% of $1 million is less than 50% of the W-2 wages paid in QTB X), when applied to QTB Y would yield $0 (because no wages were paid and no investments in qualified property were made in QTB Y), and when applied to QTB Z would yield ($120,000). When these three figures are added together, the result is a Section 199A deduction of $80,000 (i.e., $200,000 – $120,000). This is the same result that would be achieved by reducing the $1 million income from QTB X by the full $600,000 of loss from QTB Z (i.e., $400,000 x 20% = $80,000).

iv. Netting With Respect to PTPI

A variation on the issues described above applies with respect with respect to qualified publicly traded partnership income ("***PTPI***"). We note two specific uncertainties in the PTPI context when it comes to netting.

First, it is uncertain whether and to what extent PTPI should be netted against other qualified items generated by a taxpayer's other QTBs. Whereas it appears relatively clear that some form of netting is required as between QTBs that do not generate qualified publicly traded partnership income, it is less clear whether (a) PTPI should be segregated and treated as a distinct class of qualified items, with tracing rules that result in a separate loss carryforward under Section 199A(c)(2) for PTPI,[54] or (b) PTPI should be aggregated with all other qualified items generated by QTBs, subject to the same rules described in Section II.C.1.b.ii, above.

Second, assuming PTPI loss is netted with qualified items generated by other QTBs rather than being segregated, it is not entirely clear whether PTPI should be subject to the same Pre-Limitation Netting or Post-Limitation Netting rule that applies with respect to QTBs that do not generate PTPI. This uncertainty is due large in part to the fact that the limitations based on W-2 wages or unadjusted basis for most QTBs do not apply in the PTPI context. However, because we believe that the benefits and drawbacks described above in weighing Pre-Limitation Netting and Post-Limitation Netting apply with equal force in the context of PTPI, our view is that the more sensible and more administrable approach would be to apply Pre-Limitation Netting or Post-

54 In such a case, it would appear that negative PTPI could still reduce eligibility for the Section 199A deduction with respect to REIT dividends described in Section 199A(b)(1)(B), if PTPI can be negative.

Limitation Netting (whichever is chosen) consistently with respect to both QTBs that generate PTPI and QTBs that do not generate PTPI.

v. Recommendation

We believe that either of the two approaches described above is worthy of consideration by Treasury and the IRS. While we do not express a view as to which of the two approaches is the most appropriate way to reconcile the Section 199A statutory language with the drafters' intent, we believe that adoption of a consistent approach one way or another is critical for taxpayers. To further ensure consistency, we believe that any approach chosen should apply in the same manner for current year losses from an unprofitable QTB as it would for any carryforward of losses from a prior-year pursuant to Section 199A(c)(2).

c. *Confirmation that Loss Carryforwards Described in Section 199A(c)(2) Are Taken into Account Solely for Section 199A Purposes*

While there is no provision explicitly indicating that QBI losses reduce overall taxable income, the lack of any explicit override to generally applicable rules for calculating taxable income strongly suggests that such losses do reduce taxable income for purposes of applying the Section 199A(a)(1)(B) cap to the extent that any such items are deductible under other sections of the Code. That is, we believe that the various loss and loss carryforward provisions of Section 199A are merely for the purposes of calculating the deductible amount under Section 199A and do not otherwise change the taxpayer's calculation of its overall taxable income for any particular year.

For example, assume that a taxpayer has a net loss from QTB A of $1 million, net income from QTB B of $1.5 million (the deduction for which will not be limited under Section 199A(b)(2)), and $2 million of income from SSTB C. Subject to any other loss limitation rules, the taxpayer has $2.5 million of net income. We do not believe that Section 199A should affect this result. We believe, however, that in calculating its taxable income, the taxpayer's deduction under Section 199A should be reduced because of the loss with respect to QTB A.

There is some tension between this reading and the actual words of Section 199A(c)(2), which provides that net QBI losses "shall be treated as a loss from a qualified trade or business in the succeeding taxable year." This could be read to imply that instead, net QBI loss cannot be applied to reduce current year taxable income and must be carried forward until the taxpayer has net positive QBI in a future year. This would create an analogue to the passive loss rules under Section 469. In this case "active" losses from a QTB would be suspended until there was additional "active income" from the same or a similar QTB.[55]

We believe that this is an incorrect reading. In addition, creating a new suspended loss rule for losses with respect to QTBs is both not required by the statute and will lead to needless

55 Calculated by allocating a proportionate amount of loss to each QTB.

complexity, particularly given the limited duration of Section 199A.[56] Instead we recommend that Treasury and the Service clarify, that any Section 199A(c)(2) is carried forward for the sole purpose of limiting the Section 199A deduction in a future year.

D. Calculation of W-2 Wages and Limitations on QBI Based on Compensatory Payments

The calculation of W-2 wages and the treatment of compensatory payments are the subject of significant uncertainty under Section 199A. We believe that the two issues requiring immediate guidance are (1) the treatment of professional employee organizations ("PEOs") and similar arrangements and (2) the meaning of "reasonable compensation" under Section 199A(c)(4). We discuss each of these points and make recommendations below.

In addition to the issues discussed below, we note that if an analogue to the Section 469 "aggregate" approach described above is not implemented, additional guidance will be required in many cases to help taxpayers determine whether and to what extent W-2 wages paid by a related person should be taken into account for purposes of Section 199A. Additional guidance may also be considered where employees of a related C corporation provide services to a partnership, S corporation, or individual to which such C corporation is related.[57]

1. Professional Employment Organization and Similar Arrangements Where Common Law Employer Is Not Payor of Wages

As drafted, Section 199A does not include clear principles under which a taxpayer can determine whether W-2 wages are properly allocable to a specific QTB. This is particularly troublesome for taxpayers who make use of PEOs or similar arrangements in which the taxpayer is the common law employer of a person but wages are reported by another taxpayer. PEOs and similar arrangements are commonly used by smaller businesses to outsource employee management tasks, including management of payroll tax withholding and reporting.

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56 Consider for example, the fate of such carryforwards when (and if) Section 199A expires in accordance with its terms.

57 In addition to the uncertainties described herein, we note that Section 199A by its terms creates an incentive for service providers to seek treatment as an independent contractor rather than as an employee. This incentive exists because independent contractors appear generally to be eligible for the Section 199A deduction, whereas employees are clearly excluded under Section 199A(c)(4)(A). At the same time, a flow-through person paying a service provider may prefer employee classification to increase that person's W-2 wage base for purposes of the Section 199A deduction. We note that this tension is not specific to Section 199A (there are many other instances in the Code and Regulations in which the distinction between employee and independent contractor are relevant). However, we believe that Section 199A increases the likelihood that taxpayers will attempt to affirmatively (and artificially) plan into one status or the other. We believe this is the case particularly in fields like truck driving, hair styling, and nursing, where historically the line between independent contractor and employee has not been readily apparent. Whether an individual decides to press for employee status (where a greater degree of benefits may be available) or independent contractor status (where a Section 199A deduction may be available) will presumably depend on the individual's preferences and circumstances.

Treasury Regulations issued under old Section 199 for purposes of the domestic production activity deduction specifically provided rules under which W-2 wages paid and reported by a person who was not the common law employer of an employee could be attributed to the common law employer.[58] We recommend that these rules be applied for purposes of Section 199A as well.

2. Meaning of "Reasonable Compensation"

Section 199A(c)(4)(A) provides that QBI does not include "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business." Accordingly, any income of the taxpayer that is treated as "reasonable compensation" will not be eligible for the Section 199A deduction.

Outside of the subchapter C context, "reasonable compensation" is a term generally used to refer to the required payment of a salary to the owner (or owners) of an S corporation who provide services to the S corporation. Because under long-standing U.S. federal income tax principles a partner cannot be treated as an employee of a partnership,[59] the "reasonable compensation" rules have not been applied in the partnership context.[60] However, the statutory language of Section 199A is not explicitly limited to taxpayers who own interests in a QTB through an S corporation, and certain public statements by Treasury officials have suggested that Treasury and the Service may consider regulations under which the income of a partner or a sole proprietor may be treated as "reasonable compensation" for purposes of Section 199A.[61]

We believe that use of the term "reasonable compensation" in Section 199A(c)(4) was clearly intended as a means of incorporating the long-standing statutory and regulatory authorities that have for many decades applied solely in the corporate context. We believe that if Congress intended that Treasury and the IRS revisit such a fundamental principle of tax law, this would have been made clear in the statutory text and legislative history. The absence of any explicit suggestion strongly implies that Congress intended no such deviation, and accordingly we believe that if any portion of a partner's distributive share or a sole proprietor's items of income were intended to be treated as "reasonable compensation," a legislative amendment may be required.[62]

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58 Treas. Reg. § 1.199-2(a)(2).

59 Rev. Rul. 69-184, 1969-1 C.B. 256. The continuing validity of the holding in Rev. Rul. 69-184 was reinforced through the recent promulgation of Treasury Regulations under Section 7701 of the Code. *See* Treasury Decision 9726, 81 Fed. Reg. 26693 (2016) ("[T]he Treasury Department and the IRS do not believe that the regulations alter the holding of Rev. Rul. 69–184, 1969–1 CB 256").

60 *See, e.g.*, Chief Counsel Advice 201640014 (Sept. 30, 2016) ("Partnership is not a corporation and the 'wage' and 'reasonable compensation' rules which are applicable to corporations and were at issue in the *Brinks* case do not apply.")

61 *See, e.g., No Plans to Apply Reasonable Compensation Beyond S Corps*, TAX NOTES (Feb. 26, 2018) (reporting then-Treasury Deputy Assistant Secretary for Tax Policy Dana Trier taking the position that "Treasury has the power to issue guidance expanding reasonable compensation beyond subchapter S corporations.")

62 If, notwithstanding our recommendation, Treasury and Service were to take the view that regulations altering the meaning of "reasonable compensation" were appropriate in order to achieve parity between S corporations on the one hand, and partnerships and sole proprietorships on the other hand, we believe that it

Notwithstanding our view that Congress did not intend to redefine "reasonable compensation" to include a partner's distributive share for purposes of Section 199A, we believe Treasury and the Service do have authority under Section 707 to treat certain economic entitlements of partners as "guaranteed payments" that, pursuant to Section 199A(c)(4)(B) and Section 199A(c)(4)(C), would be excluded from QBI. We note that Treasury and the Service have recently issued proposed regulations regarding disguised payments for services, including the treatment of minimum amounts guaranteed to be received by a partner without regard to the income of the partnership.[63]

E. Guidance Regarding Other Issues and Ambiguities

1. Qualified Property

Section 199A(b)(6) defines "qualified property" as tangible depreciable property held by, and available for use in the qualified trade or business at the close of the taxable year, that was used by such business in the production of QBI, and the "depreciable period" for which has not ended before the end of the taxable year. The "depreciable period" is further defined as ending either 10 years after the property was first placed in service by the taxpayer, or the last day of the last full year that the applicable recovery period applies to such property under Section 168, whichever is later.

There are several ambiguities with this rule with respect to which we recommend clarification:

- How are improvements to tangible property treated? Do they get a new depreciable period?

- How do qualified property rules operate in the case of Section 1031 exchanges? Does unadjusted basis carry over to replacement property? Does an exchange alter the depreciable period?

- Section 199A(f)(1)(A)(iii) (including flush language) suggests that members' shares of unadjusted basis in property held by a pass-through entity is determined immediately after acquisition of the property. Do those percentages change if the members' interests in the entity change or a new member joins the pass-through entity?

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would also be appropriate to treat any such "reasonable compensation" as W-2 wages for purposes of calculating a taxpayer's Section 199A deduction. Such an approach would ensure that in attempting to create parity between S corporations, partnerships, and sole proprietorships, Treasury and the Service would not inadvertently handicap partnerships and sole proprietorships by limiting the extent to which their "reasonable compensation" paid in a taxable year can support a Section 199A deduction.

63 *See* Disguised Payments for Services, 80 Fed. Reg. 43652 (July 23, 2015); Prop. Reg. § 1.707-1(c), Example 2 (full amount guaranteed to partner without regard to partnership income treated as guaranteed payment, even if partnership has items of income equal to or exceeding partner's entitlement). We believe that these regulations, if finalized, would represent a more appropriate avenue for administrative guidance. *See also*, New York State Bar Association Tax Section, Report on the Proposed Regulations on Disguised Payments for Services (Nov. 13, 2015).

2. Partnership issues

The statute contains specific provisions outlining treatments of pass-through entities.[64] There are still some ambiguities regarding how specific partnership provisions of the Code would apply in the context of Section 199A, which we have identified below.

a. *Section 702 Separately Stated Items*

It appears that there is an intention that the allocation of wage expense and depreciation must be separately reported items, at least where the partnership has non-corporate partners. Confirmation of this result would be helpful. In addition, it is possible that partnerships now should be reporting income, unadjusted basis and W-2 wages on a business-by-business basis, together with a determination of SSTB or QTB status so that partners can accurately prepare their tax returns. The Service should consider amendments to Schedule K-1 and IRS Form 1065 to achieve this result.

b. *Special Allocations under Section 704*

Special allocations that otherwise have substantial economic effect under the Section 704 rules appear to be taken into account in measuring W-2 wages and unadjusted basis in qualified property under Section 199A(f)(1), but confirmation would be helpful.[65] That is, the statute clearly contemplates that such amounts be allocated in the same manner as the allocation of the underlying wage expense and depreciation.[66] In addition, to the extent that a partnership is engaged in multiple trades or businesses, and items with respect to the trades or businesses are allocated differently, we believe that the allocation of W-2 wages and the unadjusted basis of assets should also be allocated on a business-by-business basis in accordance with the sharing percentages for each particular business.

We have considered whether to recommend that Treasury and the Service consider additional anti-abuse rules beyond mere compliance with the substantial economic effect standard for such allocations. For instance, a partnership could issue a preferred equity instrument to a corporate taxpayer not eligible for the Section 199A deduction, with the common equity held by an individual in a manner that has the effect of allocating a disproportionate amount of the W-2 wage expense to the individual rather than the corporation. Congress has clearly authorized Treasury and the Service to promulgate such rules if they believe it is necessary pursuant to the regulatory authorization in Section 199A(f)(4). At this time, we do not believe that additional restrictions on partnership allocations beyond the substantial economic effect standard of Section 704(b) are necessary. However, if Treasury and the IRS were to find situations where the substantial economic effect standard was insufficient to prevent abuse, we recommend that these regulations be narrowly targeted to disregard, solely for purposes of Section 199A special allocations, a principal purpose of which is to increase the Section 199A deduction available to

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64 Section 199A(f)(1).

65 We note that such an approach was taken in Treas. Reg. § 1.199-5 (issued under old Section 199).

66 Section 199A(f)(1).

one or more partners.[67] If Treasury or the Service would like us to consider any particular anti-abuse rules, we would be pleased to submit an additional report.

c. *Treatment of Section 751 Inclusions*

It is unclear whether income treated as ordinary income under Section 751 should be "qualified business income." Section 199A(c)(3) defines "qualified items of income, gain, deduction, and loss" by reference to Section 864(c).

The *Grecian Magnesite* case[68] and Section 864(c)(8) read in tandem strongly suggest that all income from the sale of a partnership interest is described in Section 864(c) to the extent the property of the partnership is used in a U.S. trade or business.

However, Section 199A(e)(5) lists out (i) the taxpayer's allocable share of the QBI from a publicly traded partnership and (ii) income described in Section 751 as separate categories of "qualified publicly traded partnership income," which could be read to imply that income described in Section 751 is not "qualified business income." Alternatively, the language in Section 199A(e)(5) may be intended to clarify that income described in Section 751 does not otherwise need to meet the standards for "qualified business income" to qualify as "qualified publicly traded partnership income."[69]

d. *Purchases and Sales of Partnerships Interests*

It appears that Section 706 principles should be taken into account in measuring QBI in the context of a transfer of a partnership interest, but we believe confirmation would be helpful. It is less clear how Section 704(c) and Section 734 or Section 743 principles should be taken into account in calculating QBI, if at all. In particular, Section 199A(f)(1) provides that a partner's allocable share of the unadjusted basis of property is determined "in the same manner as the partner's. . . allocable share of depreciation." The provision does not specify whether this is a Section 704(b) "book" concept (which would lead to one result) or a "tax" concept that takes into account Section 704(c) (which could lead to another result). In addition, regulations under Section 743 and Section 734 could lead to different conclusions in many cases when measuring a taxpayer's share of the unadjusted basis of tangible assets. Treasury Regulation Section 1.743-1(j)(1) provides that the Section 743 adjustment does not affect the partner's capital account or change how the partnership calculates income under Section 703. On the other hand, for purposes of calculating a depreciation deduction allocable to the partner, Treasury Regulation Section

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67 In making this recommendation, we are mindful of the complexity of other regimes in Subchapter K that police special allocations, such as the "fractions rule," and would recommend that considerable thought be given to crafting any such standard, particularly if it applies to provisions other than Section 199A, given the potential effects on other provisions of the Code.

68 *Grecian Magnesite Mining, Industrial & Shipping Co.*, 149 T.C. No. 3 (2017).

69 That is, Section 751(a) gain is not included in the allocable share of income from a qualified publicly traded partnership since it is not a share of income from the partnership itself. Therefore, a special rule may have been needed. Note that regulations under old Section 199 specifically counted Section 751 gains as "domestic production gross receipts. *See* Treas. Reg. §1.199-5(f).

1.743-1(j)(2) then adjusts the purchasing partner's distributive share of income to take into account additional depreciation as a result of the adjustment. Therefore guidance will be needed regarding how these items could shift allocations of unadjusted basis in property for purposes of Section 199A. In addition, guidance is also needed as to how allocations of unadjusted basis in qualified property may be calculated once the adjusted basis of property is actually depreciated to zero (either because the useful life is less than 10 years or as a result of bonus depreciation).[70]

3. Additional Issues

a. *Application to Nonresident Aliens*

We recommend confirming that a foreign individual with effectively connected income is entitled to benefit from the Section 199A deduction.

b. *Application of Section 1231*

It is not entirely clear whether income treated as capital gain pursuant to Section 1231 is excluded from QBI under Section 199A(c)(3)(B). Nor is it entirely clear that losses treated as ordinary pursuant to Section 1231 are taken into account in measuring QBI. We believe, however, that the better reading of Section 199A is that gain or loss treated as long-term capital gain pursuant to Section 1231(a)(1) should not be treated as QBI, whereas qualified items of gain or loss treated as ordinary pursuant to Section 1231(a)(2) should be taken into account in measuring the Section 199A deduction.[71]

c. *Electing Small Business Trusts*

Treasury Regulation Section 1.641(c)-1(d)(2)(i) provides that the "S portion" of an electing small business trust "takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to Section 1366 and the regulations thereunder." Clarification should be provided that (1) the deduction described in Section 199A is permitted in calculating the trust's taxable income pursuant to Section 641,[72] and (2) the S portion's share of W-2 wages and unadjusted basis in qualified property are taken into account for

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[70] We note that Treas. Reg. § 1.199-5 (issued under old Section 199) grappled with some analogous issues in the context of the domestic production activities deduction, and accordingly may serve as a helpful base for guidance.

[71] In addition, we believe it is instructive that for purposes of measuring a taxpayer's limitation on the Section 199A deduction under Section 199A(a)(1)(B)(ii), Congress specifically referred to Section 1(h) in defining "net capital gain." Importantly, it is clear under Section 1(h), such "net capital gain" would generally take into account amounts treated under Section 1231 as long-term capital gain, subject to certain exceptions under Section 1(h)(6)(B) and Section 1(h)(8).

[72] We note that the statutory language under Section 641(c) limits deductions allowed to electing small business trusts to items specified in Section 641(c)(2)(C). However, Congress failed to specifically amend Section 641(c)(2)(C) to take into account the deduction described in Section 199A. We believe that this was a drafting oversight. If Treasury does not believe regulations can be issued, we suggest it be addressed through a technical correction.

purposes of Section 199A notwithstanding that W-2 wages and unadjusted basis in qualified property are technically not described in Section 1366.

d. *Application of the Rules to Cooperative Dividends*

It appears that there was a potentially unintended benefit conferred on cooperatives with respect to qualified cooperative dividends in that qualified cooperative dividends are effectively calculated on gross proceeds of sales to cooperatives rather than net proceeds. In light of this benefit (and because the SSTB restrictions do not apply to qualified cooperative dividends), we understand that many taxpayers who have not traditionally operated in cooperative form may be considering utilizing a cooperative both within and without the agricultural context to achieve a superior result under Section 199A.[73] While it is our understanding that legislative amendments to Section 199A to address these issues are currently being contemplated,[74] we recommend that Treasury and the Service nonetheless consider the application of Section 199A to cooperatives in drafting regulations.

III. Conclusion

The issues addressed above are only a subset of the significant issues raised by Section 199A. The Tax Section would be happy to issue a more detailed report addressing some or all of the issues listed above. We note that certain of these issues (such as the treatment of a partner's distributive share as "reasonable compensation" pursuant to Section 199A(c)(4)(C) or the application of Section 199A(g)) may be more properly addressed through Congressional amendment to Section 199A.

* * *

[73] We note that an amendment of some aspect of these rules appears to have been agreed by lawmakers. *See* Joshua Rosenberg, *Omnibus Spending Bill Would Fix Tax Law's 'Grain Glitch'*, Law 360 (Mar. 21, 2018).

[74] *See* Lynnley Browning, *Rich Americans Have Found Yet Another Tax Loophole*, Bloomberg Politics (Mar. 6, 2018).

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Report No. 1393
March 28, 2018

The Honorable David J. Kautter
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Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable David J. Kautter
Acting Commissioner
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1111 Constitution Avenue, NW
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The Honorable William M. Paul
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Re: *Report No. 1393 on Section 163(j)*

Dear Messrs. Kautter and Paul:

I am pleased to submit Report No. 1393 adressing Section 163(j) of the Internal Revenue Code of 1986, as amended (the "**Code**"), which was amended by P.L. 115-97 (the "**Act**"), enacted on December 22, 2017. Under Section 163(j), a taxpayer's annual deduction for business interest expense is generally limited to the sum, for the relevant taxable year, of (A) the taxpayer's business interest income, (B) 30% of the taxpayer's adjusted taxable income, and (C) any floor plan financing interest of the taxpayer.

As discussed in the Report, we recommend that guidance be issued under Section 163(j) addressing several technical and interpretive questions, including: (1) the definitions of "interest," "business interest expense," "business interest income," and "adjusted taxable income" as used in the provision; (2) in the case of a taxpayer that conducts both one or more trades or businesses subject to Section 163(j) and one or more trades or businesses excluded from the scope of the provision pursuant to Section 163(j)(7), rules for allocating interest expense among those trades or businesses; (3) guidance concerning the application of Section 163(j) to consolidated groups, including where a member enters or leaves a group; (4) clarification of the rules in Section 163(j)(4) regarding the application of the statute to partners and partnerships; and (5) guidance as to the interaction of Section 163(j) with international tax rules in the Code, including the rules concerning controlled foreign corporations and U.S. shareholders and the rules concerning effectively connected income of a foreign corporation. In addition to providing specific recommendations in the Report concerning these and other issues, we also set forth in the concluding section of the Report a list of additional questions as to which it may be appropriate to issue guidance.

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

Respectfully submitted,

Karen G. Sowell

Karen G. Sowell
Chair

Enclosure

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Report No. 1393

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 163(j)

March 28, 2018

PLEASE SEE PANEL ONE MATERIALS
OR ACCESS REPORT 1393 ONLINE AT:

http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2018/1393_Report.html