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Report No. 1403
October 19, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Principal Deputy Chief Counsel and
Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1403 on Proposed Section 199A Regulations*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1403, commenting on proposed regulations (the "***Proposed Regulations***") issued by the Department of Treasury and the Internal Revenue Service (together, "***Treasury***") under new Section 199A on August 8, 2018. This Report supplements our prior Report No. 1392 submitted on March 23, 2018, requesting guidance with respect to certain issues with respect to which we believe taxpayers would need immediate and substantial guidance in order to interpret and comply with new Section 199A.

We commend Treasury for so quickly proposing comprehensive regulations regarding a new and complex statutory regime which will affect millions of taxpayers in such a short timeframe. We understand that Treasury intends to issue final regulations on an expedited schedule and, therefore, has requested comments from the public on an expedited schedule. In response to that request, this Report addresses certain issues generally applicable to taxpayers whose income exceeds the threshold amount defined in Section 199A(e)(2). In light of the time constraints, however, the Report does not address all aspects of Section 199A and the Proposed Regulations.

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. 1403

New York State Bar Association Tax Section

REPORT ON PROPOSED SECTION 199A REGULATIONS

OCTOBER 19, 2018

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I. Introduction

This Report[1] comments on proposed regulations (the "***Proposed Regulations***")[2] issued by the Department of Treasury and Internal Revenue Service (together, "***Treasury***") under new Section 199A[3] on August 8, 2018. This Report supplements our prior report (the "***Prior Report***")[4] submitted on March 23, 2018, requesting guidance with respect to certain issues with respect to which we believe taxpayers would need immediate and substantial guidance in order to interpret and comply with new Section 199A.

We commend Treasury for so quickly proposing comprehensive regulations regarding a new and complex statutory regime which will affect millions of taxpayers in such a short timeframe. We understand that Treasury intends to issue final regulations within the period described in Section 7805(b)(2), and has requested comments from the public on an expedited schedule. In response to that request, this Report addresses certain of the requested area for comment, as well as certain other issues that we believe should be addressed in final regulations. In the interest of expediency, this Report does not provide an overview of the statutory and proposed regulatory framework for Section 199A, but rather addresses specific issues with respect to which we have comments and recommendations. Our comments do not address all aspects of Section 199A and the Proposed Regulations, and in particular, we do not purport to address (i) issues specific to trusts, estates, or REITs or (ii) issues related to the classification of service providers as employees, partners or independent contractors. In general our comments focus on provisions applicable to taxpayers whose income exceeds the threshold amount defined in Section 199A(e)(2) (the "***Threshold Amount***").

II. Summary of Principal Recommendations

The following is a summary of the principal recommendations in this Report, organized by Section of the Proposed Regulations.

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1 The principal drafters of this Report were Sara Zablotney, Adam Kool, and Tijana Dvornic, with substantial contribution from Jonathan Talansky and Elizabeth Kessenides. The drafters would like to acknowledge the support and assistance of Swift Edgar, Laila Hosseini, and Chris Saki in preparing this Report. Contributions from Andy Braiterman, Robert Barnett, Jonathan Brennan, Robert Cassanos, Pamela Endreny, Phillip Gall, Stephen Land, Joel Scharfstein, Michael Schler, Martin Shenkman, Eric Sloan, Karen Gilbreath Sowell, and Alan Tarr are reflected in this Report. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("***NYSBA***") and not those of the NYSBA Executive Committee or the House of Delegates.

2 REG-107892-18, Federal Register Vol. 83, No. 159, August 16, 2018 at 40844-4099, (hereinafter, the "***Preamble***") at 40884.

3 Except as otherwise noted, all "***Section***" references in this Report are to sections of the Internal Revenue Code of 1986, as amended (the "***Code***"), references to "***Treasury Regulations***" are to the Treasury Regulations promulgated thereunder, and references to "***Proposed Regulations***" are to proposed Regulations.

4 New York State Bar Association Tax Section Report No. 1392, *Report on Section 199A* (March 23, 2018). We have attached the Prior Report hereto as an Appendix for ease of reference.

Proposed Regulations Section 1.199A-1

- We request clarification regarding the related party standard for "passive" leasing and licensing income, and propose to limit such exception to cases where the counterparty is a RPE[5] engaged in a QTB.

- We request clarification as to when certain real estate activities may be aggregated to constitute a trade or business for purposes of Section 199A.

- We recommend that there be a presumption that a RPE that has only entity partners is not a RPE absent knowledge of an individual beneficial indirect owner.

Proposed Regulations Section 1.199A-2

- We recommend that book, rather than tax, depreciation govern allocation of UBIA in qualified property in the case of partnerships.

- Instead of the deemed liquidation at fair market value approach for allocating UBIA in qualified property once tax depreciation is exhausted within a partnership, we recommend one of the following methods: (i) rules based on the allocation of nonrecourse indebtedness, (ii) rules based on the application of the remedial method where tax depreciation is exhausted, (iii) rules based on the hypothetical allocation of loss if qualified property had a tax basis equal to a specified amount (*e.g.*, UBIA), (iv) rules "freezing" UBIA based on the final year in which tax depreciation is generated, or (v) rules allocating UBIA in proportion to aggregate depreciation deductions previously allocated.

- We recommend consideration of alternatives for the treatment for UBIA in qualified property for purposes of any Section 734 and Section 743 adjustment.

- We recommend that UBIA in qualified property not be stepped down as a result of a non-recognition transaction in which a substantially all of the assets of a QTB are transferred.

- We request clarification as to when UBIA in qualified property is measured in cases in which interests in a RPE are transferred.

Proposed Regulations Section 1.199A-3

- We recommend distinguishing items incurred in a trade or business applying Section 162 principles from other items. Under our proposal, trade or business items may only be aggregated if aggregation is permitted. Items of deduction/loss should be taken into account in calculating a taxpayer's QBI if such items are attributable to a QTB under Section 861 principles.

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5 Terms used in this summary that are not defined are defined in the discussion below.

- We recommend that if a loss disallowed under, *e.g.*, Sections 465, 469 or 904(d), is later used, only such losses generated after 2018 be taken into account for QBI purposes using a LIFO/closed system approach.

- We recommend that in addition to pre-2018 Section 481 adjustments, other sorts of income deferred between pre-2018 and post-2018 periods (*e.g.*, deferrals under Section 108(i), installment sales) should be excluded from QBI. However, Rev. Proc. 2004-34 income deferred from 2017 to 2018 should be treated as QBI.

- We recommend that the categorical exclusion of Section 707(a) payments and Section 707(c) guaranteed payments for capital be narrowed.

Proposed Regulations Section 1.199A-4

- We recommend that overlapping ownership should be a very important factor, but not a requirement to aggregate pursuant to Proposed Treasury Regulations Section 1.199A-4.

- We recommend clarification of the overlapping ownership standard by reference to principles similar to those in the Section 414 context, and we recommend expanding the factors that indicate relatedness.

- We recommend that taxpayers be permitted to elect Section 199A groups for Section 469 purposes as Section 199A grouping is generally narrower as compared to grouping permitted for Section 469 purposes.

- We recommend that taxpayers be required to substantiate their qualifications for aggregation as a precondition to aggregation, but that RPEs not be required to provide information to taxpayers in order to permit aggregation.

- We recommend that aggregation be permitted at the RPE level with consent of partners, including as part of partnership agreement.

- We believe that, except for the case of a taxpayer's failure to substantiate satisfaction of the aggregation requirements, granting the Commissioner authority to disaggregate Section 199A groups is unnecessary. However, we recommend that the Commissioner have the power to aggregate for purposes of Section 199A in appropriate circumstances.

Proposed Regulations Section 1.199A-5

- We believe that the Services Requirement is too narrow and that the Proposed Regulations should mirror the statute's broader definition of an SSTB.

- We believe that the standard for measuring whether a given trade or business "involves" the performance of services in SSTB is too broad, not required and over-inclusive, and accordingly recommend revising the Proposed Regulations with respect to this point.

- We recommend that the precise contours of specific categories of SSTBs be clarified either through example or through additional regulatory guidance.

- We recommend that when applying the anti-abuse rule in Proposed Regulations Section 1.199A-5(c)(2) with respect to services provided to an SSTB, no per se rule should apply in the event a trade or business provides 80 percent or more of its property or services to the SSTB. Whether or not the per rule is retained, we recommend: (i) measuring by revenue rather than by "property and services," (ii) clarifying the common ownership standard, (iii) clarifying the measurement period, (iv) implementing a start-up exception, and (v) clarifying the treatment of shared expenses.

III. Detailed Discussion of Recommendations

A. Proposed Regulations Section 1.199A-1

Proposed Regulations Section 1.199A-1 contains the basic computational and definitional framework for the remainder of the Proposed Regulations. This Part III.A contains our comments with respect to these provisions.

1. Basic Computational Approach

Treasury has requested comments regarding the basic computational rules in Proposed Regulations Section 199A-1(d) for the purposes of applying Section 199A in cases where the taxpayer has income above the Threshold Amount (the "***Computational Rules***").[6] Under the Computational Rules, the taxpayer applies the following rules in order:[7]

- First, the taxpayer determines whether its income is in the Phase-In Range[8] with respect to the Threshold Amount. If so, it computes the applicable percentage of qualified business income ("***QBI***"), W-2 wages, and unadjusted basis immediately after the acquisition ("***UBIA***") in qualified property for any qualified trade or business ("***QTB***") in which it is engaged under Proposed Regulations Sections 1.199A-1(b)(8) and 1.199A-1(d)(iv)(B).[9]

- Second, the taxpayer "combines" the QBI, W-2 wages and UBIA in qualified property with respect to any trades or businesses aggregated under Proposed Regulations Section 1.199A-4.[10]

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6 Preamble at 40887.

7 Proposed Regulations Section 1.199A-1(b)(2).

8 As defined in Proposed Regulations Section 1.199A-1(b)(3).

9 Proposed Regulations Section 1.199A-1(d)(2)(i).

10 Proposed Regulations Section 1.199A-1(d)(2)(ii).

- Third, the taxpayer offsets the QBI attributable to each QTB that generated positive QBI with the QBI from each trade or business that produced negative QBI, in proportion to the relative amounts of QBI in businesses that generate positive QBI. If after this netting there is a net negative amount of QBI remaining, the QBI component for the taxpayer for that year for all QTBs is zero, and the negative amount is carried forward to be treated as negative QBI from a QTB in the next year.[11]

- Fourth, the taxpayer calculates a QBI component amount for each net positive QTB and adds those QBI component amounts together for purposes of computing the deduction. This QBI component amount for each trade or business is the lesser of (1) 20 percent of the QBI for that trade or business or (2) the greater of (x) 50 percent of W-2 wages with respect to that trade or business, or (y) the sum of 25 percent of W-2 wages for that QTB plus 2.5 percent of the UBIA in qualified property with respect to that QTB.

- Fifth, the taxpayer's Section 199A deduction with respect to such QBI is the lesser of the amount computed under step 4 and 20 percent of the excess of the taxpayer's taxable income for such year over the taxpayer's net capital gain for such year plus cooperative dividends.

In cases where a taxpayer has multiple QTBs, the Computational Rules include an approach under which losses from loss-making QTBs are offset against income from profitable QTBs on a pro rata basis prior to application of the limitations of Section 199A(b)(2)(4).[12] This is consistent with the "Pre-Limitation Netting" approach described in our Prior Report.[13] We generally support the basic Computational Rules adopted by the Proposed Regulations, and agree that they lead to fair and administrable results for both the government and taxpayers, and we continue to support the application of a Pre-Limitation Netting approach as a consistently applied, fair and administrable standard.

2. Definitional Comments

Many of the important definitional concepts are contained in Proposed Regulations Section 1.199A-1 by cross reference to other portions of the Proposed Regulations. To the extent we have comments on those cross-referenced definitions, we have addressed them later in this Report. However, we do have comments regarding the definition of "trade or business" and "relevant pass-through entities" for purposes of Section 199A.

a. Trade or Business

Proposed Regulations Section 1.199A-1(b)(13) defines "trade or business" by reference to Section 162, other than the trade or business of performing services as an employee. We generally

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[11] Proposed Regulations Section 1.199A-1(d)(2)(iii).

[12] Proposed Regulations Section 1.199A-1(d)(2)(iii)

[13] Prior Report at 22-25.

agree with this standard and think that it correctly identifies the sorts of activities that Congress meant to encourage by enacting Section 199A.[14] However, Proposed Regulations Section 1.199A-1(b)(13) provides a special rule for rental or licensing of tangible or intangible property that does not rise to the level of a trade or business if the property is rented or licensed to a trade or business which is commonly controlled under Proposed Regulations Section 1.199A-4(b)(1) (apparently whether or not the taxpayer chooses to aggregate such activities).

As discussed in greater detail below in Part III.D.2, this related party standard is vague, and the application of attribution rules is unclear. Also, as written, the provision appears to permit a passive leasing or licensing-type activity to benefit from Section 199A, even if the counterparty is not a RPE or an individual. We question whether that was Congress's intention.

> **Example 1.** A, B, C and D each own 25 percent of the sole class of outstanding stock of X, a C corporation that is engaged in a trade or business for purposes of Section 162. X owns 80 percent of the sole class of common units of Y, a RPE. A and B each own 10 percent of the sole class of common units of Y. Y's only activity is to triple net lease real estate to X, which activity does not constitute a trade or business for purposes of Section 162. A and B together directly own 50 percent of the value of X and 20 percent of the capital and profits of Y. Taking into account their stock ownership of X, A and B together also indirectly own 40 percent of the capital and profits of Y. It is unclear whether A and B benefit from the Section 199A deduction with respect to their rental income from Y's leasing activity (assuming the other requirements for deductibility are met).

We recommend (1) limiting the exception for passive leasing or licensing activity to scenarios where the related party is a RPE or individual, and (2) in either case, to give taxpayers more certainty, the Proposed Regulations should be modified to explicitly cross reference existing attribution rules (*e.g.*, 267, 707 and/or 414) to ascertain with certainty which businesses may be treated as qualifying.

Although we acknowledge that this is an issue broader than Section 199A, we note that in this context it is not entirely clear whether and how activities (which may, for instance, be conducted through separate disregarded entities) may be aggregated in order to find a trade or business; particularly in a real estate context.[15] While Section 199A may not be the correct forum to address such issues, we do note that many taxpayers (*e.g.,* those who own and rent a small number of properties in pass-through form) may be left with uncertainty as to the applicability of the Section 199A deduction to them. A few examples clarifying Treasury's view on these types of activities might be helpful.[16]

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[14] This is consistent with our recommendation in the Prior Report. *See* Prior Report at 13.

[15] For example, as noted below in Part III C.1.a.i, it is not entirely clear how the Effectively Connected Standard should be applied with respect to interests in partnerships in light of Section 875(1)'s general principle that a partner is attributed the U.S. trade or business of a partnership in which he or she owns an interest.

[16] In this regard, we note that the Preamble suggests that "in most cases, a trade or business cannot be conducted through more than one entity." Preamble 40894. This statement seems to suggest that there exists some subset of cases in which a trade or business could be conducted through more than one entity. We believe that clarifying

b. Definition of "Relevant Pass-Through Entity" ("*RPE*")

The Proposed Regulations correctly limit many of their requirements and benefits to a RPE, which is defined as "a partnership (other than a PTP) or an S corporation that is owned directly or indirectly by at least one individual, estate or trust."[17] While we generally agree with this definition, we believe it is incomplete in the case of tiered partnerships. A lower-tier partnership may have no knowledge (or ability to obtain knowledge) regarding its status as a RPE. We suggest that in the case of a lower tier partnership whose only partners are upper tier partnerships and/or C corporations that there is a presumption that such entity is not a RPE (so that such entity is not required to report information required by these Proposed Regulations) unless the RPE has knowledge that it has indirect owners that are individuals. Individuals who wish to obtain the benefit of the Section 199A deduction for a business held through tiers of RPEs may contract to obtain the required information.

B. Proposed Regulations Section 1.199A-2

Proposed Regulations Section 1.199A-2 provides the rules for calculating and allocating among members of a RPE the amount of W-2 wages and the UBIA in qualified property attributable to a QTB. Treasury has requested comments on several aspects of these Proposed Regulations. As a general matter we agree with the government's approach to calculation and allocation of W-2 wages. We believe that the importation of old Section 199 standards reflects a sensible and administratively efficient resolution to many of the issues and uncertainties noted in our Prior Report.[18] However, we have a number of comments and recommendations with respect to the provisions addressing UBIA in qualified property, which we describe below.

1. UBIA

As described above, if a taxpayer's income for any taxable year exceeds the Threshold Amount, then the taxpayer's Section 199A deduction is subject to limitation to the extent of the greater of (x) 50 percent of the W-2 wages with respect to the QTB or (y) the sum of 25 percent of the W-2 wages with respect to the QTB, plus 2.5 percent of the UBIA in qualified property (the "***UBIA Limitation***").[19] Proposed Regulations Section 1.199A-2 contains the proposed rules regarding the calculation and allocation of UBIA in qualified property for the purposes of the UBIA Limitation. Our comments regarding these Proposed Regulations largely fall into three groups: (a) the interaction of the UBIA Limitation rules and Subchapter K with respect to RPEs,

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this concept (including how disregarded entities are treated for this purpose) through an example would be helpful to taxpayers considering the application of Section 199A to investments often conducted in multiple entity form, like the real estate investment activities described in this paragraph.

[17] Proposed Regulations Section 1.199A-1(b)(9). A trust or estate is treated as a RPE to the extent it passes through QBI, W-2 wages, UBIA in qualified property, qualified REIT dividends, or qualified PTP income.

[18] Prior Report at 27-28.

[19] Section 199A(b)(2)(B).

(b) the effect of non-recognition transactions on the UBIA Limitation, and (c) certain technical comments.

a. UBIA Rules and Subchapter K

We note that the Proposed Regulations lead to some strange results in connection with common commercial transactions with respect to RPE interests that are partnership interests. In particular, we believe that further consideration is required with respect to approach of the Proposed Regulations to (1) allocations of UBIA in qualified property from a partnership and (2) adjustments to asset basis pursuant to Sections 734(b) and 743(b).

(1) Allocations of UBIA from Partnerships

Section 199A(f)(1)(A)(iii) requires that with respect to any partnership RPE, each partner is treated as having UBIA in qualified property "in an amount equal to such person's 'allocable share' of the UBIA in qualified property." Section 199A(f)(1) further clarifies in flush language that a partner's "allocable share" of UBIA in qualified property is determined "in the same manner as the partner's. . . allocable share of depreciation." In interpreting this language, Proposed Regulations Section 1.199A-2(a)(3) generally provides that in the case of qualified property held by a partnership, each partner's share of the UBIA in qualified property is an amount which bears the same proportion to the total UBIA in qualified property as the partner's share of tax depreciation bears to the RPE's total tax depreciation, with respect to the property for the year.

Importantly, the Proposed Regulations appear to reflect a decision to base a partner's allocable share of depreciation under the Section 704(c) rules on "tax" allocations rather than the Section 704(b) rules applicable to "book" allocations. While we believe that measuring a partner's allocable share of UBIA in qualified property based on "tax" allocations rather than "book" allocations may arguably hew more closely to the text of Section 199A(f)(1)(A)(iii), we do not believe that this is required by the statute, and we note below several technical issues that arise as a result of this decision.[20]

i. Application of Section 704(c) Principles to UBIA

We note as an initial matter that the decision to base UBIA allocations on "tax" allocations will have significant consequences in the case of qualified property that is contributed to a partnership at a time when the fair market value of the property significantly exceeds its tax basis.

[20] We acknowledge that the Treasury Regulations have used the term "allocable share" to refer to Section 704 allocations (taking into account Section 704(c)) in the past, but we do not believe that such usage is binding in the Section 199A context. *See, e.g.*, Treasury Regulations Section 1.1446-6 ("A foreign partner's allocable share of partnership ECTI for the partnership's taxable year that is allocable under section 704 to a particular foreign partner is equal to that foreign partner's distributive share of partnership gross income and gain for the partnership's taxable year that is effectively connected and properly allocable to the partner under section 704 and the regulations thereunder, reduced by the foreign partner's distributive share of partnership deductions for the partnership taxable year that are connected with such income under section 873(a) or 882(c) and properly allocable to the partner under section 704 and the regulations thereunder, in each case, after application of the rules of this section.").

This result follows from the application of the ceiling rule under Treasury Regulations issued under Section 704(c), as illustrated in the following example:

> **Example 2.** A and B form partnership AB in year 1 to conduct a QTB and agree that each will be allocated a 50 percent share of all partnership items. AB will make allocations under Section 704(c) using the traditional method. A contributes Asset 1, which is qualified property with an adjusted tax basis of $4,000 and a fair market value of $10,000, and B contributes $10,000 cash. Asset 1 is depreciated using the straight-line method and has a remaining useful life of 5 years, but a remaining UBIA life of 8 years. Under the traditional method, in year 1, each of A and B would be allocated $1,000 per year of Section 704(b) book depreciation, but 100 percent of the $800 of tax depreciation with respect to Asset 1 is allocated to B. Accordingly, 100 percent of the UBIA with respect to Asset 1 is allocated to B under Proposed Regulations Section 1.199A-2(a)(3).

The result of Example 2 is to shift 100 percent of the UBIA with respect to Asset 1 from A to B during the remaining useful life of Asset 1. Thus, A has potentially suffered a significant decrease in her entitlement to a deduction under Section 199A as a result of the contribution of Asset 1 to AB (beyond the simple loss of UBIA associated with the nonrecognition transfer of Asset 1 to the partnership, which we discuss below in Part III.B.1.b). We believe that substantially similar results would generally be achieved if a partnership were to use the "remedial method" described in Treasury Regulations Section 1.704-3(d).[21]

The results contemplated by the Proposed Regulations are perhaps even more surprising and counterintuitive in the case of Section 704(c) allocations made using the traditional method with curative allocations. The traditional method with curative allocations generally permits a partnership to make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners.[22] Treasury Regulations issued under Section 704(c) specifically contemplate that "if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of Section 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference, notwithstanding that the corresponding book depreciation is allocated to the contributing partner."[23] However, Treasury Regulations Section 1.704-3(c)(3)(iii) provides that to be "reasonable," a curative allocation "must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule."

It is not entirely clear how the traditional method with curative allocations should be applied with respect to qualified property in the context of a RPE, as illustrated in the following example:

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21 And indeed, similar results occur upon a revaluation of property under Treasury Regulations Section 1.704-1(b)(2)(iv)(*f*).

22 Treasury Regulations Section 1. 704-3(c)(1).

23 *Id.*

> **Example 3.** The facts are the same as Example 2, except that AB elects to use the traditional method with curative allocations, and AB uses $2,000 of the cash contributed by B to acquire Asset 2, which is qualified property that is depreciated using the straight-line method over a 10-year recovery period. As is the case in Example 2, all $800 of the depreciation deductions generated with respect to Asset 1 are allocated to B under the ceiling rule. If the partnership did not make any curative allocations with respect to Asset 2, $100 of the $200 of depreciation attributable to Asset 2 would be allocated to A, and the remaining $100 would be allocated to B. However AB makes a curative allocation of $100 of depreciation from Asset 2 to B such that B is allocated 100 percent of the depreciation deductions with respect to Asset 2. It appears that B therefore is allocated 100 percent of the UBIA with respect to Asset 1 and Asset 2.

Example 3 assumes that curative allocations of depreciation from Asset 2 are "reasonable," and therefore the traditional method with curative allocations, as further described in Treasury Regulations Section 1.704-3(c) is available. However, Treasury Regulations Section 1.704-3(c)(3)(iii) provides that to be a reasonable method, a curative allocation "must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule." The rule further provides that "if the item limited by the ceiling rule is depreciation or other cost recovery, a curative allocation of income to the contributing partner must be expected to have substantially the same effect as would an allocation to that partner of partnership income with respect to the contributed property." It is unclear to us whether an increased availability of the Section 199A deduction would therefore preclude the application of the traditional method with curative allocations in such circumstances. Such an interpretation would in essence mean that curative allocations of depreciation generated by qualified property could never be "reasonable" within the meaning of the Treasury Regulations, at least in scenarios where the existence of UBIA in qualified property would make the difference between a Section 199A deduction and no deduction for a particular partner, because, by definition, a curative allocation of depreciation from qualified property will increase the noncontributing partner's allocable share of UBIA with respect to qualified property.

Whether these results were intended by Congress when crafting Section 199A is not clear based on the legislative history, but we believe that consideration should be given to whether and to what extent substantial shifts in UBIA in qualified property as a result of Section 704(c) principles are appropriate when applying Section 199A. At a minimum, we recommend that any final regulations issued under Section 199A confirm the application of Section 704(c) principles in the circumstances described above, and particularly address whether and to what extent the traditional method with curative allocations may be permitted with respect to depreciation with respect to qualified property.

But we also recommend that Treasury consider an alternative approach to allocating UBIA in qualified property allocations of Section 704(b) items. Under this approach, UBIA in qualified property would be allocated to the partner or partners to whom allocations of depreciation are made for Section 704(b) book purposes under Treasury Regulations Section 1.704-1(b)(2)(iv)(*g*). Although we acknowledge that the statutory support for such an approach is less clear, we do think that such an approach would align the allocation of UBIA in qualified property more closely with the partners' economic investment in the qualified property in question. That is, Section 704(b) book allocations of depreciation, which require substantial economic effect or being in accordance with the partner's interest in the partnership, should tend to represent each partner's entitlement to the economic gains and losses with respect to the asset in question. Such an approach should minimize swings of UBIA in qualified property as among partners, unless special allocations are used in a manner that causes swings of the underlying Section 704(b) book allocations. As discussed below, an anti-abuse approach could be used to govern any abusive such allocations (though we think that the existing Subchapter K rules are reasonably effective on their own). We believe that this approach is also the natural corollary of our recommendation with respect to non-recognition transactions discussed below in Part III.B.1.b but believe it should apply in any event because of the distortions caused by Section 704(c) (and reverse Section 704(c)) allocations.[24]

ii. Qualified Property Not Producing Tax Depreciation – Deemed Liquidation Approach

Proposed Regulations Section 1.199A-2(a)(3) provides that where qualified property no longer produces tax depreciation, each partner's share of UBIA in qualified property is based on how gain would be allocated to the partners pursuant to Sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. Although we appreciate the standard may, in many cases, deliver appropriate results, we believe that the proposed approach poses substantial administrative difficulty and in some cases leads to surprising and counterintuitive outcomes. In addition, as the goal of the Proposed Regulations appears to be to allocate the original cost basis of property, we think it is strange to use fair market value at a later date (which may be more or less than the original cost) to allocate such cost basis for UBIA purposes. Accordingly, we recommend reconsideration of the Proposed Regulations' approach.

Beginning with our administrative concerns, Proposed Regulations Section 1.199A-2(a)(3) requires the partnership to determine the fair market value of all qualified property that does not produce tax depreciation. In many cases such property will have been held by the taxpayer for a significant period of time before tax depreciation is exhausted, making an accurate determination of fair market value uncertain and potentially costly. This is especially the case where presumptions analogous to the "value equal basis" rule of Treasury Regulations Section 1.704-1(b)(2)(iii)(c) are not be available (*i.e.*, because tax depreciation is exhausted, "book" depreciation will often be exhausted as well).

Additionally, the approach of the Proposed Regulations can lead to particularly strange results when applied to property that is subject to the requirements of Section 704(c) depending

[24] We note that in certain cases partnerships may not maintain capital accounts in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv). In such a case Treasury might consider permitting UBIA to be allocated in accordance with each partner's tax allocation of items of depreciation from qualifying property. Alternatively, regulations under Section 199A could operate in a manner that effectively assumes Section 704(b) "book" allocations even if capital accounts are generally not maintained. Treasury Regulations Section 1.704-3(a)(3) takes a similar approach, providing that "[a] partnership that does not maintain capital accounts under § 1.704-1(b)(2)(iv) must comply with this section using a book capital account based on the same principles (*i.e.*, a book capital account that reflects the fair market value of property at the time of contribution and that is subsequently adjusted for cost recovery and other events that affect the basis of the property)."

on the Section 704(c) method selected by the partnership for such property, as the example below illustrates.

> **Example 4.** A and B form partnership AB and agree that each will be allocated a 50 percent share of all partnership items. AB will make allocations under Section 704(c) using the traditional method with "back-end" curative allocations described in Treasury Regulations Section 1.704-3(c)(3)(iii)(b). A contributes Asset 1, which is qualified property with an adjusted tax basis of $2,000 and a fair market value of $10,000, and B contributes $10,000 cash. Asset 1 is depreciated using the straight-line method over a 5-year recovery period and was acquired by A four years prior to the contribution to AB.
>
> For the first year that AB holds Asset 1, B is allocated all $2,000 of tax depreciation with respect to Asset 1, and therefore B is allocated 100 percent of the UBIA with respect to Asset 1. However, assume that at the end of year 2, Asset 1 has a fair market value of $8,000. Because under applicable Section 704(c) principles A would be allocated 100 percent of the gain with respect to Asset 1, 100 percent of the UBIA with respect to Asset 1 would be allocated to A in year 2.

This "flipping" of UBIA in qualified property is likely to occur in many cases involving Section 704(c) property, including, and counterintuitively, as a result of "reverse" Section 704(c) allocations required as a result of a book-up of a partnership's assets to fair market value under Treasury Regulations Section 1.704-1(b)(2)(iv)(*f*). This is the natural result of the Proposed Regulations' use of rules based on loss/deduction when an asset is generating tax depreciation, and the use of rules based on income/gain when an asset no longer generates tax depreciation.

These results seem inappropriate to us and we do not believe this rule is mandated by the text of Section 199A. Accordingly, we recommend that Treasury consider the following alternatives when finalizing the Proposed Regulations, particularly if they do not adopt our recommended approach of using "book" allocations to drive allocations of UBIA in qualified property:

- Rules based on the allocation of nonrecourse indebtedness under Treasury Regulations Section 1.752-3.

- Rules based on the application of the remedial method under Treasury Regulations Section 1.704-3 where tax depreciation is exhausted.

- Rules based on a hypothetical allocation of loss if the qualified property had a tax basis equal to a specified amount (*e.g.*, UBIA).

- Rules "freezing" the allocation of UBIA in qualified property based on the final year in which tax depreciation was actually generated with respect to contributed property.

- Rules allocating UBIA in qualified property in proportion to the aggregate depreciation deductions previously allocated to each partner.

Any of the rules described above would need to be carefully considered and the potential for inappropriate tax planning would need to be properly assessed in each case. But we believe that each of these rules may ultimately produce a more administrable rule with more logical outcomes in terms of the allocation of UBIA in qualified property, assuming that any final regulations retain the approach of the Proposed Regulations to allocate UBIA in qualified property based on tax depreciation.

iii. Special Allocations of Depreciation Deductions

In our Prior Report[25] we raised the possibility of an anti-abuse provision to address special allocations of depreciation that cause shifts in UBIA among the partners. We noted in our Prior Report that we believed as a general matter that the substantial economic effect standard for Section 704(b) allocations would generally provide an appropriate safeguard for special allocations of depreciation deductions to manipulate the allocation of UBIA.[26] We suggested that any anti-abuse rule 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 one or more partners.[27]

It does not appear that the Proposed Regulations prohibit or in any way limit a partnership's ability to specially allocate items of W-2 wages or depreciation to its partners so long as such special allocations have substantial economic effect under Section 704(b) principles or otherwise constitute valid allocations pursuant to Section 704(c). We continue to believe that, in general, the Subchapter K requirements with respect to partnership allocations provide a sufficient backstop for addressing special allocations that might otherwise shift W-2 wages and UBIA in qualified property among partners. However, we recommend that if Section 704(c) principles continue to govern the allocation of UBIA with respect to contributed property, Treasury should include a specific anti-abuse rule aimed at the improper use of a Section 704(c) method to increase a Section 199A deduction and, if appropriate, address abusive taxpayer positions through future guidance. We also believe that this anti-abuse rule should extend to the method chosen for allocating UBIA in qualified property after the tax basis of partnership property is eliminated, as we believe whatever method is chosen could lead to abuse.

iv. Adjustments to Asset Basis Pursuant to Sections 734(b) and 743(b)

As discussed in greater detail below, the Proposed Regulations generally provide that UBIA in qualified property is equal to the basis on the placed in service date of such property as determined under Section 1012 or other applicable Sections of Chapter 1 of the Code. The

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25 Prior Report at 31.

26 *Id.*

27 *Id.*

Proposed Regulations specifically note that for these purposes "other applicable sections" include Subchapter O, Subchapter C, Subchapter K and Subchapter P.[28]

In contrast to the general definition of basis for these purposes that takes into account the rules of Subchapter K, Proposed Regulations Section 1.199A-2(c)(3)(iii) provides that basis adjustments under Sections 734(b) and 743(b) are not treated as qualified property. In explaining the exclusion of Section 734(b) and Section 743(b) adjustments from the definition of "qualified property," the Preamble expresses concern that treating these special basis adjustments as qualified property could result in inappropriate duplication of UBIA in qualified property.[29]

Whether and to what extent transfers of partnership interests or distributions from partnerships should result in adjustments to UBIA represents a highly complex and difficult issue. As a general matter, we believe that Treasury should base guidance in this area on the following three principles: (1) first, guidance should seek to create parity as between sales or exchanges of partnership interests and acquisitions of undivided interests in partnership assets, (2) second, guidance should seek to create a regime in which UBIA in qualified property is generally conserved in the case of partnership distributions of such property (*i.e.*, aggregate UBIA as between partnership and partner should generally be the same following a distribution of partnership assets as it was prior to such distribution), (3) third, any guidance should seek to set an appropriate balance between administrability and precision of results afforded.

We have considered three approaches that may be used to address the types of transactions at issue. Because we believe that each approach has significant benefits and drawbacks, we have provided an explanation of each of the three approaches, but have not adopted a specific recommendation for Treasury at this time.

The first of these approaches simply ignores Section 734(b) and Section 743(b) adjustments when measuring UBIA in qualified property, consistent with the approach in the Proposed Regulations. This approach is by far the most administratively manageable, but as illustrated below, offers problematic opportunities for tax planning and traps for unwary taxpayers. The second approach adjusts UBIA in qualified property based on adjustments to tax basis pursuant to Section 734(b) or Section 743(b). This approach is administratively more complex than the first approach, but this approach in some (but not all) cases creates parity between transfers of partnership interests and assets sales, and in some (but not all) cases conserves UBIA in the case distributions of qualified property. The final approach we considered requires an entirely new regime for UBIA that mirrors the principles of Sections 734, 743, and 755. This approach is the most administratively complex, but offers the greatest likelihood of creating parity between transfers of partnership interests and assets sales and conserving UBIA in the case of distributions of qualified property. We explain each of these alternatives in greater detail, below.

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[28] Proposed Regulations Section 1.199A-2(c)(3).

[29] Preamble at 40889.

(A) Approach #1: No Adjustment to UBIA Upon Events Giving Rise to a Section 734(b) or Section 743(b) Adjustment

The first approach we considered is the approach taken in the Proposed Regulations—that Section 734(b) and Section 743(b) adjustments are ignored when measuring a partner's share of UBIA in qualified property. The most obvious benefit of this approach lies in its simplicity. Where no adjustments are made to UBIA in qualified property in connection with transfers of partnership interests or distributions of partnership property, measurement of a partner's share of UBIA in qualified property becomes a relatively simple exercise of (1) determining such UBIA with respect to the asset, and (2) determining each partner's allocable share of the partnership's UBIA. As the Preamble correctly notes, this approach may in some cases avoid duplication of UBIA, as illustrated by the following example:

> **Example 5.** X and Y form partnership XY, each contributing $10,000 cash and agreeing to share all partnership items pro rata (*i.e.* 50/50). XY purchases Asset 1 for $20,000. Asset 1 is qualified property that is subject to straight-line depreciation over a ten-year period. At the beginning of year 6 when Asset 1 has a tax basis of $10,000 and a fair market value of $20,000, X sells her interest in XY to Z for $10,000. XY makes an election under Section 754 for the year in which the sale from X to Z occurs. Pursuant to Section 743(b), XY increases its basis in Asset 1 by $5,000 (*i.e.*, the excess of Z's basis in its partnership interest over Z's share of the adjusted basis of the partnership's property). In year 6, XY allocates each of Y and Z 50 percent of the depreciation deductions attributable to Asset 1 before taking into account the Section 743(b) adjustment, and accordingly Y and Z are each allocated $10,000 of XY's $20,000 UBIA with respect to Asset 1. If Z's $5,000 Section 743(b) adjustment were treated as "qualified property," Z's UBIA would be $15,000, resulting in duplication of UBIA.

However, the decision not to make adjustments to UBIA with respect to events that would give rise to basis adjustments under Section 734(b) and Section 743(b) comes at a cost. Where the fair market value of an asset exceeds its UBIA at the time a partnership interest is sold or exchanged, partners are arguably penalized for purchasing a partnership interest as opposed to acquiring an undivided interest in the assets of the partnership, as illustrated in the following example:

> **Example 6.** The facts are the same as in Example 5, except that at the beginning of Year 6, Asset 1 has a fair market value of $30,000 instead of $20,000 and Z purchases X's interest in XY for $15,000. In year 6, XY allocates each of Y and Z 50 percent of the depreciation deductions attributable to Asset 1 before taking into account the Section 743(b) adjustment, and accordingly Y and Z are each allocated $10,000 of XY's $20,000 UBIA with respect to Asset 1.

In this example, had Z purchased an undivided 50 percent interest in Asset 1, Z would have had UBIA in qualified property of $15,000 (*i.e.*, 50 percent of Asset 1's $30,000 fair market value). However, Z's allocable share of UBIA is in fact only $10,000 as a result of Z's purchase of a partnership interest in XY.

Perhaps more troubling is the failure to take into account Section 734(b) and Section 743(b) downward adjustments. Because UBIA of assets that have depreciated in value can be retained and effectively transferred to new partners where no downward adjustment is made, the approach incentivizes taxpayers to engage in certain partnership transactions where UBIA in qualified property is high but the fair market value of such property is low.

> **Example 7.** X and Y form partnership XY, each contributing $10,000 cash and agreeing to share all partnership items pro rata (*i.e.*, 50/50). XY purchases Asset 1 for $20,000. Asset 1 is qualified property that is subject to straight-line depreciation over a ten-year period. At the beginning of year 6 when Asset 1 has a tax basis of $10,000 and a fair market value of $1,000, Z wishes to acquire Asset 1. Rather than purchase Asset 1 directly, Z acquires 49.5 percent of the interests in XY from each of X and Y (*i.e.*, in total a 99 percent interest in XY) in exchange for $990. Under Section 743(b), XY must reduce the tax basis of Asset 1 by $8,910 (the excess of Z's $9,900 share of adjusted partnership basis over Z's outside basis of $990). In year 6, XY allocates each of X and Y 0.5 percent of the depreciation deductions attributable to Asset 1 and XY allocates to Z 99 percent of the depreciation deductions attributable to Asset 1 before taking into account the Section 743(b) adjustment, resulting in Z apparently being allocated $19,800 of UBIA.

Similarly problematic results occur in the case of fact patterns that require downward Section 734(b) adjustments:

> **Example 8.** E, F and G form partnership EFG. E contributes $5,000 to EFG, F contributes $4,900 to EFG, and G contributes $100 to EFG. The partners agree to allocate all losses pro rata based on contributed capital (*i.e.* 50 percent to E, 49 percent to F and 1 percent to G). EFG acquires Asset 1 for $8,000 and Asset 2 for $2,000. Each of Asset 1 and Asset 2 is qualified property. At a time when Asset 1 is worth $2,550 and Asset 2 is worth $2,450, but the partners' outside basis in their partnership interests is unchanged, EFG distributes Asset 2 to F in liquidation of F's interest in EFG.
>
> Under Section 732(b), F takes Asset 2 with an adjusted basis of $4,900. Under Section 734(b)(2), EFG must reduce its basis in Asset 1 by $2,900 (the amount by which F's basis in Asset 2 exceeds EFG's basis in Asset 2). However, applying the UBIA rules as drafted in the Proposed Regulations, F's UBIA in Asset 2 appears to be $4,900, while EFG's UBIA in Asset 1 remains $8,000. In effect, it appears $2,900 of UBIA has been duplicated as a result of the failure to take into account the Section 734(b) adjustment.

We believe the results of Examples 7 and 8 are inappropriate as a policy matter, but are nonetheless mandated by the text of the Proposed Regulations. While it may be possible to attack these transactions on anti-abuse grounds (either through a newly adopted rule for purposes of Section 199A in final regulations or by virtue of Treasury Regulations Section 1.702-1(e)), the alternative approaches to adjusting UBIA in qualified property that are described below may prove more effective in discouraging abusive transactions involving Section 734(b) and Section 743(b) adjustments (albeit at the cost of greater administrative complexity).

(B) Approach #2: UBIA Adjustments Based on Section 734(b) and Section 743(b) Adjustments

The second approach we considered involves the increase or decrease of UBIA based on adjustments made under Section 734(b) and Section 743(b), with appropriate modifications to avoid duplication. For example, in the case of Section 743(b) adjustments, upward adjustments might be taken into account solely to the extent the fair market value of an asset (as determined for purposes of Treasury Regulations Section 1.755-1) exceeds its UBIA. In the case of assets that have appreciated above their UBIA, this approach avoids duplication of UBIA with respect to such asset and equalizes the UBIA with respect to such asset of a transferee partner when comparing the transfer of an interest in a partnership to an acquisition of the partner's pro rata share of an interest in the partnership's assets.

> **Example 9.** The facts are the same as in Example 5, except that at the beginning of Year 6, Asset 1 has a fair market value of $30,000 instead of $20,000 and Z purchases X's interest in XY for $15,000. Pursuant to Section 743(b), XY increases its basis in Asset 1 by $10,000 (*i.e.*, the excess of Z's basis in its partnership interest over Z's share of the adjusted basis of the partnership's property). Z's share of the adjusted basis of partnership property taking into account the Section 743(b) adjustment is $15,000, and Z's share of UBIA is $10,000. Accordingly, $5,000 of the Section 743(b) adjustment is treated as qualified property under this proposed rule.
>
> In year 6, XY allocates each of Y and Z 50 percent of the depreciation deductions attributable to Asset 1 before taking into account the Section 743(b) adjustment, and accordingly Y and Z are each allocated $10,000 of XY's $20,000 UBIA with respect to Asset 1. XY allocates to Z 100 percent of the depreciation deductions attributable to the Section 743(b) adjustment, and accordingly Z is allocated $5,000 of UBIA attributable to the Section 743(b) adjustment.

Unfortunately, however, tying UBIA adjustments to adjustments under Section 734(b) and Section 743(b) does not always provide a result that equalizes a transferee partner's UBIA as between a purchase of a partnership interest and a purchase of partnership assets. For example, where the fair market value of an asset is less than its UBIA but greater than its adjusted tax basis at the time of the transfer of a partnership interest, Section 743(b) contemplates an *upward* adjustment in adjusted tax basis, but parity of UBIA as between transfers of partnership interests and partnership assets would mandate a *downward* adjustment in its UBIA.

> **Example 10.** The facts are the same as in Example 5, except that at the beginning of Year 6, Asset 1 has a fair market value of $16,000 instead of $20,000 and Z purchases X's interest in XY for $8,000. Pursuant to Section 743(b), XY increases its basis in Asset 1 by $3,000 (*i.e.*, the excess of Z's basis in its partnership interest over Z's share of the adjusted basis of the partnership's property). Because the Section 743(b) adjustment is upward, Z appears to retain UBIA of $10,000 in Asset 1 notwithstanding that Z would have had UBIA of $8,000 in Asset 1 if Z had purchased a 50 percent undivided interest in the asset.

We also believe that the results that arise in connection with downward Section 743(b) adjustments warrant caution. In particular, because adjusted tax basis in nearly every case will be less than UBIA in qualified property, simply matching a UBIA adjustment to a downward Section 743(b) adjustment will fail to result in parity in results as between acquisitions of partnership interests and acquisitions of partnership assets.

> **Example 11.** The facts are the same as in Example 7. However, pursuant to Treasury Regulations Section 1.743-1(j)(4)(ii) Z is allocated 100 percent of the negative basis adjustment under Section 743(b), which is taken into account in calculating Z's UBIA. Accordingly, Z's allocable share of UBIA in qualified property with respect to XY is reduced by $8,910, and Z's total UBIA with respect to Asset 1 is $10,890 ($19,800 - $8,910).

Notably, the results in Example 11 do not perfectly replicate UBIA in qualified property if Z had directly purchased a 99 percent undivided interest in Asset 1 from XY, and therefore do not perfectly mirror an asset-level transaction. In Example 11, Z is effectively enjoying 99 percent of the UBIA attributable to the depreciation of Asset 1 from $20,000 to $10,000 (*i.e.*, $9,900), and 99 percent of the portion of the UBIA attributable to the remaining $1,000 in value of Asset 1 (*i.e.*, $990) for a total of $10,890.

Finally, we believe that adjustments to UBIA in qualified property based on Section 734(b) can lead to imprecise and counterintuitive results based on the application of Treasury Regulations Section 1.755-1(c). In particular, Treasury Regulations Section 1.755-1(c) contemplates that a distribution of partnership property that is capital gain property requires an adjustment to the partnership's capital gain property. "Capital gain property" for these purposes includes both capital assets and Section 1231(b) property. As such, Section 734(b) and Section 755 offer the possibility of increasing or decreasing the tax basis of qualified property that is Section 1231(b) property in connection with the distribution of capital assets (which are generally not qualified property). We believe this shifting of basis as between property that is "qualified property" and property that is not "qualified property" in some cases presents inappropriate opportunities for tax planning, and in other cases presents traps for unwary taxpayers. However, we believe that these results are likely difficult to avoid if UBIA adjustments are based solely on existing rules under Sections 734, 743 and 755.

(C) Approach #3: Creation of New UBIA Regime to Create Parity Between Transfers of Partnership Interests and Transfers of Partnership Assets

The final approach we considered offers the most accurate results in terms of creating parity as between purchases of partnership interests and purchases of partnership assets and in terms of conserving UBIA in the case of a distribution of qualified property. However, this third approach comes at the cost of the greatest amount of administrative complexity and would require the greatest amount of care in crafting precise guidance. Rather than keying off of the existing regimes for adjustments to tax basis under Sections 734, 743, and 755, the third approach creates an entirely new regime in which adjustments to UBIA are made without reference to the adjustments required under Section 743(b) or Section 734(b).

While we believe that there are a number of ways to formulate the required adjustments, one approach in the case of a sale or exchange of a partnership interest may be to calculate the transferee partner's share of partnership UBIA without regard to any Section 743(b) adjustment and then adjust the result to take into account the UBIA that would have been allocated to such partner if the UBIA of the qualified property in question were equal to the fair market value of the qualified property at the time of the transferee partner's acquisition of the partnership interest.

> **Example 12.** The facts are the same as in Example 10. The transferee partner Z's $10,000 of UBIA is redetermined by calculating what Z's UBIA would have been if Asset 1 had a UBIA equal to $16,000 (*i.e.*, the fair market value of Asset 1 at the time of Z's acquisition). Accordingly, Z's allocable share of UBIA is reduced to $8,000 (*i.e.*, $16,000 x Z's 50 percent share of UBIA).

This formulaic approach similarly provides more accurate results in the case of a fact pattern requiring a downward adjustment in both UBIA and adjusted tax basis:

> **Example 13.** The facts are the same as in Example 7. Z is initially allocated 99 percent of the $20,000 UBIA of Asset 1 (*i.e.*, $19,800). However, under this proposed formula, Z's UBIA is redetermined by calculating what Z's UBIA in Asset 1 would have been if Asset 1 had a UBIA equal to $1,000 (*i.e.*, the fair market value of Asset 1 at the time of Z's acquisition). Accordingly, A's UBIA with respect to Asset 1 for Year 6 is $990 (*i.e.*, $1,000 x Z's 99 percent share of UBIA).

Partnership distributions that would give rise to Section 734(b) adjustments present a more difficult problem in terms of creating a new regime for adjusting UBIA. We can envision at least two variations with respect to partnership distributions. In the first variation, a new regime analogous to Section 755 and the Treasury Regulations promulgated thereunder would be adopted such that when a partner receives a distribution of partnership qualified property and takes UBIA in excess of the partnership's UBIA in such asset by virtue of the application of Section 732(b), such excess reduces the UBIA of the qualified property of the partnership. Inverse adjustments would be made in the event a partner receives a distribution of qualified property and takes UBIA that is less than the partnership's UBIA in such asset.

> **Example 14.** The facts are the same as in Example 8. Upon the distribution of Asset 2 to F, EFG reduces its UBIA in Asset 1 by $2,900 (*i.e.*, the excess of the $4,900 UBIA that F takes in Asset 2 pursuant to Section 732(b) over the $2,000 UBIA of Asset 2 in the hands of the partnership). Accordingly, UBIA of Asset 1 is reduced from $8,000 to $5,100. This results in an aggregate UBIA of $10,000 as between E, F and G both before and after the distribution of Asset 2.

Alternatively, a second variation would seek to avoid recreating a new Section 755 regime, and instead would create a hypothetical UBIA increase or reduction that is allocated among continuing partners when qualified property is subject to adjustment upon distribution to a partner. Thus, where a partner receives a distribution of partnership qualified property and takes UBIA in excess of the partnership's UBIA in such asset by virtue of the application of Section 732(b), such excess results in a negative adjustment to the UBIA of the continuing partners and may be allocated, for example, pro rata based on the aggregate allocation of UBIA in qualified property to each partner.

> **Example 15.** The facts are the same as in Example 14. Rather than reducing UBIA of Asset 1 from $8,000 to $5,100, Asset 1 retains UBIA of $8,000, but EFG creates a negative UBIA adjustment of $2,900 that will be allocated to the partners of UBIA based on their pro rata share of UBIA allocated from Asset 1 and any other qualified property owned by EFG.

Importantly, neither of these variations provides perfect conservation of UBIA in qualified property where the partnership no longer holds any qualified property following the distribution in question (in which case the partner has no UBIA in qualified property) or where a required downward adjustment to UBIA exceeds the aggregate UBIA in qualified property that the partnership claims in qualified property. In such a case, aggregate UBIA as between the partner receiving the distribution and the partnership is effectively increased. This result is analogous to a situation in which a required downward adjustment pursuant to Section 734(b) exceeds the adjusted tax basis of partnership assets (in which case partnership asset basis is reduced to zero, but not below zero pursuant to Treasury Regulations Section 1.755-1(c)(3)). Thus, we believe that the case for Section 734(b) adjustments changing UBIA in qualified property may be harder to justify.

As noted at the onset of this discussion, in light of the substantial complexity associated with the interaction of Section 199A and the principles of Section 734(b) and Section 743(b), we have not adopted a specific recommendation as to which of the three approaches described above should be adopted. We encourage Treasury to carefully consider the various benefits and challenges of each approach described above when crafting guidance on this important topic, and we stand ready to provide additional thoughts and analysis on this issue upon the government's request.

b. UBIA Rules and Non-Recognition Transactions

Proposed Regulations Section 1.199A-2(c)(2)(iv) appears to borrow from Section 168(i)(7) to determine the effect of non-recognition transactions for purposes of calculating the amount of UBIA with respect to qualified property that an entity inherits for purposes of the UBIA limitation. Under the Proposed Regulations, the transferee entity inherits both the holding period of the qualified property and the basis of the qualified property for UBIA purposes, to the extent that the basis does not exceed the transferor's basis. To the extent that the transferee has an increase in the basis, that portion is treated as a separate piece of property with a new placed in service date.

In practice, the effect of this rule is to limit the availability of UBIA in qualified property to support a Section 199A deduction after a non-recognition transaction. Proposed Regulations Section 1.199A-2(c)(4) Example 3 confirms this result. In Example 3, C operates a QTB in a sole proprietorship. In the example, C has a machine with a cost basis of $10,000 that C purchased in 2011. In 2018, when C's basis in the machine is $2,500, C incorporates her sole proprietorship as an S corporation in a transaction described in Section 351. The example concludes that for purposes of determining the S corporation's remaining ten-year period for UBIA, it should take a tacked holding period in the asset. Therefore, for purposes of the UBIA limitation, the machine's placed in service date is in 2011. However, for purposes of computing the amount of UBIA eligible to be counted towards the UBIA limitation, the S corporation uses the adjusted basis of the property upon its contribution (*i.e.*, $2,500).[30]

We think that this rule leads to counter-intuitive results that are not required by the statute in several instances, including the example described, above. To the extent that through 2018 C was using the UBIA of the machine to support her Section 199A deduction, merely by incorporating, C could lose the benefit of Section 199A.[31] Similarly, if C combined her business with a similar business run by D into a partnership, both C and D would lose UBIA and therefore potentially the eligibility for the deduction.[32] We do not think that the statute should be interpreted in a manner that chills the formation of business entities, particularly where the transaction in question involves an entire trade or business that is merely being operated in another form.[33]

A close examination of the legislative text and legislative history supports our view. Section 199A(b)(2)(B)(ii) refers to "the unadjusted basis immediately after the acquisition of all qualified property." The Proposed Regulations appear to take the view that this requires the measurement of UBIA after the "acquisition" by a taxpayer of qualified property, for this purpose treating a non-recognition transaction as an "acquisition." However, Section 199A(b)(2)(B)(ii) does not specify an acquisition by a taxpayer. We think that the better reading of this language is that "unadjusted basis immediately after the acquisition of qualified property" is a single concept that is meant to describe the quantum of basis that is available with respect to any qualified property.

Put differently, we believe that "unadjusted basis immediately after the acquisition" of qualified property is measured by relation to, and with respect to, a QTB rather than with respect to a specific taxpayer. We believe that this reading is supported by the statutory text and the

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30 Proposed Regulations Section 1.199A-2(c)(2)(iv)(B). Section 168(i)(7) provides that if any property is transferred in a Section 332, 351, 361, 721 or 731 transaction, the transferee steps into the shoes of the transferor for purposes of computing the depreciation deduction available to the transferee with respect to its carryover basis. Thus, under Section 168(i)(7) for purpose of computing its depreciation deduction, the S corporation would be treated as inheriting the machine with a basis of $2,500, which it can continue to depreciate on the same schedule as did C. Proposed Regulations Section 199A-2(c)(2)(iv) comes to a slightly different conclusion with respect to this transaction for purposes of Section 199A. It appears to apply a step in the shoes rule with respect to the remaining depreciable period, BUT also mechanically looks at the property as if it were newly placed in service for Section 199A UBIA purposes.

31 We acknowledge that if C wished to limit her liability, C could form a single member LLC under applicable state law and these results would not apply.

32 Section 721 is a transaction covered by Section 168(i)(7).

33 We note that regulations under old Section 199 specifically provided that, except in limited circumstances, where property is transferred in a Section 351, 721 or 731 transaction, whether the gross receipts of the entity were domestic production gross receipts was determined based solely on the activities performed by the transferee, and not by reference to any activities performed by the taxpayer prior to the transfer of the relevant property. Treasury Regulations Section 1.199-8(e). A "step in the shoes" concept applied for Section 381 transactions. Treasury Regulations Section 1.199-8(e)(3). But the context for determining domestic production gross receipts (which was a creature of annual accounting) is different than determining UBIA in qualified property.

legislative history. In particular, Section 199A(b)(6) provides that "qualified property" is defined "with respect to any qualified trade or business for a taxable year," and is more specifically defined as "held by, and available for use in, the qualified trade or business at the close of the taxable year." The legislative history also states that "qualified property means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the end of the taxable year."[34] In addition, Section 199A(b)(5) instructs Treasury to provide special rules where a taxpayer acquires or disposes of "the major portion of a trade or business or the major portion of a separate unit of a trade or business." All of this supports the view that UBIA should be measured on a QTB by QTB basis, rather than on a taxpayer by taxpayer basis.

Therefore, we recommend that qualified property's relationship to the QTB being transferred in a non-recognition transaction, rather than whether that trade or business is or was held in any particular form, govern how non-recognition transactions affect its UBIA in qualified property. This approach is consistent with several other provisions where access to certain tax regimes turns on whether or not the transaction is in connection with the transfer of substantially all of the assets of a trade or business. For instance, under Treasury Regulations Section 1.1001-3(e)(4)(C), the substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration. Similarly, qualification as an acquisitive "reorganization" pursuant to Section 368(a)(1)(C) or Section 368(a)(1)(D) requires that substantially all of the assets of the corporation be transferred, and Section 279(c)(3)(A)(ii) provides certain benefits with respect to interest deduction limitations where an acquiring corporation acquires substantially all of the assets of another corporation.[35] Thus, in the case of the transfer of substantially all of the assets of any QTB to an S corporation or other RPE in a non-recognition transaction, the S corporation or RPE should "step into the shoes" of the transferor with respect to both the UBIA in qualified property of the transferor, and with respect to the remaining "depreciable period" for such property under Section 199A(b)(6)(B). For example, under our proposal, in Example 3 in the Proposed Regulations, the S corporation would inherit C's $10,000 UBIA, which would continue to be available to it until the later of 2021 and the last day of the last full year of its recovery period that would otherwise apply to the property.[36]

We believe that our recommendation leads to correct results where two operating businesses are combined as well, particularly taking into account the principles described above.

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34 *See* S. Amdt. 1681 to H.R. 1 § 11011 (Nov. 29, 2017); Conference Report to Accompany H.R. 1, H.R. Rep. 115-466 (1st Session) (hereinafter the "***Conference Report***") at 222.

35 *See also* Rev. Rul. 95-74 1995-2 C.B. 36 (in connection with the transfer of substantially all of the assets associated with a manufacturing business to a newly formed corporation, contingent environmental remediation liabilities were not treated as "liabilities" for purposes of Section 357 or Section 358 of the Code).

36 Alternatively, we could imagine an approach where an entity does take a new UBIA in qualified property based on the carryover basis, but in that case, we think it would be appropriate for a new holding period to start. Given the complexity of maintaining multiple holding periods for multiple purposes, we do not recommend this approach.

For example:

> **Example 16.** C operates a QTB through an S corporation, X. X has a machine with an unadjusted cost basis of $10,000 that X purchased in 2011 (Asset 1). D operates a QTB in a similar line of business through an S corporation, Y. Y also owns a machine with an unadjusted cost basis of $5,000 that it purchased in 2018 (Asset 2). In 2018, when X's basis in Asset 1 is $2,500 and its fair market value is $5,000, C and D decide to merge in a statutory merger treated as a reorganization under Section 368(a)(1)(A).

Under the Proposed Regulations, if C merges into D, then the UBIA in qualified property with respect to the combined businesses is $2,500 with respect to Asset 1 and $5,000 with respect to Asset 2. If D merges into C, however, the UBIA in qualified property with respect to the combined businesses is $10,000 with respect to Asset 1 and $5,000 with respect to Asset 2.

Under the proposal discussed above, the result achieved with a D into C merger under the Proposed Regulations would occur in both cases. While it is certainly the case that in many instances form (and direction of a merger) can lead to drastically different tax results for the parties, we do not see a principled reason why the availability of the UBIA in qualified property should turn on this distinction.

> **Example 17.** C operates a QTB in a sole proprietorship. C has a machine with an unadjusted cost basis of $10,000 that C purchased in 2011 (Asset 1). D has a QTB in a similar line of business, and D also owns a machine with an unadjusted cost basis of $5,000 that it purchased in 2018 (Asset 2). In 2018, when C's basis in Asset 1 is $2,500 and its fair market value is $5,000, C and D contribute their sole proprietorships to a new partnership, CD, each receiving a 50 percent interest. Assume each of Asset 1 and Asset 2 has 5 years of remaining useful life and are subject to straight-line depreciation.

Under the Proposed Regulations, CD would have UBIA of $7,500. CD could access the UBIA associated with (i) Asset 1 until the later of 2021 or the expiration of the asset's remaining recovery period and (ii) Asset 2 until the later of 2028 or the expiration of the asset's remaining recovery period. For years 2018-2023, CD would have $1,000 per year of book depreciation and $500 per year of tax depreciation for Asset 1, and $1,000 per year of book and tax depreciation for Asset 2. Assuming that CD uses the traditional method, D would be allocated $500 of tax depreciation with respect to Asset 1 and $500 of tax depreciation with respect to Asset 2. C would only be allocated $500 of tax depreciation from Asset 2. The UBIA with respect to Asset 1 of $2,500 would be entirely allocated to D, and the $5,000 of UBIA with respect to Asset 2 would be allocated $2,500 to each of C and D.

Under the proposal discussed above, CD would have UBIA in qualified property of $15,000, $10,000 attributable to Asset 1 and allocated entirely to D and $5,000 attributable to Asset 2 split equally between C and D. (Note that if instead, the UBIA in qualified property were allocated based on Section 704(b) book depreciation as proposed above, then C and D would share the UBIA in qualified property of $15,000 equally).

> **Example 18.** J operates a QTB as a sole proprietor through a single member LLC, K. K has an eligible asset (Asset 1) that it purchased in 2011 for $10,000 and no other assets other than self-created goodwill. In 2018, when Asset 1 has been fully depreciated for tax purposes, but has a FMV of $2,500, L invests $12,000 of cash for a 50 percent interest in K. This transaction is treated as a transaction described in Rev. Rul. 99-5 situation 2. L is treated as contributing cash to K and J is treated as treated as contributing the assets of the QTB to K, in a transaction described in Section 721.

Under the Proposed Regulations, K would be treated as having a UBIA in qualified property with respect to Asset 1 of $0. Under the proposal above, K would be treated as having a UBIA with respect to Asset 1 of $10,000 that its owners could access until the later of 2021 or the expiration of its remaining recovery period.

We acknowledge that the proposed approach may not be correct in all circumstances. For instance:

> **Example 19.** Assume the same facts as in Example 17, above. However, in this case, assume that C is a C corporation and D is an individual. In this case, D would be able to access all of the UBIA with respect to Asset 1 contributed by C to CD. Since prior to 2018, C's assets would not have been eligible for the Section 199A deduction (because the asset was not used in any trade or business of an individual or RPE prior to the contribution), query whether D should ever be able to access any UBIA with respect thereto.

We believe that the best reading of the statute and Regulations would in this case reduce the UBIA of Asset 1 to its basis at the time of the contribution (*i.e.*, the time at which it becomes owned by a RPE). This could be clarified in any ultimate non-recognition rule.

There is additional complexity regarding such a rule when a partnership is divided, and in such cases this rule will also have to be coordinated with our recommendations regarding Section 734(b) adjustments. A division of a partnership into two or more partnerships may be treated in one of two ways. Unless an exception applies, the division is generally treated as if the divided partnership contributes certain assets and liabilities to a recipient partnership (or partnerships), then distributes the interests in such recipient partnership in partial or liquidation of the divided partners' interest in the partnership (the so-called "assets over" form).[37] Alternatively, if in form a partnership actually distributes out assets and liabilities to its partners who then contribute such assets and liabilities to a newly formed partnership, the form of that transaction is respected (the so-called "assets up" form).[38] In either case, it appears that under the Proposed Regulations, the UBIA in qualified property of any "recipient partnership" (as defined in Treasury Regulations

[37] Treasury Regulations Section 1.708-1(d)(3)(i).

[38] Treasury Regulations Section 1.708-1(d)(3)(ii).

Section 1.708-1(d)(3), which may or may not be the partnership that in form transfers assets and liabilities) is reset to the adjusted basis of such qualified property at the time of the division.[39]

We think that similar concepts to our other non-recognition examples can apply in these circumstances as well. Where a single RPE conducts two separate and identifiable QTBs, then we believe that it will be relatively easy to determine the UBIA in qualified property that is associated with that QTB on the division of the RPE into two or more entities. Where a single RPE conducting a QTB divides into two or more entities, then we think that tracing rules could apply to allocate the UBIA in qualified property among the resulting partnerships. We suggest an anti-abuse rule, which would restart the UBIA's useful life and basis in certain circumstances.

> **Example 20.** A, B, C and D own equal shares in a bakery run through ABCD LLC, which is taxed as a partnership. The bakery provides counter service and ready to purchase cakes and cookies, but also caters and makes custom treats to order, including for weddings and other large events. ABCD has $100,000 of UBIA in qualified property, the adjusted basis of which is zero. Each of A, B, C and D has an outside basis in their ABCD partnership interest of $25,000. A and B are more interested in operating the bakery, but C and D want to focus on catering and custom orders. In order to accomplish this, ABCD contributes assets and liabilities constituting the dessert catering business (which happen to include 50 percent of ABCD's qualified property) to new CD LLC, then distributes interests in CD LLC to C and D in full redemption of their interests in ABCD.
>
> Assume ABCD has historically tracked and reported the bakery business and the catering business as separate trades or businesses. Under Treasury Regulations Section 1.708-1(d) and Section 721, new partnership CD is initially treated as receiving the qualified property in a non-recognition transaction. As a result of the distribution, each of C and D take a basis in their CD interests equal to their outside basis in ABCD. Under the Proposed Regulations, new partnership CD inherits UBIA in qualified property of zero, and ABCD's UBIA in qualified property is reduced to $50,000.[40] Under our proposal, because CD inherited a separate trade or business of ABCD, CD would retain $50,000 of UBIA (as would ABCD).
>
> Alternatively, assume ABCD has not historically tracked and reported the bakery business and the catering business separately, but rather as a single business. Provided that neither business is an SSTB, we think that it is appropriate for the same result as in the first alternative but tracing the UBIA to property that ends up on the balance sheet of each partnership. However, if either partnership is an SSTB, query whether the step in the shoes rule we propose should apply.

39 *I.e.*, under Proposed Regulations Section 1.199A-2(c)(2)(iv), as a result of the deemed Section 721 transaction, the UBIA in qualified property deemed contributed would be deemed to be equal to its adjusted basis at the time of the division. We believe that the same result occurs in an "assets up" division.

40 Proposed Regulations Section 1.199A-2(c)(1).

> Assume instead that C and D want to open an Italian restaurant using restaurant equipment previously owned by ABCD rather than to run the existing catering business. Query whether the step-in-the-shoes rule we propose should apply or if the property should be treated as newly placed in service in a new business. Although we acknowledge that this rule will require Treasury to determine when a business in historic or new, this is not a novel concept in the tax law.

On balance, given the allocation methodologies we suggest above (and particularly a shift to using "book" rather than "tax" depreciation to govern allocation of UBIA in the Subchapter K context), we believe that UBIA in qualified property will not be inappropriately shifted among partners as long as the "step in the shoes" rule that we propose above is limited to situations in which the associated QTB is transferred. In addition, we suggest an anti-abuse backstop for cases where a principal purpose of the QTB transfer in a non-recognition transaction is to increase the UBIA in qualified property for non-contributing partners.

In addition, in cases where a QTB is not being transferred, we do not necessarily believe that an approach different than that in the Proposed Regulations should apply.

> **Example 21.** Assume the same facts as in Example 17, above, but instead assume that C does not own Asset 1 in connection with a trade or business, but rather in connection with a hobby, and that she originally purchased the asset for $2,500. Assume that Asset 1 has appreciated over its initial basis to $5,000. For valid business reasons, C contributes Asset 1 to CD 2018, which is engaged in a QTB. Under the Proposed Regulations, CD would receive Asset 1 with a UBIA of $2,500, but its placed in service date would be 2018. However, in this case, no special rule is necessary because the asset was first placed in service in a trade or business in 2018.

> **Example 22.** Assume upper tier RPE X owns Asset 1 in connection with its trade or business (QTB A), which it originally purchased in 2011 for $10,000. In 2018, when Asset 1 has an adjusted basis of $2,500, RPE X contributes Asset 1 to RPE Y in a Section 721(a) transaction. RPE Y is engaged in a different QTB that is not (or cannot) be aggregated with RPE X under Proposed Regulations Section 1.199A-4.

Under the Proposed Regulations, RPE Y would have a UBIA with respect to Asset 1 of $2,500, and its owners would be able to apply that UBIA through the later of 2021 and the end of its useful life.

If our proposal did not have a limitation connected to the transfer of substantially all of the assets of a QTB, then RPE Y would inherit RPE X's UBIA with respect to Asset 1. This might shift UBIA in qualified property to partners in X who did not economically fund the original basis in a way that is inappropriate. However, under our proposal, because Asset 1 does not constitute substantially all of the assets of the QTB to which it relates, it would not be eligible for the full step in the shoes approach that we have proposed.

c. Other UBIA Issues

i. Deemed Contributions Under Rev. Rul. 99-5[41]

One very common transaction is one in which an existing sole proprietor sells a portion of her business to a third party for cash, and the business continues to operate as a partnership.

> **Example 23.** J operates a QTB as a sole proprietor through a single member LLC, K. K has an eligible asset that it purchased in 2011 for $10,000 and no other assets other than self-created goodwill. J has decided that she wishes to spend less time focusing on K. In 2018, when the asset has been fully depreciated for tax purposes, but has a FMV of $2,500, J sells a 50 percent interest in J for $12,000 cash to L. This transaction is treated as a transaction described in Rev. Rul. 99-5 situation 1. L is treated as purchasing an undivided interest in each of K's assets for $12,000. Of that amount, $1,250 is treated as allocated to the eligible asset under Section 1060 and the remainder to goodwill. Then each of J and L are treated as contributing their respective portions of the assets to K in a Section 721 transaction. Under the Proposed Regulations, if L elects out of Section 168(k) bonus depreciation, K would have UBIA in the eligible asset of $1,250 which would be allocated between J and L as described above. However, if L does fully expense the asset under Section 168(k), it appears that K has no UBIA at all.[42]

ii. Time for Determining UBIA in Qualified Property

Section 199A and the Proposed Regulations generally provide that UBIA with respect to any particular trade or business is calculated by reference to qualified property held with respect to a qualified trade or business at the close of a taxable year.[43] There is therefore a cliff effect with respect to qualified property — if a QTB disposes of qualified property during a taxable year, then that qualified property is not available for purposes of calculating the amount of UBIA in qualified property available to support the deduction for the taxable year.

However, neither the statute nor the Proposed Regulations are clear as to whose taxable year matters for these purposes, and the application of the rules in cases where interests in pass-through businesses are transferred is unclear.

> **Example 24.** M, N, O and P each own a 25 percent interest in the capital and profits of partnership MNOP. At the end of year 1, MNOP has $100,000 of UBIA in qualified property which is allocated among the partners equally. However, on June 30 of year 2, P sells 100 percent of its interest to Q in an arm's length

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41 1991-1 C.B. 434 (February 8, 1999).

42 See Proposed Treasury Regulations Section 1.168(k)-2(f)(1)(iii). A forthcoming report on those proposed regulations will discuss this special rule in greater detail.

43 Section 199A(b)(6)(A). Proposed Regulations Section 1.199A-3(c)(1).

> transaction. Alternatively MNOP redeems 100 percent of P's interest in MNOP for fair market value.

Under Section 706(c)(2)(A), in either case, the taxable year of MNOP closes with respect to P. However, the taxable years of MNOP and P more generally do not close. Under Section 706(d) and Treasury Regulations Section 1.706-4, MNOP may use any reasonable method to allocate items of income, gain, loss or deduction of the partnership. In each case, is P permitted to utilize a portion of the UBIA in qualified property to support a Section 199A deduction based on such UBIA as of the date that MNOP's taxable year ends with respect to P? May Q (or remaining partners MNO) use the same UBIA with respect to the taxable income allocated to it for the remaining portion of MNOP's taxable year? Must P and Q (or remaining partners MNO) share the UBIA based on the portion of the taxable year's depreciation with respect to such UBIA allocated to them under Section 706?

> **Example 25.** Same facts as Example 18, above, but assume further that on December 30, year 2, MNOP sells 50 percent of its qualified property.

In this example, may P access its share of UBIA in qualified property that existed as of the date that MNOP's taxable year ended with respect to it or is there no UBIA in qualified property available to P at all?

We respectfully request that Treasury exercise their regulatory authority under Section 199A(b)(5) to clarify the result in the examples above. Section 199A(f)(1)(A) applies the provisions of Section 199A at the partner or shareholder level. However, UBIA in qualified property appears to be measured at the trade or business level. We are uncertain as to which answer is more correct—measuring UBIA in qualified property as of the date of a partner's termination of its interest or on the date that the partnership's year ends under ordinary principles. We do note that there are reporting complexities and other concerns with both approaches. Either way, in order for partners to have certainty as to the effect of normal commercial transactions, Treasury should clarify what rule applies.

In the Subchapter S context, the general rule is that income for the taxable year is allocated among shareholders on a pro rata basis, by assigning a pro rata portion of each corporate item to each day of the taxable year.[44] Where a shareholder terminates her entire interest, Section 1377(a)(2) provides an election to use a closing of the books method if all other shareholders agree. Furthermore, under Section 1362(e)(6)(D), if there is a 50 percent change in ownership of the S corporation during the taxable year, a closing of the books method is required. However, there is no analogous rule that terminates the taxable year of the S corporation in whole or in part as a result of a sale of S corporation stock. Therefore, in the case of a sale of shares of S corporations, it may be most correct to look at the qualified property held by the S corporation at the end of its taxable year, and then give all shareholders who were owners during the taxable year access to the UBIA of such property in calculating their Section 199A deduction for the taxable year in question.

[44] Section 1377(a)(1).

C. Proposed Regulations Section 1.199A-3

1. Calculation of QBI

Though we generally agree with the computational approach adopted in Proposed Regulations Section 1.199A-1, we do have comments and suggestions on the approach taken in Proposed Regulations Section 1.199A-3 with respect to calculating the foundational component of the Section 199A deduction — QBI.

a. Components of QBI

i. The "Effectively Connected" Standard

Proposed Regulations Section 1.199A-3(b)(1) defines "qualified business income" as the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer as described in Proposed Regulations Section 1.199A-3(b)(2). In turn, Proposed Regulations Section 1.199A-3(b)(2) provides that "qualified items of income, gain, deduction and loss" ("***Qualified Items***") are the items of income, gain, deduction and loss that are effectively connected with the conduct of a trade or business within the United States (applying the principles of Section 864(c)), to the extent such items are included or allowed in determining taxable income for the taxable year (the "***Effectively Connected Standard***").

The Preamble emphasizes that Qualified Items are not per se included in a taxpayer's QBI. That is, even if an item of income, gain, loss or deduction passes muster under the Effectively Connected Standard it may or may not be (or reduce) QBI eligible for the deduction under Section 199A.[45] The Preamble further emphasizes that in addition satisfying the Effectively Connected Standard, the Qualified Item must be "with respect to" a QTB. Thus, the Preamble contends, certain items of income, gain, loss and deduction that are treated as per se included in determining effectively connected income without requiring a U.S. trade or business (*e.g.*, the election to treat certain U.S. real property sales as effectively connected pursuant to Section 871(d)) may theoretically satisfy the Effectively Connected Standard, but cannot be QBI because such items are not attributable to a trade or business that is a QTB.[46]

As a general matter, we agree with the Service's interpretation of the statutory text with respect to the application of the Effectively Connected Standard. However, we believe that the Proposed Regulations may not give sufficient guidance on important aspects of the Effectively Connected Standard. In particular, it is not entirely clear how the principles of Section 875(1) interact with Section 199A's adoption of Section 864(c) principles in determining whether an item of income, gain, loss or deduction is a Qualified Item.

Section 875(1) generally provides that a non-U.S. person is considered as engaged in a U.S. trade or business to the extent that a partnership in which he or she owns an interest is engaged in a U.S. trade or business. Section 875(1) embodies an "aggregate" theory of partnerships that

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45 Preamble at 40891-40892.

46 *Id*.

attributes the business of a partnership to its partners in order to determine the source of income allocable from the partnership when measuring whether a non-U.S. person is engaged in a U.S. trade or business. Without Section 875(1), a non-U.S. person potentially would be able to avoid the rules of Section 864(c) simply by investing through a domestic partnership rather than holding direct interests in a U.S. trade or business.

In contrast, the Section 199A deduction requires the existence of a trade or business. Although authority on this matter is not entirely consistent,[47] it appears to be the Service's position that, in general, the existence of a trade or business is measured at the entity level and is not attributed to the partners in a partnership. For example, in Rev. Rul. 2008-39,[48] an upper-tier partnership ("***UTP***") owned interests in several lower-tier partnerships ("***LTPs***"). Although the LTPs were engaged in trades or businesses, UTP's activities consisted solely of acquiring, holding, and disposing of interests in LTPs, and without regard to the activities of the LTPs, such activities did not constitute a trade or business. In holding that a management fee paid by UTP to its manager was not deductible under Code Section 162, Rev. Rul. 2008-39 implicitly concludes that the trade or business of the LTPs is not attributed to UTP. The Service's approach to the trade or business determination thus appears to be more consistent with an "entity" theory of partnerships in which a partnership is treated as a taxable entity separate from its owners.[49]

The Proposed Regulations do not clearly address this tension between a predominantly "aggregate" approach that applies in the Section 864(c) context with the Service's view that an "entity" approach more generally applies when measuring the existence of a trade or business. And the Preamble only adds to the confusion, as it cites the general rule of Section 875(1) in its general description of the Effectively Connected Standard, without further explanation.[50]

> **Example 26.** A and B form partnership AB by each contributing $50. A funds her $50 contribution with a loan bearing 10 percent interest from Bank, an unrelated third party. A would not have borrowed this $50 but for her investment in partnership AB. B funds her capital contribution with cash on hand. In Year 1, AB earns $30 of taxable income attributable to the conduct of a QTB. AB allocates $15 of taxable income to each of A and B. A pays $5 of interest to Bank.

[47] *See, e.g., Dagres v. Comm'r*, 136 T.C. 263 (2011) (finding that a venture capitalist's loans to a failed start-up were eligible for a bad debt deduction because he was attributed the management trade or business of a tax partnership in which he owned an interest); *Butler v. Comm'r*, 36 T.C. 1097 (1961) (loans from a partner to a partnership were "in furtherance of and in proximate relationship to" the partnership's business; partner entitled to a business bad debt deduction).

[48] 2008-2 C.B. 252.

[49] *See also* Preamble at 40894. ("However, in most cases, a trade or business cannot be conducted through more than one entity.") Note that this position is not entirely universal: Treasury Regulations under Section 355 (as well as Proposed Regulations) do aggregate activities performed by multiple entities for purpose of the "active trade or business" requirements of Section 355(b)(1) in certain circumstances.

[50] Preamble at 40892.

In light of the tension between "aggregate" and "entity" treatment under the Proposed Regulations, it is not entirely clear whether A's $5 interest deduction would constitute a Qualified Item that is taken into account in measuring A's QBI. On the one hand, the interest deduction incurred by A is clearly related to A's investment in AB and would not have been incurred but for A's need to contribute capital to AB. Applying an "aggregate" view consistent with the principles of Section 864(c) would very likely result in the interest expense being allocated to the $15 of income allocable from AB, resulting in net QBI of $10.[51] On the other hand, A's interest deduction is not incurred by AB in the course of a QTB, and applying an "entity" view consistent with Rev. Rul. 2008-39 would suggest that A's interest expense may not be "with respect to" AB's QTB, and accordingly the interest expense would not be taken into account in measuring A's QBI with respect to AB's QTB.

Under the facts of Example 26, we believe the better approach is to apply the "aggregate" principles of Section 864(c), thereby pairing A's $5 interest expense and A's $15 of gross income from AB's QTB. Failing to apply an "aggregate" theory of partnerships in this context would permit taxpayers to inappropriately inflate QBI by separating income associated with a QTB from the deductions and expenses incurred by the taxpayer in carrying on or otherwise supporting that QTB.

However, we believe that application of the "aggregate" theory of partnerships under Section 199A has its limits. In particular, we believe that applying an "aggregate" theory of partnerships in all cases under Section 199A would cause substantial confusion when paired with the Proposed Regulations' concept of aggregation of trades or businesses under Proposed Regulations Section 1.199A-4, as illustrated in the example below.

> **Example 27.** C and D form three partnerships, CD1, CD2, and CD3. Each of CD1, CD2 and CD3 are engaged in the trade or business of managing a restaurant. CD3 employs persons who serve back-office administrative functions on behalf of CD1 and CD2 in exchange for an arm's-length fee paid to CD3. Pursuant to Proposed Regulations Section 1.199A-4, C and D validly elect to aggregate CD1 and CD3, but not CD2.

Under the facts of Example 27, applying an "aggregate" theory to measuring Qualified Items provides uncertain results that threaten to undercut the principles of Proposed Regulations Section 1.199A-4. In particular, if a pure "aggregate" theory is applied in Example 21, it would appear that even though CD1 and CD3 have been aggregated for purposes of Proposed Regulations Section 1.199A-4, some amount of CD3's W-2 wages would potentially be allocated to CD2 to the extent that such wages are paid "with respect to" CD2's trade or business. This result thwarts the attempted grouping of CD1 and CD3, and has the effect of forcing each of CD1, CD2 and CD3 to aggregate regardless of any election C and D make under Proposed Regulations Section 1.199A-4.

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[51] *See* Treasury Regulations Section 1.861-8(b)(1); Treasury Regulations Section 1.861-8(f)(1)(iv) (applying a facts-and-circumstances test for purposes of allocating deductions to effectively connected income, which test "emphasize[s] the factual relationship between the deduction and a class of gross income"). Similar results would probably also arise under the principles of Treasury Regulations Section 1.163-8T.

We believe that resolving this tension between "entity" and "aggregate" principles requires that the Proposed Regulations distinguish between (a) items of income, gain, loss or deduction that are incurred in a trade or business applying the principles of Section 162, and (b) items of income, gain, loss or deduction that are not incurred in such a trade or business. In the case of the former, we believe that "entity" principles should apply such that the aggregation rules of Proposed Regulations Section 1.199A-4 are the sole avenue for grouping items associated with such trades or businesses. In the case of the latter, we believe that "aggregate" principles should apply such that items of income, gain, loss or deduction that are not incurred in a trade or business may nonetheless constitute Qualified Items to the extent such expenses are attributable to a QTB. While we admit that such an approach enhances the complexity of an already dense set of rules under Section 199A and may not resolve every uncertainty with respect to the application these rules, we believe that the clarification is necessary to substantially mitigate the structural tension between "aggregate" and "entity" principles inherent under Section 199A.

i. Loss disallowance rules

(A) General Suspended Loss Rules

Proposed Regulations Section 1.199A-3(b)(iv) provides that if a loss generated by a QTB is not available to a taxpayer in a particular year because of the operation of, *e.g.,* Sections 465, 469, 704(d) and 1366(d), the loss is not taken into account by the taxpayer in calculating the QBI component attributable to such QTB for Section 199A purposes for the taxable year. Instead, if and when the loss is finally used by the taxpayer to reduce its regular income tax liability, it is taken into account by the taxpayer both in calculating its income tax liability for the taxable year and for the purposes of the Section 199A deduction. This has the effect of matching the Section 199A deduction with the net income actually recognized by the taxpayer with respect to a QTB for any particular taxable year. If and when the taxpayer is allowed to use the loss (whether against income from a particular QTB or otherwise), the Section 199A deduction is commensurately reduced. In effect, the benefit of the earlier Section 199A deduction received in the earlier year is "recaptured" in a later year, when the loss is used. This approach is consistent with the approach taken with respect to former Section 199.[52]

Proposed Regulations Section 1.199A(b)(iv) also provides that losses that were incurred but disallowed in years ending before January 1, 2018 are not taken into account at all in calculating QBI, even if they are later taken into account for regular tax purposes (the ***"Pre-2018 Suspended Loss Rule"***). We generally agree with this approach—because there was no Section 199A deduction in the year incurred, these losses should not reduce the Section 199A deduction for the later year in which such loss is taken into account. This is also similar to the approach taken for purposes of old Section 199 with respect to losses that were suspended prior to 2004.[53]

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[52] Treasury Regulations Section 1.199-8(h). While we think that this is a sensible way to interpret the statute with respect to such losses, we would like to point out that if the statute is not extended, upon the expiration of the statute, the opportunity to "recapture" the earlier Section 199A benefit disappears. This same issue existed with respect to old Section 199.

[53] Treasury Regulations Section 1.199-8(h).

However, we do believe that some ordering principle is necessary so that when the loss is taken into account, the taxpayer can identify the portion attributable to pre-2018 years. For instance, under Section 469, if the loss of a taxpayer is disallowed, that loss is carried forward to the next year and treated as a deduction or credit from the passive activity for the succeeding taxable year a thus loses its relationship to the original year of generation.[54] Similarly, under Section 704(d), any suspended loss is carried forward until the partner to whom the loss was allocated has basis sufficient to support that loss.[55] Section 1366(d)(3) similarly provides for an undifferentiated indefinite carryforward of suspended losses.

Therefore, in order to make the Pre-2018 Suspended Loss rule work, some principle is necessary in order to determine which portion of a suspended loss that is later taken into account pre-dates the applicability of Section 199A. While we believe either a "last-in-first-out" (***"LIFO"***) or a "first-in-first-out" (***"FIFO"***) approach to suspended loss utilization would work mechanically, because of the recapture issues described above, on balance we believe that a LIFO (or closed system) approach might works best for this purpose, and is consistent with the approach taken for purposes of old Section 199.[56] To contrast the two approaches:

> **Example 28.** Assume that A is an investor in partnership X, a RPE that is engaged in a QTB, and sole proprietorship Y, also engaged in a (different) QTB. In all relevant years, Y has W-2 wages sufficient to support a deduction equal to 20 percent of the income of X and Y. In 2017, X allocates to A losses and deductions that exceeded A's basis in X by $60, which losses and deductions are suspended under Section 704(d); Y broke even. In 2018, X allocates to A an additional $30 of losses, also suspended under Section 704(d) (such that A has a total of $90 of losses suspended under Section 704(d) with respect to X); and Y had $200 of income. In 2019, X allocates $80 of income to A and Y breaks even again.
>
> Because A's $30 of 2018 losses is not deductible by A in 2018, it does not reduce A's Section 199A deduction with respect to Y in 2018. Thus, under the Proposed Regulations, in 2018, A has a Section 199A deduction of $40, attributable to Y's income.
>
> In 2019, A has income of $80, which, for regular tax purposes is entirely offset by A's suspended loss with respect to X for regular tax purposes. If we apply a LIFO approach (in effect, ignoring the existence of pre-2018 losses in their entirety), then in 2019, A's 199A deduction should be based on $80-$30=$50 of QBI (or a Section 199A deduction of $10). Alternatively, regulations could treat the 2018 suspended loss as not being "used" until the entirety of the pre-2018 suspended loss has been

54 Section 469(b); Treasury Regulations Section 1.469-1(f)(4).

55 Section 704(d)(2); Treasury Regulations Section 1.704-1(d)(1).

56 We do recognize that in the context of Section 172 NOL deductions, the rule is different (*i.e.*, after the application of current year losses, the taxpayer reduces its oldest NOLs first). However, those rules were developed in a universe in which NOLs had a 20 year expiration date. In addition, the statutory framework for NOLs is different and does not involve a carryforward and treatment as a newly incurred loss in the next succeeding year, which is the construct applicable to many of the suspended loss carryforwards.

taken into account (a FIFO approach). In this case, A would have a Section 199A deduction equal to 20 percent of $60, or $12. Notionally, A should have $20 of carryforward under Section 199A(c) that is attributable to losses generated in a Post-2018 period that have not yet offset a Section 199A deduction. We think that the former approach is the better approach and more accurately reflects items that arise within the Section 199A period.

We also believe that a special rule will be required to identify which Section 469 losses are attributable to a QTB when such losses are used to offset a taxpayer's income if the Section 469 and Section 199A groupings differ. As discussed below, we do not necessarily believe that Section 469 and Section 199A groupings should be required to be consistent (though we do recommend that taxpayers be permitted to elect to use Section 199A groupings for Section 469 purposes). If such groupings are not consistent, we recommend that any Section 469 carryforward that is later used should be allocated across a taxpayer's Section 199A groupings based on income with respect to such groupings in the year of origination.[57]

(B) Section 461(l) Rules

The Proposed Regulations include a slightly different mechanic for handling losses that are disallowed under new Section 461(l). New Section 461(l) provides that non-corporate taxpayers may not deduct "excess business losses" in any taxable year, and such losses must be carried forward and treated as a NOL under Section 172. For these purposes, an excess business loss is the excess of the deductions of the taxpayer attributable to trades or businesses over the taxpayer's trade or business income plus $250,000 (in the case of an individual, increased to $500,000 for married taxpayers filing jointly), as indexed for inflation.[58]

Under the Proposed Regulations, NOLs generally are not taken into account in computing QBI (because negative QBI is separately tracked and taken into account under the netting rules). However, Section 461(l) excess business losses are slightly different than ordinary NOLs — they more resemble losses suspended under Sections 465, 469, 704(d) or 1366 in that they would have been taken into account to reduce positive taxable income, but for a particular statutory loss disallowance rule. The Proposed Regulations therefore take a hybrid approach: Proposed Regulations Section 1.199A-3(b)(1)(v) requires that such amounts be taken into account in calculating QBI with respect to any particular trade or business in the year that portion of the net operating loss is taken into account for purposes of computing regular taxable income. This seems like a correct result in concept. That is, like with suspended losses, losses disallowed and carried forward under Section 461(l) are only applied to reduce the Section 199A deduction as and when used by the taxpayer to reduce taxable income.

57 Note that in the former Section 199 context, Treasury Regulations Section 1.199-8(h) provided that such losses would be allocated across qualified production activities "in a manner consistent with Sections 465 and 469, and any other applicable provision of the code." Since former Section 199 did not have a grouping or aggregation concept, this precise issue did not arise.

58 Sections 461(l)(3)(A)(ii)(II) and (B).

However, the regulatory language effecting this result is not entirely clear. Proposed Regulations Section 1.199A-3(b)(v) provides "to the extent that the net operating loss is disallowed under section 461(l), the net operating loss is taken into account for purposes of computing QBI." Read in isolation, without the benefit of the Preamble, this language could be read to suggest that any loss that is disallowed under Section 461(l) and added to a NOL is nonetheless taken into account in the year that it is incurred (thus creating a negative QBI amount with respect to the applicable trade or business that must be netted). The Preamble suggests that the intent of this language is to require taxpayers to determine what portion of any use of a NOL deduction in a later year is attributable to a Section 461(l) disallowed loss.[59] In particular, the Preamble states: "[h]owever, to the extent the net operating loss is comprised of amounts attributable to a trade or business that were disallowed under section 461(l), the net operating loss is considered attributable to that trade or business and will constitute QBI to the extent the requirements of Section 199A, including Proposed Regulations Section 1.199A-3, are satisfied."[60] This could be clarified.

Also, assuming that we are interpreting the main thrust of the rule correctly, the proposed mechanics seem to require identification of losses for purposes of calculating QBI at multiple levels: First, where a taxpayer has multiple sources of tax losses in a taxable year, some of which are associated with a QTB and some of which are not, it is necessary to determine the extent to which losses with respect to a QTB are treated as disallowed under Section 461(l) and carried forward under Section 172, and which losses are treated as currently deductible (and therefore reduce the current Section 199A deduction). Second, when a net operating loss is actually utilized in a later taxable year following a Section 461(l) loss disallowance to offset a taxpayer's income, it is necessary to determine which portion of that net operating loss is attributable to a loss with respect to a QTB that was previously disallowed. Further guidance (including potentially through an example of what is intended) would be helpful. We can imagine FIFO/LIFO approaches in each of the two circumstances noted above, but applying a pro rata rule may be more consistent with other decisions made in crafting guidance under 199A if a FIFO approach is not adopted with respect to the general suspended loss rules discussed above (compare, for example, rules allocating the net losses of certain QTBs pro rata against the taxpayer's net income from QTBs with overall income).

b. Pre-2018 Income

Proposed Regulations Sections 1.199A-1(f)(2), 1.199A-2(d)(2)(ii) and 1.199A-3(d)(2)(ii) clarify that if a RPE has a taxable year that begins before January 1, 2018 and ends after December 31, 2018, all relevant Section 199A items from the pre-2018 period are treated as incurred by an individual owner of the RPE in the year in which the RPE's taxable year ends (*e.g.*, 2018) for purposes of the Section 199A deduction. We believe that this is generally consistent with the operation of Section 706(a), though we think it would be useful to clarify that Section 706(c)(2) principles apply (so that it is clear that a partner in such a RPE that sold its interest in such partnership prior to 2018 does not get the benefit of Section 199A).

59 Preamble at 40891.

60 *Id*.

However, the Proposed Regulations do not clearly deal with all income that is deferred from a pre-2018 period into a post-2018 period. There are many reasons why income may be deferred from one period to another, including the effect of Section 481(a) timing adjustments that are spread over three years under Section 481(b)(1), deferred revenue taken into account by the taxpayer under Rev. Proc. 2004-34,[61] remaining deferrals of cancellation of indebtedness income under Section 108(i) and installment sales of property that occurred prior to December 31, 2017. Proposed Regulations Section 1.199A-3(b)(1)(iii) clearly contemplates that pre-2018 Section 481 adjustments do not constitute QBI, which we believe is correct and consistent with how pre-2018 losses are treated. However, Proposed Regulations Section 1.199A-3(b)(2) appears clearly to contemplate that other deferred items obtain the benefit of the Section 199A deduction as they are items of income that would be treated as included or allowed in determining taxable income for the taxable year and, unlike Section 481(a) adjustments, there is no specific regulatory exclusion.[62]

We believe that the exclusion of Section 481 adjustments is too narrow, and we recommend that the category of items that are not taken into account be expanded to include items like income from installment sales arising in taxable years ending before January 1, 2018, Section 108(i) inclusions and similar items. However, we do not believe that items deferred under Rev. Proc. 2004-34 should be excluded, provided that this method of accounting has been consistently used with respect to the QTB in question. Deferred revenue of the type described in this Revenue Procedure generally relates to recurring income, and if it were to be excluded, then the taxpayer in effect would lose the Section 199A deduction with respect to a year of deferred revenue.[63] Moreover, such deferred revenue is economically earned in the year in which it is taken into account in taxable income (or possibly a later year).

2. Treatment of Section 707 Payments

Section 199A(c)(4)(A) categorically excludes all guaranteed payments under Section 707(c) in respect of services from the definition of QBI. Section 199A(c)(4)(C) authorizes Treasury to exclude payments in respect of services described under Section 707(a) from the definition of QBI. As discussed below, the Proposed Regulations generally (i) follow the statute with respect to Section 707(c) guaranteed payments in respect of services, (ii) exercise the statutorily specified regulatory authority to exclude all Section 707(a) payments from QBI, and (iii) also exclude Section 707(c) guaranteed payments for capital from QBI. Although administratively convenient, we believe that certain of these decisions are broader than warranted, as discussed below.

[61] 2004-1 C.B. 911.

[62] Proposed Regulations Section 1.199A-3(b)(1)(iii).

[63] *E.g.*, assume that the QTB regularly receives advance payments that it elects to report under Rev. Proc. 2004-34. If the QTB receives $100 advance payments in each of 2016, 2017, 2018 and 2019 from its customers that relate to future services/goods to be provided by the QTB that is deferred under the Rev. Proc., in 2017, tax is paid on the 2016 amount, in 2018, tax is paid on the 2017 amount, etc. If the 2017 advance payment was not eligible to be treated as QBI when taken into account in 2018, then the taxpayer would get no benefit from the recurring advance payments until 2019, effectively skipping a year.

a. Payments for Services

(1) Section 707(a)

Section 199A(c)(4)(C) provides that QBI does not include, "to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business." The Proposed Regulations exclude from the definition of QBI "any payment described under Section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or a RPE."[64] The Preamble explains that Treasury excluded all Section 707(a) service payments because "within the context of section 199A, payments under section 707(a) for services are similar to, and therefore, should be treated similarly as, guaranteed payments, reasonable compensation, and wages, none of which is includable in QBI."[65] The Preamble also explains that once a Section 707(a) payment is classified as such and excluded from the calculation of QBI, the payment retains its characteristics as such through multiple tiers of entities.[66] Treasury has requested comments on whether there are situations in which it is appropriate to include Section 707(a) payments in QBI.

We agree that many Section 707(a) payments, since they are by definition paid to partners in a non-partner service-providing capacity, should be excluded from QBI in the same manner as other compensatory payments. When paid outside the partnership context most of these payments would indeed be treated as employee compensation income.[67] And we acknowledge that given the difficulties in distinguishing Section 707(c) guaranteed payments in respect of services from Section 707(a) payments in many common situations, a rule that treats such payments similarly is

64 Proposed Regulations Section 1.199A-3(b)(2)(ii)(J).

65 Preamble at 40893.

66 *Id.*

67 It is the position of Treasury that a person cannot be both a partner in and an employee of a partnership. Rev. Rul. 69-184, 1969-1 C.B. 56. Treasury issued proposed regulations under Section 707(a) in 2015 that were intended to distinguish payments to partners that were in reality disguised compensation rather than distributive share. Proposed Regulations Section 1.707-2(c). Under those proposed regulations, whether an arrangement is treated as disguised compensation depends on all the facts and circumstances, including a non-exhaustive list of six factors set forth in the regulations. Consistent with the legislative history of Section 707, those regulations identify "significant entrepreneurial risk" as the most important of the factors. While an arrangement that lacks significant entrepreneurial risk will be treated as disguised compensation an arrangement presumably can be treated as a Section 707(a) payment even if there is significant entrepreneurial risk, since the proposed Section 707(a) regulations state that "an arrangement that has significant entrepreneurial risk will generally not constitute a payment for services *unless other factors establish otherwise*." The other factors include (1) whether the service provider holds, or is expected to hold, a transitory partnership interest or interest of short duration, (2) whether the allocation and distribution are received when a third party service provider would otherwise expect payment, (3) whether the service provider became a partner to receive tax benefits it would not otherwise receive if it rendered services in a third party capacity, and (4) whether the value of the service provider's continuing interest is small in relation to the allocation and distribution.

certainly administratively convenient.[68] However, we also believe that there are categories of Section 707(a) payments that should be identified as "good" QBI.

Contrast the following examples:

> **Example 29.** T is an upper-tier partnership that owns 5 percent of the capital and profits of lower-tier partnership X. X has a single trade or business: the development, testing, and sale of medical devices. T conducts an engineering business that has a particular expertise in designing equipment and materials necessary to produce the medical devices produced by Partnership X. T is engaged by X to design bespoke equipment for X to produce a new medical device in exchange for contingent payments based on the success of such medical device. These contingent payments are appropriately treated as payments described in Section 707(a)(1) in many circumstances, since T is receiving the payments separate and apart from its capacity as a partner of X. T's compensation is consistent with arm's length principles. Under Proposed Regulations Section 1.199A-3(b)(2)(ii)(J), the payment to T is *per se* excluded from QBI, and the owners of T may not include such payment for the purposes of calculating their Section 199A deduction with respect to their income from T. However, had T provided such services to a pharmaceutical company in which it did not own an interest, the income for these services would presumably be treated as QBI. Where T in this example holds a relatively small interest in X, these divergent results under Section 199A become more questionable. Query whether the result is different if T and X have overlapping ownership and are aggregated under Proposed Regulations Section 1.199A-4.
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> **Example 30.** Same facts as Example 29 except T receives only a fixed upfront payment in exchange for its work. Same result as Example 29 (either because the fixed upfront payment is a Section 707(a) payment, or perhaps alternatively because the upfront payment is a Section 707(c) payment without regard to partnership income).
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> **Example 31.** Same facts as Example 29, except T provides services solely to Partnership X in T's capacity as a partner. T receives a partnership distribution in respect of the partnership income generated through the design of the engineering equipment. Under the Proposed Regulations the payment appears to be QBI because T's distributive share of partnership income (A) is received in a partner capacity (and so is not a Section 707(a) payment), and (B) is determined based on partnership income (and so is not a Section 707(c) guaranteed payment).
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> **Example 32.** Same facts as Example 29, except T is not a partner in X, but is rather owned by the same partners as the partners in X. T and X are not aggregated

[68] See discussion in New York State Bar Association Tax Section Report No. 1357, *Report on Guaranteed Payments and Preferred Returns* (November 14, 2017), hereinafter "Report 1357".

under Proposed Regulations Section 1.199A-4. Since the payment is not a guaranteed payment of any kind, T's owners may treat the payment as QBI.

These examples show that it is not always easy to determine when a partner is providing services in a partner capacity (in which case the relevant payment should be treated as a distributive share that may well constitute QBI if it is not a Section 707(c) guaranteed payment), in a third party capacity that should be governed by Section 707(a).[69] And it is not always readily apparent when a payment is a Section 707(c) guaranteed payment for services or a Section 707(a) payment for services. The Proposed Regulations take a simple approach—if a transaction is treated as a Section 707(a) payment or Section 707(c) guaranteed payment, then the income from that transaction is *per se* excluded from QBI, but if the transaction is not treated as a Section 707(a) payment or Section 707(c) guaranteed payment, then income from such transaction is potentially QBI. This leaves taxpayers with only one level of uncertainty: the classification of the payment for purposes of Section 707. There is virtue in this approach in that in some sense, the uncertainties regarding the classification remain the same, even though the stakes for taxpayers are now higher.

However, we think that the examples above also highlight the arbitrary results that this bright line test produces. Payments made to partner-service providers, even if not in the nature of traditional "compensatory" payments for services that in any non-Subchapter K context would be treated as wage income, are treated differently than identical payments made to non-partners.

We request that Treasury reconsider their approach to Section 707(a) payments for services. We believe that payments like those in Example 29, even if they constitute Section 707(a) payments, should generally be treated as QBI in the hands of the recipient because these payments are in effect income earned by T in connection with its engineering business. In particular, we think that the statement in the Preamble describing Section 707(a) payments as similar to "guaranteed payments, reasonable compensation and wages" is not fully accurate. We recommend that the rule with respect to Section 707(a) payments be limited to Section 707(a) payments that (1) would constitute payments in respect of an SSTB, or (2) when viewed outside the context of a partnership would be seen as wage-type income in the hands of the recipient.[70] On the flip side, Section 707(a) payments that are themselves received in connection with a partner's QTB should generally give rise to QBI. Such an approach promotes consistency and prevents unnecessary traps for the unwary.

We acknowledge that a standard for Section 707(a) payments that looks to the activities of the recipient is more complex and would require the development of additional regulatory rules and examples if such an approach is applied in the Section 199A context. We also acknowledge that such a standard may be less administrable as compared to a 100 percent exclusion of Section 707(a) payments for services. However, we do think that such an approach could lead to more rational and equitable results given the broad scope of payments that could potentially be described by Section 707(a).

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[69] *See, e.g.*, McKee Nelson & Whitmire: *Federal Taxation of Partnerships & Partners*, ¶ 14.02[4][a].

[70] For example, using principles similar to those in Proposed Regulations Section 1.707-2(c).

b. Section 707(c) Guaranteed Payments for Capital

As described above, Section 199A by its terms excludes from QBI Section 707(c) guaranteed payments "paid to a partner for services rendered with respect to the trade or business."[71] The statute is silent on guaranteed payments for capital ("***GPCs***").[72] In the Proposed Regulations, Treasury determined that any such payment is categorically "not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI."[73] According to the Preamble, these payments are not attributable to a trade or business "[b]ecause…[they] are determined without regard to the income of the partnership."[74] The Proposed Regulations do provide, however, that the partnership's deduction with respect to a GPC will be taken into account for purposes of computing QBI (so long as it is deductible and properly allocable to the trade or business under the general rules of Section 199A).

We believe that GPCs are a hard case. On the one hand, we agree with the conclusion that, to the extent that a GPC is best thought of as akin to interest, the better answer is that it should not create QBI eligible for a deduction with respect to the QTB making the guaranteed payment and suffering the loss associated with the guaranteed payment. And indeed, in many ways, a GPC is very similar to interest. In such case, any other rule would in effect allow a GPC to have the effect of a gross income allocation with no regard to the QTB conducted (or not) by the recipient.[75] However, if this rule is retained, we do not believe that GPCs should be treated any worse than interest. That is, if such payments are properly allocated (however unlikely that might be) to a QTB of the recipient, they should constitute QBI to that recipient in respect of such QTB.

However, GPCs are not necessarily entirely akin to interest, and as we previously explained in a prior report,[76] partnerships often include complex waterfalls that govern the sharing of capital and income from a partnership where a particular partner might have a preferred return on its invested capital (which may or may not be treated as a Section 707(c) payment) and an additional interest in the partnership's net profit in excess of such preferred return. The apparent simplicity of excluding GPCs from the QBI definition belies the significant uncertainty that currently exists

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71 Section 199A(c)(4)(B).

72 We note that the version of Section 199A proposed by the House specifically included GPCs in the QBI definition: "Net business income or loss includes the amounts received by the individual taxpayer as wages, director's fees, guaranteed payments and amounts received from a partnership other than in the individual's capacity as a partner, that are properly attributable to a business activity. . . " H.R. Rep't No. 115-466, 115th Cong., 1st Sess. (Dec. 15, 2017).

73 Proposed Regulations Section 1.199A-3(b)(1)(ii).

74 Preamble at 40891. Note that the Preamble does not deny that such payments would otherwise satisfy the Effectively Connected Standard.

75 Though perhaps in a case where a partner only holds a preferred interest that is entitled to a fixed return, the question is largely moot (other than in the case where the underlying income consists of REIT dividends or PTP allocations) because arguably the interest would not attract any W-2 wages or depreciation with respect to UBIA in qualified property.

76 Report 1357.

in identifying payments that constitute GPCs.[77] A preferred return in the circumstances described above can simply attract the first dollars of net income earned by the partnership. However, the accrual can exceed partnership taxable income, and therefore is at risk of being treated as a GPC. While not necessarily dependent on the partnership's net income, it can hardly be said that these instruments are shielded from the economic risk of the underlying business. In fact, senior debt can materially affect the return on these investments.

In addition, the statutory basis for excluding all GPCs is not entirely clear. Congress expressly excluded 707(c) payments for services from being treated as QBI, but it did not address GPCs.[78] Section 707(c) refers to both services and capital, and accordingly Congress could easily have addressed GPCs simply by excluding from QBI "any payment described in Section 707(c)." Though the Preamble does not mention this, payments under Section 707(c), including GPCs, are payments made to a partner in its capacity as a partner that are nonetheless treated as being made to a party that is not a partner for limited purposes. Section 707(c) states that GPC treatment applies "only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses)." The Joint Committee on Taxation has stated that "a guaranteed payment made by a partnership to a partner for services, or for the use of capital, is treated in the same manner as if made to a non-partner for purposes of inclusion of the payment in income by the recipient, and deduction and capitalization by the partnership. For all other purposes, guaranteed payments are treated in the same manner as a distributive share of partnership income."[79] So Section 707(c) payments are betwixt and between — for purposes of calculating gross income (and therefore arguably for purposes of calculating QBI), the payment is treated as made to a non-partner, and in that sense, the approach taken by the Proposed Regulations makes sense. However, for every other purpose, the payment is treated as distributive share, which instead supports a different treatment.

Thus, based on the negative implication in the statute, and the fact that GPCs are, at least for many purposes, treated as distributive share, there are arguments that the GPC should be treated as QBI, at least in circumstances where the recipient of the GPC *also* is entitled to net income earned by the partnership.

However Treasury treats GPCs in final regulations under Section 199A, we believe that the enactment of Section 199A simply increases the stakes of whether a particular arrangement is classified as a GPC, a gross income allocation, or something else. Although beyond the scope of this Report, we continue to urge Treasury to clarify the relevant definitions under Section 707(a) and Section 707(c) to increase taxpayer certainty on this important and very common issue.

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77 See, *e.g.*, Rev. Rul. 81-300, 1981-2 CB 143; *Pratt v. Comm'r*, 64 TC 203 (1975); Prop. Reg. Section 1.707-2(c), Example 2.

78 The legislative history is focused on similarity of Section 707(c) payments in respect of services to reasonable compensation. There is no mention of GPCs.

79 Joint Committee on Taxation, ''Review of Selected Entity Classification and Partnership Tax Issues'' (Apr. 8, 1997), at 45.

D. Proposed Regulations Section 1.199A-4

1. Aggregation in General

Proposed Regulations Section 1.199A-4 provides rules that authorize individuals to aggregate certain QTBs (excluding SSTBs), treating these QTBs as a single QTB for purposes of applying the W-2 wage and UBIA Limitations of Proposed Regulations Section 1.199A-1(d)(2)(iv). The Preamble sensibly suggests that the purpose of permitting aggregation under Proposed Regulations Section 1.199A-4 is to provide consistent results to taxpayers regardless of whether related business operations are conducted through a single entity or through multiple entities.[80]

As a general matter, Proposed Regulations Section 1.199A-4 imposes five requirements before permitting aggregation of two or more QTBs:

1. The same person or group of persons directly or indirectly owns 50 percent or more of each trade or business (measured by shares in the case of an S corporation, and capital or profits in the case of a partnership).

2. Such ownership exists for the majority of the taxable year in question.

3. All items attributable to each trade or business are reported on returns with the same taxable year (not taking into account short taxable years).

4. None of the trades or businesses to be aggregated are SSTBs.

5. Two of the three factors related to operational integration must be satisfied.

We agree with Treasury that permitting aggregation of QTB activities under Section 199A is a sensible and appropriate approach. We believe that permitting aggregation enhances administrability and minimizes the incentive for taxpayers to engage in tax-motivated restructuring of business operations. However, we believe that several aspects of the aggregation rules could be clarified and enhanced to further the goals of Proposed Regulations Section 1.199A-4.

2. Overlapping Ownership Requirement

a. Necessity for Overlapping Ownership Requirement

Proposed Regulations Section 1.199A-4(b)(1)(i) provides that trades or businesses can be aggregated only where the same person or group of persons directly or indirectly owns 50 percent or more of each trade or business (the "***Overlapping Ownership Requirement***"). In the case of an S corporation, ownership is measured by total shares owned, and in the case of a partnership, ownership is measured by capital or profits.

[80] Preamble at 40894 ("Allowing taxpayers to aggregate trades or businesses offers taxpayers a means of combining their trades or businesses for purposes of applying the W-2 wage and UBIA in qualified property limitations and potentially maximizing the deduction under section 199A.")

As an initial matter, we believe that Treasury may wish to consider whether the overlapping ownership requirement should in all cases serve as a predicate for aggregation. If the purpose of the aggregation rules is to allow operationally integrated trades or businesses to be taxed as a single unit for purposes of Section 199A, it is not entirely clear why overlapping ownership should be a threshold inquiry for determining whether aggregation is appropriate. It is entirely possible, for example, that (1) two businesses are closely integrated from an operational perspective but lack 50 percent overlapping ownership and (2) two business are largely separate from an operational perspective but clearly claim overlapping ownership. While we acknowledge that overlapping ownership should be an important indicator of integration of two trades or businesses,[81] we believe there are circumstances in which the firm requirement for overlapping ownership may inappropriately exclude taxpayers from the aggregation rules, as illustrated in the example below.

> **Example 33.** On January 1 of Year 1, A and B form S corporation AB1 and S corporation AB2. Each of AB1 and AB2 are engaged in the trade or business of landscaping. A contributes $51 to each of AB1 and AB2 in exchange for 51 percent of the equity of each of AB1 and AB2. B receives 49 percent of the stock of each of AB1 and AB2 in exchange for B's agreement to manage the landscaping business of AB1 and AB2. AB1 and AB2 each adopt a December 31 taxable year and neither AB1 nor AB2 is engaged in an SSTB. AB1 and AB2 provide the same landscaping services and share significant centralized business elements.
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> In Year 1, AB1 and AB2 satisfy all of the requirements for aggregation pursuant to Proposed Regulations Section 1.199A-4, and accordingly B elects to aggregate the QTBs of AB1 and AB2. However, on January 1 of Year 2, A transfers his 51 percent interest in AB2 to C in exchange for $51. Throughout Year 2, AB1 and AB2 are operated in a manner identical to their operation in Year 1, and B owns an identical interest in each of AB1 and AB2. However, because AB1 and AB2 no longer satisfy the Overlapping Ownership Requirement, B is not able to aggregate the QTBs of AB1 and AB2.

We believe that results in Example 33 are not necessarily desirable as a policy matter. Neither B's interest in the two businesses nor the operational integration of the two businesses has changed as between Year 1 and Year 2, yet B may be subject to substantially different results under Section 199A as a result of the change in A's ownership in Year 2. If the purpose of the aggregation requirements is to ensure integration of businesses, it is not entirely clear how this purpose is furthered in the context of Example 33. Certainly it is the case as a general matter that the integration described in Example 33 becomes less likely as ownership in the two entities changes, but we believe that this perhaps warrants the treatment of overlapping ownership as an important factor in measuring relatedness, and we are concerned that at least in some cases, making overlapping ownership a prerequisite to aggregation may artificially restrict access to Section 199A. Based on this concern, we encourage Treasury to consider whether the overlapping ownership requirement should be revised such that it is one factor (albeit one with special weight)

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[81] *See, e.g.*, Treasury Regulations Section 1.469-4T(g)(3)(v) (using overlapping ownership as a factor, but not a precondition, to determining whether two or more activities constitute a single integrated business for purposes of Treasury Regulations Section 1.469-4T(g)).

that is taken into account in measuring the interrelatedness of two QTBs than an affirmative requirement for aggregation.[82]

We also note that in the case of tiered RPEs, this standard is likely to mean that no aggregation occurs. That is, for good commercial and non-tax reasons UTPs are often unwilling to share ownership information with LTPs.[83]

b. Technical Issues in Overlapping Ownership Test

Regardless of whether the Overlapping Ownership Requirement survives as a necessary condition to aggregation or whether overlapping ownership is reduced to a factor in measuring the level of integration between two businesses, we believe that taxpayers would be well-served by clarification regarding (1) how to determine whether the same person or group of persons owns 50 percent or more of two trades or businesses, and (2) the meaning of the phrase "directly or indirectly" when used in the overlapping ownership test.

(1) Same Person or Group of Persons Owning 50 Percent or More

i. Ownership and Attributions

The Overlapping Ownership Requirement requires that "the same person or group of persons . . . owns 50 percent or more of each trade or business to be aggregated." While the application of this rule appears to be relatively straightforward when each person in a group owns identical interests in two businesses, it is not clear how this rule should apply where equity holders own disproportionate interests in two different trades or businesses.

> **Example 34.** Assume that A owns 1 percent of the profits and capital of PRS1 and 99 percent of the profits and capital of PRS2. B, in turn, owns 99 percent of the profits and capital of PRS1 and 1 percent of the profits and capital of PRS2. It is not entirely clear based on the language of Proposed Regulations Section 1.199A-4(b)(1)(i) whether A and B constitute a group of persons who own 50 percent of the capital and profits of each of PRS1 and PRS2. Read literally, it would appear

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82 We base this recommendation in part on our reading of the Proposed Regulations that aggregation does not affect a taxpayer's allocation of QBI, W-2 wages, or UBIA from a QTB, and instead aggregation only applies for purposes of applying the limitations described in Proposed Regulations Section 1.199A-1(d)(2)(iv) (although we believe that a clear statement to this effect in final regulations may be helpful). Proposed Regulations Section 1.199A-2(a)(3); Proposed Regulations Section 1.199A-2(b)(4). Thus, for example, suppose that Taxpayer owns 100 percent of the stock of S corporation 1 and 0 percent of the stock of S corporation 2. Even if Taxpayer were to take the questionable position that the QTBs of S corporation 1 and S corporation 2 are so functionally integrated that they may be aggregated without any overlapping ownership, such aggregation would be of no practical effect. This is because under the Proposed Regulations, Taxpayer would not be allocated any QBI, W-2 wages, or UBIA from S corporation 2 in light of taxpayer's 0 percent interest in S corporation 2, and accordingly Proposed Regulations Section 1.199A-1(d)(2)(iv) would effectively be applied to Taxpayer without regard to the QBI, W-2 wages or UBIA of S corporation 2 despite the Taxpayer's aggregation position.

83 See below in Part III.D.3

that this standard is satisfied notwithstanding the small amount of common ownership as between PRS1 and PRS2.[84]

We believe that such a result may permit abuse and inappropriately permit taxpayers to aggregate trades or businesses where actual overlap in ownership is relatively low. As such, we suggest that final regulations either clarify or modify the application of the Overlapping Ownership Requirement. One approach might be to mandate that the persons who are considered in measuring common ownership must own a minimum threshold percentage of the entity in question. For example, anyone who owns less than 10 percent of the value of an enterprise could be excluded from the group of owners whose ownership is considered in testing whether the 50 percent common ownership threshold is satisfied. Alternatively, final regulations could provide that only a person's lowest ownership interest in any applicable RPE is taken into account in measuring whether the 50 percent test is satisfied.[85] Applying such a test to the example above, each of A and B would only be considered to own an aggregate of 2 percent overlapping interests rather than 100 percent. We believe either approach would yield results more consistent with Treasury's intent in crafting the Overlapping Ownership Requirement.

We additionally note that the measurement of interests in capital and profits in the case of partnerships introduces some degree of uncertainty and opportunity for planning with respect to the Overlapping Ownership Requirement. For example, two partnerships that plan to borrow from the same lender may decide to issue preferred equity to such lender reflecting 50 percent of the capital of the partnerships and thereby seemingly satisfy the Overlapping Ownership Requirement. Similarly, complex allocations of partnership income may give taxpayers a position in certain cases that there is a 50 percent overlap in partnership "profits" even if substantially less than 50 percent of the taxable income of a partnership is allocated to the person holding such profits interests in a given taxable year. While we acknowledge that these imperfections in measuring capital and profits introduce additional uncertainty to the Overlapping Ownership Requirement, we believe that this uncertainty derives from a broader lack of clarity regarding the measurement of partnership capital and profits that permeates many rules throughout the Code and Treasury Regulations. We do not believe that Section 199A represents an appropriate venue for resolving such a complex issue, and accordingly we agree with the approach of the Proposed Regulations in

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84 We note that this result is not necessarily inconsistent with the application of Section 707(b) of the Code, which applies where the same persons own 50 percent or more of the capital or profits of two partnerships. *See* McKee Nelson & Whitmire: *Federal Taxation of Partnerships & Partners*, ¶ 14.04[2][d], Example 14-18 ("Individual A owns a 99 percent profits and capital interest in partnership AB, and a 1 percent profits and capital interest in partnership BA. Individual B owns the reciprocal interests in each partnership—1 percent of AB and 99 percent of BA. Sections 707(b)(1)(B) and 707(b)(2)(B) apply to sales between these partnerships because the same persons own 100 percent of both partnerships, even though the common cross-ownership is only 2 percent.)

85 Such an approach to an overlapping ownership test occurs, for example, under Treasury Regulations Section 1.414(c)-2(c)(1) ("The term 'brother-sister group of trades or businesses under common control' means two or more organizations conducting trades or businesses if (i) the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)-4) a controlling interest in each organization, and (ii) *taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons are in effective control of each organization.*" (emphasis added)). In addition, we note with approval Section 414's focus on voting stock (in addition to value), and believe that "control" (as expressed through vote) should be considered for purposes of Section 199A for measuring whether the Overlapping Ownership Requirement is satisfied with respect to two S corporations.

using capital or profits to measure partnership ownership for purposes of the Overlapping Ownership Requirement.

(2) Meaning of "Directly or Indirectly"

In addition to the ambiguities of the Overlapping Ownership Requirement noted above, we believe it is critical for final regulations under Section 199A to clarify the meaning of "directly or indirectly" as that phrase is used in Proposed Regulations Section 1.199A-4(b)(1)(i). For these purposes, we believe that Treasury may consider a number of attribution standards. In particular, rules under Section 267(b), Section 318, Section 707(b), or Section 414(b) and (c) all may be appropriate sources of attribution. While we do not express a view on which of these attribution regimes should be applied in this context, we believe that it is very important for Treasury to define "direct or indirect" ownership in such a way that one of these attribution regimes (or a similar regime) is clearly applicable for purposes of Proposed Regulations Section 1.199A-4(b)(1)(i).[86]

c. Three-Factor Interdependency Test

In addition to considering overlapping ownership, Proposed Regulations Section 1.199A-4(b)(v) looks to the level of operational integration between two or more trades or businesses. In particular, two of the following three factors must be satisfied for aggregation to be permitted:

1. The trades or businesses provide products and services that are the same or customarily offered together.

2. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

3. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

While we agree with Treasury that operational integration is a critical aspect of any requirement related to aggregation under Section 199A, we believe that the test as proposed is in some respects unduly narrow. For example, we believe that it is possible to read the Proposed Regulations such that a "hub and spoke" structure in which a centralized "hub" provides back-office services to a number of customer-facing "spokes" would not pass this test.

> **Example 35.** A and B each owns 50 percent of the profits and capital interests in each of PRS1, PRS2, and PRS3. PRS1 and PRS2 are engaged in the trade or business of providing custodial services. PRS3 provides back-office support services for each of PRS1 and PRS2 (*e.g.*, accounting, legal, human resources, and

[86] *See* Example 1 for an illustration of the uncertainty inherent in this structure. We believe that consistent measurement of overlapping ownership will promote administrability and efficiency, and so we accordingly make the same recommendation with respect to the "crack and pack" rule under Proposed Regulations Section 1.199A-5(c)(2) and the incidental QTB rule under Proposed Regulations Section 1.199A-5(c)(3)

information technology). Although it appears that A and B are permitted to aggregate the trades or businesses of PRS1 and PRS2, it is not clear that PRS3 could be aggregated with PRS1 and PRS2. This is because PRS3 does not offer products or services that are the same or similar to PRS1 or PRS2, and PRS3 arguably is not operated in coordination with or reliance upon, the businesses of PRS1 or PRS2.[87]

We believe that existing rules are available as a means to enhance the precision of the Proposed Regulations' test for operational integration. For example, Treasury could consider applying a "facts and circumstances" test to measure operational integration using the main factors applied by Treasury Regulations Section 1.469-4T(g)(3) for purposes of determining whether two or more activities constitute a "single integrated business" for purposes of Treasury Regulations Section 1.469-4T(g). These factors under Treasury Regulations Section 1.469-4T(g)(3) include the following:

1. Whether such operations are conducted at the same location.
2. The extent to which other persons conduct similar operations at one location.
3. Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations.
4. The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations.
5. Whether such operations are owned by the same person.
6. The extent to which such operations involve products or services that are commonly provided together.
7. The extent to which such operations serve the same customers.
8. The extent to which the same personnel, facilities, or equipment are used to conduct such operations.
9. The extent to which such operations are conducted in coordination with or reliance upon each other.
10. The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations.
11. The extent to which such operations depend on each other for their economic success

[87] We note that taxpayers may take the position in this example that PRS3 is operated "in coordination with" PRS2 and PRS3. We do not read the text of the Proposed Regulations as providing for this result, but if Treasury intends that "hub and spoke" arrangements be permitted to aggregate in this context, we believe an example in the Proposed Regulations clarifying this intent would be helpful.

12. Whether such operations are conducted under the same trade name.

We believe use of these factors and similar factors may substantially increase the accuracy of the measurement of operational integration between two businesses, and are less likely to inappropriately preclude a Section 199A deduction. However, we acknowledge that adding additional factors and/or adopting a "facts and circumstances" test introduces additional complexity and administrative challenges. We appreciate that final regulations under Section 199A must strike a careful balance between accuracy on the one hand and administration on the other hand, and accordingly, while we encourage Treasury to consider refining the operational integration factor in the aggregation test, we acknowledge that it may be necessary to limit aggregation in certain circumstances for the sake of administration.

d. Relationship to Grouping Under Section 469 and Section 1411

The Preamble to the Proposed Regulations notes that Treasury does not believe that existing grouping rules under Treasury Regulations Section 1.469-4 appropriately reflect the policy considerations and technical requirements of Section 199A, and accordingly the Proposed Regulations do not adopt the Section 469 grouping rules.

As we indicated in our Prior Report,[88] we believe that the decision to decline to adopt Section 469 grouping concepts in the Section 199A context is reasonable. However, we agree with Treasury that consideration should be given to whether creation of multiple grouping regimes under both Section 199A and Section 469 creates an undue administrative burden on taxpayers. Accordingly, we propose that Treasury permit taxpayers to adopt their groupings under Proposed Regulations Section 1.199A-4 for purposes of Section 469 in final regulations. Because the Section 199A standard for aggregation is in almost all cases narrower as compared to Section 469 grouping, we believe that this addresses the concern raised regarding multiple inconsistent grouping regimes without requiring Treasury to compromise the core policy goals motivating each statute. Making the consistency election available will permit less sophisticated taxpayers to mitigate the administrative burden of multiple grouping rules, while allowing more sophisticated taxpayers to engage in multiple groupings under Section 199A and Section 469 if desired.

e. Reporting Requirement Regarding Overlapping Ownership

The Preamble requests comments as to whether final regulations under Section 199A should incorporate reporting requirements in which the majority owner or group of owners would be required to provide information about all of the other pass-through entities in which they held a majority interest.[89] We believe that requiring owners of interests in RPEs to provide such information with regard to overlapping ownership presents significant administrative and commercial burdens, particularly in light of the possibility of dispersed ownership across investment funds and similar large partnerships. Accordingly, we believe that the best approach is not to require any specific reporting from a UTP to LTPs with regard to overlapping ownership. Instead, RPEs and their equity holders can make arrangements as necessary by contract, and we

[88] Prior Report at 15-17.

[89] Preamble at 40895.

believe that final regulations should simply require partners and/or S corporation shareholders to be able to substantiate such overlapping ownership.

f. Aggregation at RPE Level

Treasury requested comments regarding whether aggregation under Proposed Regulations Section 1.199A-4 should be made available to RPEs, or if instead only individual taxpayers should be permitted to take advantage of the aggregation rules.[90] While we agree with the suggestion in the Preamble that limiting aggregation for purposes of Section 199A to individuals likely enhances flexibility at the taxpayer level,[91] we understand that there are many smaller RPEs where allocating QBI, W-2 wages and UBIA across multiple related QTBs may present a substantial administrative burden. Accordingly, we recommend that RPEs be permitted to aggregate trades or businesses to avoid this administrative burden so long as each Partner consents (including through provisions in the partnership agreement) and the requirements of Proposed Regulations Section 1.199A-4(b) are satisfied. In such case, each partner would be bound by the RPE's aggregation decision.

g. Standard for Aggregation and Disaggregation

Proposed Regulations Section 1.199A-4(c)(2)(ii) permits the Commissioner to disaggregate trades or businesses where a taxpayer fails to attach the required annual disclosure under Proposed Regulations Section 1.199A-4(c)(2)(i). The Preamble requests comments as to whether it is administrable to create a standard under which trades or businesses will be disaggregated by the Commissioner and what that standard might be.

With respect to disaggregation, we believe that additional rules permitting the Commissioner to disaggregate two previously aggregated trades or businesses may not be necessary, though we do suggest that the information required to be provided under Proposed Regulations Section 1.99A-4(c)(2)(l)(d) include all information required to support the conclusion that the aggregation conditions have been met. If two trades or businesses may appropriately be aggregated under Proposed Regulations Section 1.199A-4, it is not clear how or why disaggregation would be needed to serve the purposes of Section 199A. The Commissioner can always assert that inappropriate aggregating should be disregarded under the plain text of the rule without requiring recourse to an anti-abuse rule. As such, we do not believe that a disaggregation rule is necessary or appropriate at this time.

We do, however, believe that the Commissioner should have the right to require aggregation in situations where taxpayers engage in a transaction or series of transactions a principal purpose of which is to use the aggregation rules of Proposed Regulations Section 1.199A-4 to artificially increase the taxpayer's Section 199A deduction.

> **Example 36.** As of January 1, Year 1, A and B each own 50 percent of the capital and profits of partnership PRS. PRS is engaged in two trades or businesses. In City 1, PRS is engaged in the trade or business of managing gymnasiums. In City 2, PRS

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[90] *Id.*

[91] *Id.*

> is engaged in the trade or business of managing a personal training clinic. The gymnasium in City 1 generates approximately $1 million of net income annually and pays $20,000 in W-2 wages. The personal training trade or business in City 2 generates approximately $600,000 of losses annually and pays $160,000 in W-2 wages.
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> With a principal purpose of using the aggregation rules of Proposed Regulations Section 1.199A-4 to increase A's and B's deduction under Section 199A, on January 1 of Year 2, A and B cause PRS to divide into three partnerships, PRS1, PRS2, and PRS3. PRS3 takes all the employees of former PRS in both City 1 and City 2. PRS3 offers personal trainers directly to customers at the gymnasium in City 1 to enhance its ability to aggregate with other trades or businesses under Proposed Regulations Section 1.199A-4. PRS1 manages the gymnasium in City 1, paying PRS3 an arm's length fee to make PRS3's employees available to PRS1. PRS2 manages the personal training clinic in City 2, paying PRS3 an arm's length fee to make PRS3's employees available to PRS2.
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> At the end of Year 2, PRS1 has net income of $950,000, PRS2 has net loss of $650,000, and PRS3 has net income of $100,000. PRS3 has paid $180,000 in W-2 wages. A and B elect to aggregate PRS1 and PRS3 pursuant to Proposed Regulations Section 1.199A-4, but not PRS2. PRS1 and PRS3 generate QBI of $1,050,000. PRS2's net loss reduces aggregate QBI by $650,000 to $400,000. Each of A and B therefore will be allocated a total of $200,000 of QBI.
>
> In addition, each of A and B is allocated $90,000 in W-2 wages from PRS1 and PRS3 (*i.e.*, 50 percent of the W-2 wages paid by PRS3). Accordingly, each of A and B has a deduction equal to the lesser of $40,000 (*i.e.*, 20 percent of $200,000) and $45,000 (*i.e.*, 50 percent of the W-2 wages paid by PRS1 and PRS3). A and B each deducts $40,000 under Section 199A.

In Example 36, if PRS had not engaged in the proposed division, A and B would have been allocated only $10,000 of W-2 wages with respect to the gymnasium trade or business (*i.e.*, 50 percent of the $20,000 paid by the gymnasium business), and the $160,000 of W-2 wages paid by the personal training trade or business would not have been taken into account in measuring the W-2 wage limitation under Section 199A because the personal training business with respect to which W-2 wages were paid was in a net loss position. However, by engaging in the partnership division and taking advantage of the aggregation rules, A and B have managed to effectively utilize the W-2 wages paid by the unprofitable personal training clinic to increase the limitation on the Section 199A deduction associated with the profitable gymnasium management business.

We believe this result is not intended by the Proposed Regulations, and accordingly encourage Treasury to consider anti-abuse provisions that allow the Commissioner to aggregate trades or businesses where the taxpayer engages in a transaction or series of transactions, a principal purpose of which is to use the aggregation rules of Proposed Regulations Section 1.199A-4 to artificially increase the taxpayer's Section 199A deduction.

E. Proposed Regulations Section 1.199A-5

1. Definition of a "Specified Service Trade or Business"

For taxpayers with income above a threshold amount, the Section 199A deduction is only available in respect of income from a "qualified trade or business," which is defined as any business other than a "specified service trade or business" (an "***SSTB***") or the performance of services as an employee.[92] An SSTB is any trade or business (1) 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 (2) which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests, or commodities.[93] We appreciate the substantial guidance provided by the Proposed Regulations with respect to each listed category of SSTBs. In response to the government's request for comments on the clarity of the definitions for the statutorily enumerated SSTBs under Section 199A(d)(2)(A) and accompanying examples, we offer the following comments and recommendations.

a. In General

(1) Services Requirement

Proposed Regulations Section 1.199A-5(b)(1) defines an SSTB as "[a]ny trade or business involving the performance of services" in one or more specified fields. Despite this language, and although one purpose of the SSTB exclusion is undoubtedly to prevent individuals from converting what otherwise would be salary, wages, or self-employment income into QBI, the overall architecture of Section 199A and relevant legislative history suggest that this is not its sole purpose of the SSTB limitation, and that the performance of services is not intended to be the *sine qua non* of a business's status as an SSTB.

Several trades or businesses listed in Section 199A(d)(2)(B) (trading and dealing in securities, partnership interests or commodities) generally do not have a services component, and we do not understand the statute to require the performance of services for such trades or businesses to constitute SSTBs. Unlike Section 199A(d)(2)(A), which defines as SSTBs certain trades or businesses "involving the performance of services in" specified fields,[94] Section 199A(d)(2)(B) defines as an SSTB "any trade or business . . . which involves the performance of services *that consist of* investing and investment management, trading, or dealing in securities[,] . . . partnership interests, or commodities . . . ." (Emphasis added.) We understand the words "that consist of" to equate the listed trades or businesses to the performance of services by statutory definition; in other words, the statute does not require the actual performance of services in order for a trade or business of investing and investment management, trading, or

[92] Section 199A(d).

[93] Sections 199A(d)(2)(A) and (B).

[94] *See* Section 1202(e)(3)(A).

dealing in securities, partnership interests or commodities to amount to an SSTB. The statutory language also indicates that performance of services is not required for SSTB status in the case of a trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners.[95]

While it appears that certain non-service-based businesses can be SSTBs, certain service-based businesses are excluded from the definition. In particular, Section 199A(d)(2)(A) expressly carves out from its reference to Section 1202(e)(3)(A) the performance of services in the fields of architecture and engineering,[96] and does not refer to any of the businesses listed in Section 1202(e)(3)(B)–(E), some of which are service-based (*e.g.*, the business of operating a restaurant). In addition, the statute does not seem to draw any distinction between the treatment of an SSTB owner that is a service provider in the business and one that is not. While aspects of the policy underlying Section 199A are unclear, the foregoing observations suggest that Congress may have intended (1) to tax income from certain *industries* (whether or not involving services) operated as sole proprietorships or in pass-through entities at a higher rate and (2) to treat passive owners of SSTBs similarly to individuals providing services in respect of SSTBs.

The Proposed Regulations seem generally consistent with this understanding. Proposed Regulations Sections 1.199A-5(b)(2)(xii) and (xiii), respectively, define "the performance of services that consist of . . . trading" as simply "a trade or business of trading"[97] and similarly define "the performance of services that consist of . . . dealing in securities[,] . . . partnership interests, or commodities" as "regularly purchasing [securities, partnership interests or commodities, as applicable] from and selling [securities, partnership interests or commodities, as applicable] to customers in the ordinary course of a trade or business . . . ."[98] In each case, the actual performance of services is not required.[99] Similarly, Proposed Regulations Section 1.199A-5(b)(2)(xiv) does not require the performance of services. Nevertheless, the Proposed Regulations are replete with references to the "performance of services," even where no service requirement seems to exist.

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95 Section 199A(d)(2)(A) provides that an SSTB means any trade or business described in Section 1202(e)(3)(A) (substituting the term "employees or owners" for the word "employees"), and Section 1202(e)(3)(A), in turn, refers to "any trade or business involving the performance of services in the fields of . . . *or* any trade or business where the principal asset of such trade or business is the reputation or skill or 1 or more of its employees." (Emphasis added.)

96 Although the Senate proposed defining as SSTBs all trades or businesses "involving the performance of services described in section 1202(e)(3)(A)" which would include engineering or architecture, Congress specifically chose to exclude these archetypal service businesses from SSTB status in the final version of Section 199A. See Conference Report at 223.

97 Proposed Regulations Section 1.199A-5(b)(2)(xii). Furthermore, the Proposed Regulations provide that whether a person is a trader is determined by reference to all facts and circumstances, "regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof." *Id.*

98 *Id.* Proposed Regulations Sections 1.199A-5(b)(2)(xiii)(A), (B) and (C).

99 We note, however, that the regulatory definition of "investing and investment management" does require the performance of services. Proposed Regulations Section 1.199A-5(b)(2)(xi). For the reasons discussed in this report, it is not clear that such a requirement is consistent with the statutory language.

We believe the use of the phrase "performance of services" in the main definition of SSTB in Proposed Regulations Section 1.199A-5(b)(1) and other parts of the Proposed Regulations[100] confuses rather than clarifies. Accordingly, we recommend that Treasury explicitly clarify in the definition of SSTB whether the performance of services is required with respect to investing and investment management, trading and dealing (rather than eliminating the service requirement through unintuitive sub-definitions) and more generally remove references to the performance of services in discussing SSTBs where it is not a necessary factor.

We would also welcome additional examples involving passive owners of SSTBs or SSTBs that involve services of multiple individuals in, and income streams from, different fields. Because the SSTB exclusion is heavily informed by areas of the Code that focus on individual service providers providing services in the same field, applying the statutory language to a multi-faceted trade or business can be challenging.[101] For example, Treasury could consider examples involving businesses such as movie studios, art galleries, teaching hospitals, due diligence firms, compliance firms or legal research firms, as further discussed below.

(2) "Involving" Standard

As stated above, Section 199A defines an SSTB as any trade or business "which involves" the performance of services in or that consist of one or more specified fields.[102] Paraphrasing the statute, the Proposed Regulations define an SSTB as "[a]ny trade or business involving the performance of services in one or more of the" enumerated fields.[103] Read together with the *de minimis* rule set forth in Proposed Regulations Section 1.199A-5(c)(1) (which generally provides that a trade or business is not an SSTB if less than a specified percentage of its gross receipts are attributable to SSTB activities), we understand this provision to mean, for example, that a plumbing business (with gross receipts greater than $25 million and one set of books and records) that derives 6 percent of its revenue from consulting regarding plumbing matters in one year would be a "consulting" business for that year and the Section 199A deduction would not be available with respect to any of its income. However, if the consulting revenue dropped to 4 percent of total

[100] *See* Proposed Regulations Sections 1.199A-5(b)(2)(xi), (xii) and (xiii).

[101] While Proposed Regulations Section 1.199A-5(b)(3), Example 2 provides some guidance in the context of professional sports teams, the example does not analyze the fact that different income streams may be relevant to such enterprises (*e.g.*, concessions, advertising and merchandizing), nor is it clear whether the example should apply to other SSTBs that similarly integrate different kinds of income and activity that, each standing alone, may not be an SSTB. For further discussion of the challenges associated with the Proposed Regulations' treatment of professional sports teams, *see* American Bar Association Section of Taxation, Comments on Proposed Regulations Regarding the Deduction for Qualified Business Income Under Section 199A, at 42–44 (Oct. 12, 2018); Letter from Robert D. Manfred, Jr., Commissioner, Major League Baseball, to David J. Kautter, Assistant Secretary (Tax Policy) *et al.* (Oct. 12, 2018), *available at* https://www.regulations.gov/contentStreamer?documentId=IRS-2018-0021-0329&attachmentNumber=1&contentType=pdf.

[102] Sections 199A(d)(2)(A) and (B).

[103] *Id.* Proposed Regulations Section 1.199A-5(b)(1).

revenue the following year, the plumber would be eligible for the Section 199A deduction with respect to the entire business.

We do not perceive a sound policy reason why such a small fluctuation in one revenue stream should drive such drastically different tax consequences. We also note that denying the Section 199A deduction in respect of the non-SSTB income from a business that has more than *de minimis* service income is in tension with Congress's decision to provide the deduction to businesses other than SSTBs in the first place. Accordingly, we believe that the mere involvement of the performance of services in an enumerated field should not necessarily transform an entire trade or business into an SSTB.

While we note that Section 199A refers to a trade or business "involving" the performance of services, we believe that the statutory language is ambiguous enough to permit the final regulations to clarify, as we believe they should, that a trade or business that involves both the performance of services in field specified in Section 199A(d)(2) and the performance of services not so specified may generate qualified business income to the extent such income is derived from the performance of services outside the specified field. Even if one plausible reading of the statute is that any activity involving the performance of services in a specified field "taints" a trade or business, we believe the Service would be within its regulatory authority to provide that, for purposes of Section 199A, a person is engaged in multiple trades or businesses if one or more potential trades or businesses, standing alone, would constitute an SSTB and one or more would not, consistent with our perception of the policies underlying the statute.[104]

(3) De Minimis Rule

The Proposed Regulations provide that a trade or business with $25 million or less of gross receipts in a taxable year will not be treated as an SSTB if less than 10 percent of such gross receipts are attributable to the performance of services in a field described as an SSTB under the Regulations.[105] A trade or business with gross receipts of more than $25 million for a taxable year will not be treated as an SSTB if less than 5 percent of such gross receipts are so attributable.[106]

We believe this rule is helpful and agree that a trade or business with a *de minimis* service component ought not to be an SSTB. However, we suggest Treasury consider the interaction between the *de minimis* rule and the "involving" standard for determining when a business is an

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[104] Although regulations under Section 446 provide that a taxpayer must maintain different books and records for different businesses to use different methods of accounting, (Treasury Regulations Section 1.446-1(d)(2)), this is not a universal method for determining whether a taxpayer is engaged in more than one trade or business. For example, under the 2006 model U.S. income tax treaty, one trade or business may form a part of a second trade or business or they may be treated entirely separately, depending on whether the relevant "activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services," regardless of books and records. Technical Explanation of U.S. Model Income Tax Convention of November 15, 2006, at 63 (2006). And while we suggested a Section 446 standard in the Prior Report for purposes of identifying a QTB unit in the aggregation context, this is not the approach taken in the Proposed Regulations.

[105] Proposed Regulations Section 1.199A-5(c)(1)(i).

[106] Section 1.199A-5(c)(1)(ii).

SSTB (discussed above at Part III.*E*.1.a(2)). In particular, we would welcome guidance with respect to how a taxpayer may determine whether the gross receipts attributable to the performance of services in a field described as an SSTB amount to a separate trade or business (and thus constitute an SSTB generating income ineligible for the Section 199A deduction) or should be tested as part of a trade or business with other gross receipts (and are thus potentially eligible for the deduction by virtue of the *de minimis* rule). In addition, if Treasury accepts our recommendation with the respect to the "involving" standard, Treasury may consider making the *de minimis* rule operate reciprocally, *i.e.*, denying the Section 199A deduction to trades or businesses involving a relatively small amount of non-SSTB income.[107]

b. Health

The Proposed Regulations define the "performance of services in the field of health" to mean "the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient)."[108] The Proposed Regulations further clarify that the performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient, such as the operation of health clubs or health spas, payment processing, or the research, testing and manufacturing and/or sales of pharmaceuticals or medical devices.

The foregoing Proposed Regulation appears to be heavily informed by existing guidance under Section 1202(e)(3)(A) and Section 448 and the Treasury Regulations promulgated thereunder. Except for two notable exceptions discussed in more detail below, both the general definition of services performed in the field of health and the express exclusion of services not directly related to a medical services field generally track the language of Temporary Regulations Section 1.448-1T(e)(4). In addition, many of the specifically enumerated examples of included professions (physicians, nurses and dentists) and excluded businesses (health clubs and health spas) are also set forth in Temporary Regulations Section 1.448-1T(e)(4) or otherwise appear to be based on preexisting guidance under Sections 1202(e)(3)(A) and Section 448.[109]

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107 Under our recommended approach to the "involving" standard. taxpayers would generally be entitled to a Section 199A deduction in respect of all non-SSTB income. In that case, the current *de minimis* rule would operate solely to the taxpayer's benefit, and there could be circumstances where a taxpayer is engaged in a trade or business with a little non-SSTB income, all of which would be eligible for the Section 199A deduction. If this result is at odds with the policies that led the Service to craft the *de minimis* rule, the rule could be made symmetrical and deny the Section 199A deduction entirely in respect of income from a trade or business with (to use the thresholds in the Proposed Regulations) $25 million or less of gross receipts in a taxable year if 90 percent or more of such gross receipts are attributable to the performance of services in an SSTB (increased to 95 percent in the case of a trade or business with more than $25 million in gross receipts). This symmetry would not, however, be necessary if the current "involving" standard is retained because, as we understand the Proposed Regulations, a trade or business with any SSTB income over the *de minimis* threshold would already be considered an SSTB in its entirety.

108 Proposed Regulations Section 1.199A-5(b)(2)(ii).

109 *See* Rev. Rul. 91-30, 1991-1 C.B. 61 (veterinarians are "similar health care professionals" within the meaning of Treasury Regulations Section 1.448-1T(e)(4)(ii)); Priv. Ltr. Rul. 9222004 (Jan. 8, 1992) (physical therapy

We commend Treasury for taking Temporary Regulations Section 1.448-1T(e)(4)(i) as a starting point for the definition of the performance of services in the field of health for purposes of the Proposed Regulations, as suggested by the legislative history to Section 199A.[110] But, we believe that certain modifications and clarifications, to a large extent drawn from law and guidance developed under Section 448, would further the goal of sound tax administration and would be helpful to taxpayers.[111]

(1) Provision of Services "Directly" to a Patient

The first significant departure from the Temporary Treasury Regulations under Section 448 is the requirement that the medical services be provided *directly* to a patient.[112] It is unclear whether the addition of the words "who provide medical services directly to a patient" are meant to expand or contract the range of professionals considered to perform services in the field of health, and whether or to what extent they render inapplicable the body of law developed under Section 448. Specifically, it is unclear whether the addition of the phrase means that the touchstone for the performance of services in the field of health for purposes of Section 199A is direct patient contact rather than medical training, skills or judgment exercised in the course of diagnosis or treatment of disease, injury or disability.[113]

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involves medical services, defined by reference to Section 213 and Treasury Regulations Section 1.213-1(e)(1)(i) as "the diagnosis, cure, mitigation, treatment or prevention of disease," and physical therapists are "similar health care professionals" as the very nature of their services is "to provide evaluation, treatment, instruction, and administration of physical therapy services for the purpose of assessing, preventing, correcting or alleviating physical disability or pain"); Priv. Ltr. Rul. 8927006 (Mar. 31, 1989) (medical billing of insurance claims for doctors and patients is not included within "health services" for purposes of Section 448(d)(2)(A)); Priv. Ltr. Rul. 201712010 (Jan. 20, 2017) (laboratory testing and research company that does not diagnose or treat patients not disqualified under Section 1202(e)(3)); Priv. Ltr. Rul. 201436001 (Sept. 5, 2014) (a pharmaceutical company researching, testing, and manufacturing drugs but not providing patient services not disqualified under Section 1202(e)(3)).

110 Conference Report at 216 n.44. While the citation to Treasury Regulations Section 1.448-1T(e)(4)(i) is located in the Conference Report's discussion of the Senate's amendment to the statutory language proposed by the House of Representatives, the Conference Agreement adopted the Senate's amendment (as relevant to the provision of services in the field of health).

111 Guidance under Section 448 is of course not comprehensive, and we would welcome clarification of close cases in the field of health not addressed by authorities pursuant to Section 448 as well, including whether dieticians, substance abuse and pastoral counselors provide services in the field of health.

112 *See* Treasury Regulations Section 1.448-1T(e)(4). Presumably, given the inclusion of veterinarians, the patient need not be human.

113 *See Zia Ahmadi et al. v. Comm'r*, T.C. Summary Op. 2017-39 (holding that "the phrase 'field of health' includes services provided by healthcare *professionals* that are directly related to a medical field" (emphasis added) and that petitioner was a health care professional because of his two years of specialized training); Field Serv. Adv. 1999-919 (x-ray technologist (*not* an x-ray *technician*) provided services in the field of health for purposes of Treasury Regulations Section 1.448-1T(e)(3) in part because of extensive training required to perform x-ray and radiologic tests); Tech. Adv. Mem. 9309004 (Nov. 23, 1992) (emergency medical services are provided in the field of health for purposes of Treasury Regulations Section 1.448-1T(e)(4)(i)(A) because emergency

Such an interpretation would lead to some curious and seemingly arbitrary results. A physician who deals directly with the patient and a medical specialist (such as a radiologist[114]) who acts as an expert consultant to a physician (but generally does not see patients) have similar education and training and engage in similar activities. Both exercise medical skills and judgment in determining a patient's diagnosis and recommended treatment. By contrast, technicians who operate medical equipment (such as x-ray technicians) without exercising medical judgment are situated similarly to laboratory technicians who test blood samples in terms of the diagnosis and treatment of patients, but an x-ray technician may have a closer degree of patient contact than a radiologist.

We believe Section 199A should take a functional approach and not rely on distinctions based on patient proximity but rather define the performance of services in the field of health as the exercise of medical judgment in determining a patient's diagnosis and recommended treatment. Accordingly, we believe that radiologists should be treated similarly to general practitioner physicians (and that both should generally be considered to perform services in the field of health), and that in-hospital medical equipment technicians should be treated similarly to laboratory technicians (and that both should generally be considered not to perform services in the field of health).

(2) Pharmacists

A second departure from guidance under Section 448 is the explicit inclusion of pharmacists in the list of professionals performing services in the field of health. Consistent with the foregoing analysis, this inclusion is puzzling and should be removed in favor of the standard that a person performs services in the field of health if such person exercises medical judgment in determining a patient's diagnosis and recommended treatment.

There are several kinds of pharmacists. Retail pharmacists dispense medicines at drug stores, convenience stores or even grocery stores. Compounding pharmacists customize medications (or supervise the customization of medications) to meet a patient's needs pursuant to a prescription. Clinical pharmacists work in hospitals, clinics and other health care settings and advise doctors on optimizing medications. There are also specialized professionals such as oncology or chemotherapy pharmacists, nuclear pharmacists (who compound and dispense radioactive materials for use in nuclear medicine procedures) and research pharmacists. Additionally, people who are technically "pharmacy technicians" may be referred to colloquially as pharmacists. While all pharmacists have significant training (they must possess a doctor of pharmacy degree, which is typically a six-year program that effectively combines a bachelor's degree and graduate education), the activities a pharmacist engages in depend on individualized

medical technicians, among other things, "are trained to perform medical services in this narrow medical area at least as well as most licensed physicians and nurses").

114 A radiologist is a medical doctor that specializes in diagnosing and treating injuries and diseases using medical imaging procedures. Radiologists must complete at least eight years of medical training, are certified by the American Board of Radiology and have exacting requirements for continuing medical education throughout their practicing years. However, radiologists primarily act as expert consultants to patients' referring physicians, and while they interpret test results, perform diagnosis and recommend treatment, they may not engage with a patient directly.

circumstances, and may range from the relatively routine tasks of dispensing drugs pursuant to prescriptions to providing important advice regarding a patient's treatment as part of a medical team.

While retail pharmacists may have direct contact with a patient insofar as they typically work at the point of sale for prescription medications, they play little if any part in diagnosing or treating patients.[115] And while such pharmacists may advise patients on the side effects of drugs or the interaction among different medications, we understand that practice to be relatively automated and more similar to the role a technician has with respect to medical devices than the role physicians and nurses have with respect to patients. Accordingly, we recommend that pharmacists be removed from the list of persons categorically performing services in the field of health.[116]

c. Performing Arts

For purposes of Section 199A, the Proposed Regulations define "the performance of services in the performing arts" as:

> the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

This definition creates certain complexities and ambiguities that are similar to those discussed elsewhere in this Report but especially troubling in the context of the performing arts, as so many professionals contribute to works of art in different capacities with varying degrees of creativity, and so many service providers are independent contractors who work inside and outside the field. Particularly in light of Congress's choice to apply Section 199A to service providers and owners of SSTBs, the varying roles that different professionals have in contributing to a work of performance as complex as a film or sophisticated theatrical production necessarily complicate

[115] Additionally, if our recommendation with respect to the direct provision of services to a patient is not accepted, it would still make little sense to define certain kinds of pharmacists (*e.g.*, compounding pharmacists) as medical service providers, as they have little patient contact, if any.

[116] Our recommendation is consistent with some non-binding authority under Section 448. In the context of, among other things, determining whether a medical clinic's pharmacy ("a significant retail operation") contributes to the performance of services in the field of health, a Field Service Advisory approvingly cites Private Letter Ruling 199222004 for its "definition of medical care as the diagnosis, cure, mitigation, treatment, or prevention of disease." Field Serv. Adv. May 14, 1997, 1997 WL 33313722. The Field Service Advisory stated that, although it was possible that a pharmacy could perform qualifying activities for purposes of Section 448(d)(2)(A), "the customers and patients of the . . . pharmacy . . . are not price unconscious, treatment focused patients," and accordingly the retail activities of the pharmacy are among "the most likely nonqualifying activities" of the medical clinic. *Id*.

line-drawing. While we appreciate the difficulty of the task of drafting a comprehensive regulation, we believe the Proposed Regulation would benefit from clarifications as to the significance of whether a profession involves "skills unique to the creation of performing arts,"[117] the meaning of the exception for broadcasting, and whether ownership in a film studio or other performing arts production enterprise constitutes an SSTB.

(1) "Skills Unique to the Creation of Performing Arts"

Many individuals who are not performers but are service providers in the performing arts industry, including businesspeople and technical professionals, have a broad skill set partially applicable only to the performing arts, and partially applicable elsewhere. For example, creative and executive producers of films or theatrical productions undoubtedly apply skills learned in and specific to the performing arts, such as choosing scripts, hiring directors and predicting the receipts for films and budgeting accordingly. At the same time, they are not themselves performers and apply to their trades many skills not specific to the performing arts, from project management to financial modeling. Likewise, many "backstage" professionals (*e.g.*, hair artists, sound mixers, set builders and lighting designers) have skills that apply in and out of the performing arts field. A make-up artist for a film, by way of example, will need to understand how cosmetics will interact with lighting, camera settings and possibly special effects. Additionally, makeup in the performing arts context often may more drastically change the appearance of an actor as compared with makeup applied at a beauty salon. Indeed, makeup and hairstyling is an Academy Award category. It is nonetheless likely that all make-up artists, regardless of whether they work in the performing arts, share some common knowledge and skill, for example, with respect to the selection of colors and products appropriate to a given complexion, skin and facial features.[118]

Arguably, the Proposed Regulations provide that the only professions excluded from the definition of the "performance of services in the field of performing arts" are those that require no "skills unique" to the performing arts. Under such interpretation, arguably all close cases would be resolved in favor of denying the Section 199A deduction. It is not clear that this is what Congress intended.[119] We would appreciate the final regulations providing clarification on this

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117 *See* Proposed Regulations Section 1.199A-5(b)(2)(vi).

118 Similarly, fashion designers and costume designers share a great deal of knowledge and skill with respect to the creation of clothing (cutting and sewing fabric at the most basic level), but they may be engaged in fundamentally different projects requiring different expertise. Fashion designers create contemporary clothing, either to be worn or (in the case of certain runway designs) to advertise a couturier's skill, while costume designers apply similar mechanical skills to the production of a larger work of art, taking into account narrative and directorial requirements. In some instances, even the boundaries of "the performing arts" are unclear. Remaining in the context of the fashion industry, models and other professionals may participate in elaborately produced shows, which require skills often employed by actors and other theatrical professionals but aim to sell products only incidentally by way of entertainment. More generally, advertising, particularly video and audio advertising, requires many skills typically associated with the performing arts, but the entertainment value of advertising is ancillary to the goal of selling products. We would welcome clarity on the status of these professionals for purposes of Section 199A.

119 In contrast to guidance under Section 448, the Proposed Regulations include "directors" in the list of professionals who provide services in the field of performing arts. *See* Tech. Adv. Mem. 9416006 (Jan. 4, 1994) ("[O]nly persons who perform for an audience will be considered to perform services in the field of the performing arts. . . . Although a director may contribute artistic skills to the production of a motion picture, the

point through additional examples (*e.g.*, executive producers, creative producers, costume design, hair and makeup design) and, if the interpretation above is not what was envisaged, a revised standard (for example, Treasury may consider a standard that excludes the provision of services that do not require a skill set primarily consisting of skills unique to creation of performing arts).

We note that if the intent of the Proposed Regulations is in fact to treat the provision of services that arguably involve any skill that is unique to the creation of the performing arts as an SSTB, such a standard could lead to particularly arbitrary results when applied together with the "involving" standard (as currently articulated). Take for example a hair professional who has skills that are particularly relevant in the performing arts, such as the ability to find and recreate historical hairstyles appropriate for a period project, as well as to create elaborate hair pieces that can transform the actor into, say, a monster or an alien. In a taxable year, the professional, who maintains a single set of books and records, works on a movie set, generating fees which account for 12 percent of his or her annual income, and also provides hairstyling services to wealthy individuals and celebrities. If the professional's performance of services for the movie constitutes an SSTB because skills unique to the performing arts are involved, it appears that none of his or her income for the year is eligible for the Section 199A deduction. At the same time, a hair professional with identical skills and book of private clients who is not involved in any performing arts projects is presumably entitled to a Section 199A deduction. It is difficult to discern any apparent policy justification for this result. We thus reiterate our recommendation that Treasury reconsider whether an SSTB should be "[a]ny trade or business *involving* the performance of services"[120] in the listed fields, or should instead should be such a trade or business *to the extent* it involves the performance of such services.[121]

(2) Broadcasting Exception

Proposed Regulations Section 1.199A-1(b)(2)(vi) excludes from the definition of the performance of services in the field of performing arts the "provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public." The scope of

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activities of a director do not involve performing before an audience."). The available legislative history cited the Temporary Treasury Regulations under Section 448 with approval, suggesting that a business that derives income from a combination of performing artists and others in professions ancillary to performance may not be an SSTB, at least to the extent of its income not attributable to the services of performers. Conference Report at 216 n.45 ("The performance of services in the field of the performing arts does not include the provision of services by persons *who themselves are not performing artists* (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts)" (emphasis added)) (discussing Senate amendment). We acknowledge that, if the performance of services in the performing arts were narrowly defined to encompass only activities of performers, film studios and other performing arts production companies would arguably not constitute SSTBs because the products such enterprises create depend to such a great extent on services by people other than performers. We thus believe the inclusion of directors makes sense in light of our understanding that Congress intended to tax certain industries more heavily than others and to treat owners of and service providers with respect to SSTBs alike; however, as noted above, we believe the "skills unique" standard may be over inclusive and deny the Section 199A deduction in respect of some income that Congress intended to tax at a lower rate.

[120] *Id.* Section 1.199A-5(b)(1) (emphasis added).

[121] *See* Part III.*E*.1.a.2.

this exclusion, which is not discussed in the Preamble, is unclear.[122] That is, it is unclear whether the exception is meant merely to apply to income earned from the dissemination of content through cable, internet, mobile or other technologies, or to be something broader. We assume that a newscaster and other individuals involved with the production of a newscast do not perform services in the field of performing arts, either because delivering news has no connection to the performing arts or the broadcasting exception applies. However, we would appreciate clarification regarding the scope of the broadcasting exception as applied to professions that are expressly listed as involving services in the performing arts but are performed in the broadcasting context (*e.g.*, a director of a newscast or a broadcast of a professional sports event), as well the treatment of media and programming in gray areas that involve both creative and broadcasting elements, such as newsmagazines, "true crime" programs, documentaries, and historical film and television programs.

The scope of the broadcasting exception is also unclear when applied to trades or businesses that consist of activities of multiple individuals in different fields. For example, Treasury Regulations Section 1.448-1T(e)(4)(iii) refers to "employees of a radio station that broadcasts the performances of musicians and singers" as an example of the broadcasting exception. Presumably individuals involved with the broadcasting aspects of a TV channel or movie streaming service would be treated similarly. But it is not clear how a partnership operating a TV channel or video streaming service should be treated if the TV channel or streaming service, as is now common, also creates original programming. Similar questions arise with respect to other media companies, such as a movie studio that sells a work of performing arts to a distributor. Even though a movie studio is fundamentally engaged in the business of creating a film, such business could also arguably be considered as literally involving the dissemination of video or audio of performing arts to the public.[123]

d. Miscellaneous Clarifications

(1) Law

The application of the "skills unique" standard to the field of law further illustrates the difficulties and odd results discussed in Part III.*E*.1.c(1) above. Many professions require skills unique to the practice of law, but should not necessarily constitute the performance of services in the field of law for purposes of Section 199A, *e.g.*, research, clinical and adjunct legal academia, service as a legal secretary,[124] word processing for law firms, service as a law librarian (in either a university, law school or law firm), and ministerial compliance functions. Consistent with our

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[122] Treasury Regulations Section 1.448-1T(e)(4)(iii) also contains a broadcasting exception but helpfully provides as an example of broadcasters "employees of a radio station that broadcasts the performances of musicians and singers." It is unclear whether the omission of those words from the Proposed Regulations is intended to affect the scope of the broadcasting exception (presumably by broadening it).

[123] *See* Proposed Regulations Section 1.199A-1(b)(2)(vi).

[124] Legal secretaries typically perform tasks similar to those provided by administrative assistants in non-legal fields but may have training or experience specific to law (*e.g.*, filing court documents, managing legal correspondence (including summonses and subpoenas), using software to track billable hours and monitoring compliance with court deadlines).

recommendation with respect to performing arts, we would welcome clarification as to whether, as a general matter, the performance of services that may require some skills unique but other skills not unique to the field of law are or are not SSTBs even if the skills unique to the field of law do not predominate over other skills.

Separate from the "skills unique" standard, the scope of "the field of law" is unclear, particularly as applied to mediators. Some mediators, often in the context of divorce, may lack legal training but resolve disputes, provide services that may replace qualitatively different services by lawyers and deliberately differentiate themselves from partisans acting in the best interests of a client. We would welcome clarification of the scope of "mediation" for purposes of Proposed Treasury Regulations Section 1.199A-5(b)(2)(iii).

(2) Consulting

We note that Proposed Regulations Section 1.199A-5(b)(2)(vii) differs in significant respects from Temporary Regulations Section 1.448-1T(e)(4)(iv), despite the favorable citation to such temporary regulation in legislative history discussing the Senate's proposed version of Section 199A.[125] The Proposed Regulations define the field of consulting as "the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems,"[126] while under Temporary Regulations Section 1.448-1T(e)(4)(iv) consulting is merely "the provision of advice and counsel." It is unclear whether and to what extent the difference in phrasing is meant to be meaningful. We would appreciate for Treasury to clarify in final regulations the extent to which the law developed under Section 448 and related Treasury Regulations may be relied on to determine whether a particular activity constitutes "consulting" for purposes of the Section 199A regulations. To the extent the Regulations are meant to cover similar activities, we recommend their words be conformed.

(3) Accounting and Financial Services

Consistent with case law,[127] the Preamble states that bookkeeping services are in the field of accounting.[128] The Preamble also excludes payment processing and billing analysis.[129] We recommend the text of final regulations itself incorporate these points and clarify whether persons providing ministerial compliance functions provide services in the field of accounting.

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[125] *See* Conference Report at 216 n.46.

[126] Proposed Regulations Section 1.199A-5(b)(2)(vii).

[127] *See Rainbow Tax Serv., Inc. v. Comm'r*, 128 TC 42, 47 (2007).

[128] Preamble at 40,897.

[129] *Id.*

The Preamble also excludes "taking deposits or making loans"[130] from the definition of the performance of services in the field of financial services. We believe these exclusions are helpful clarifications, and we recommend they be incorporated into the text of the final regulations.

(4) Further Guidance

As a general matter, regardless of whether the specific standards discussed in this Report are adopted, we recommend that the final regulations address the gray areas in many definitions, including those discussed above, especially in activities that may be "adjacent" to enumerated SSTBs.[131]

e. Reputation or Skill

Proposed Regulations Section 1.199A-5(b)(2)(xiv) sets forth a very narrow interpretation of what constitutes a "trade or business where the principal asset of such trade or business is the reputation or skill or one or more employees or owners." Specifically, the regulation defines such a business as:

> any trade or business that consists of any of the following (or any combination thereof): (A) [a] trade or business in which a person receives fees, compensation or other income for endorsing products or services; (B) [a] trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, [or] (C) [r]eceiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format[132].

For purposes of the foregoing, the term "fees, compensation, or other income" includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain or loss from the partnership, or the receipt of stock of an S corporation and the corresponding income, deduction, gain or loss from the S corporation stock.[133]

Section 1202(e)(3)(A), as modified by Section 199A(d)(2)(A), defines a "qualified trade or business" in relevant part as "any trade or business where the *principal asset* of such trade or business is the reputation or skill of 1 or more of its employees or owners," words echoed in the Proposed Regulations.[134] (Emphasis added.) However, the definition of "trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners" for purposes of Proposed Regulations Section 199A-5(b)(1)(xiii) does not depend on the nature or relative values of the assets of a particular trade or business. Instead, the Proposed

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130 Preamble at 40,898.

131 *See* Prior Report at 10–12.

132 Proposed Regulations Section 1.199A-5(b)(2)(xiv).

133 *Id.* Proposed Regulations Section 1.199-5(b)(2)(xiv)(D).

134 *See* Proposed Regulations Section 199A-5(b)(1)(xiii).

Regulations treat as an SSTB certain kinds of income received by particular individuals (*e.g.*, endorsement fees, royalties from licensing one's likeness, and speaking fees), an approach that bears a strained relationship to the relevant statutory text and does not find obvious support in the legislative history or other sources of law.[135]

While we recognize that the Proposed Regulation is administrable, we believe its approach can produce anomalous and even arbitrary results. For example, it is unclear why the trade or business of being a well-known chef and owning 10 restaurants in Proposed Regulations Section 199A-5(b)(3) Example 8 should not be considered an SSTB when presumably such chef is not cooking at more than one restaurant at a time and such restaurants are successful in significant part due to the chef's reputation, while a non-chef celebrity endorsing 10 restaurants would appear to be engaged in an SSTB.[136] It is also unclear why the existence of an SSTB could apparently turn on whether or not the business is conducted as a sole proprietorship. If the chef in Example 8, rather than conducting the restaurants as a sole proprietor, contributed such restaurants and the right for the restaurants to use the chef's name and likeness to a partnership, the chef would be engaged in an SSTB by analogy to Example 9. Moreover, by avoiding inquiry into what the principal asset of a trade or business is, the Proposed Regulations (as illustrated in Example 9) can treat different owners of a business the principal asset of which is the reputation or skill of one or more of its employees or owners unequally, granting the benefit of the Section 199A deduction to some owners but not others. This consequence is inconsistent with all other SSTBs[137] and, we believe, Congressional intent.

Nevertheless, we recognize the difficulties in defining "trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners," particularly in the absence of detailed legislative history or other clear indicia of Congressional intent. As noted in our Prior Report, we have not reached consensus on any particular definition, and we refer to the menu of possibilities discussed therein.[138]

2. Services Provided to Related SSTB

A trade or business will be treated as an SSTB if it "provides 80 percent or more of its property or services to an SSTB" and there is 50 percent or more common ownership of the trade or business and the SSTB.[139] Where a trade or business meets the 50 percent common ownership requirement with the SSTB but provides less than 80 percent of its property or services to an SSTB, the portion of the trade or business providing property or services to the SSTB is treated as part of the SSTB.[140] We recommend that the final regulation be clarified in several ways, discussed

135 *Id.* Proposed Regulations Section 199A-5(b)(2)(xiv).

136 *See id.* Proposed Regulations Section 199A-5(b)(3) Ex. 9.

137 *See, e.g., id.* Proposed Regulations Section 199A-5(b)(3) Ex. 2.

138 *See* Prior Report at 10–12.

139 *Id.* Proposed Regulations Section 1.199A-5(c)(2)(i).

140 *Id.* Proposed Regulations Section 1.199A-5(c)(2)(ii).

below, and that Treasury reconsider whether the 80 percent *per se* rule is preferable to a pure proportionate approach.

a. Clarifications

(1) "Property or Services"

It is unclear what it means for a trade or business to "provide 80 percent or more of its property or services to an SSTB"[141] and, specifically, how to measure the provision of property and services for purposes of this rule. We believe an approach that would lead to clear and consistent results would be to measure a trade or business's gross revenue earned from an SSTB rather than focusing on the provision of property and services.

(2) Clarification of Common Ownership Standard

As discussed above, in Part III.D.2.b, we believe the standards for common ownership throughout the Proposed Regulations would benefit from clarification. We also note that the standard for 50 percent common ownership articulated for purposes of Proposed Regulations Section 1.199A-5(c)(2), which measures ownership by reference to Sections 267(b) and 707(b), is not synchronized with the 50 percent common ownership standard for aggregating trades or businesses pursuant to Proposed Regulations Section 1.199A-4, which depends on direct or indirect equity ownership,[142] nor is it identical to the standard for 50 percent common ownership described in Proposed Regulations Section 1.199A-5(c)(3).[143] We recommend Treasury consider adopting a single standard for measuring overlapping ownership for purposes of Section 199A.

(3) Clarification of Timeframe

The Proposed Regulations provide no specific time period within which ownership and/or the provision of property or services should be tested. We assume an annual basis would be appropriate consistent with the Code's general reliance on annual reporting and accounting, but we would welcome explicit confirmation of this point.

(4) Reconsideration of 80 Percent *Per Se* Rule

Except possibly for the sake of administrative convenience, we do not perceive a policy reason why a trade or business that provides 80 percent or more of its property or services to an SSTB should be completely shut out from the Section 199A deduction. Even where 90 percent

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141 *Id.* Proposed Regulations Section 1.199A-5(c)(2)(i).

142 *See id.* Proposed Regulations Section 1.199A-4(b)(1)(i).

143 For purposes of Proposed Regulations Section 1.199A-5(c)(2)(iii), "50 percent or more common ownership includes direct or indirect ownership by related parties within the meaning of sections 267(b) or 707(b)," while Proposed Regulations Section 1.199A-5(c)(3) applies to a trade business that "has 50 percent or more common ownership with an SSTB, including related parties (within the meaning of sections 267(b) or 707(b))." It is unclear whether the slight differences in the phrasing of these two regulations is intended to be meaningful and, if so, how (or why).

of the trade or business's income is derived from a related trade or business, the remaining 10 percent appears to represent a "good" trade or business that Congress intended to incentivize through Section 199A. Consistent with our recommendation discussed above with respect to the "involving" standard and our recommendation with respect to the measurement of providing property and services, we recommend that a taxpayer be deemed to be engaged in an SSTB to the extent such taxpayer derives income from an SSTB, regardless of the percentage (except, potentially, under a *de minimis* rule). Thus, if the real estate partnerships in the example to Proposed Regulations Section 1.199A-5(c)(2) leased any percentage of its building to third parties, the owners of the partnerships would be considered engaged in an SSTB to the extent the partnerships' income is attributable to legal services and property used in the legal services business (including any income attributable to the lease paid by the law firm) and not so engaged to the extent income is attributable to real estate leasing to third parties.

3. Incidental Trades or Businesses

A trade or business is treated as an SSTB if it meets a 50 percent overlapping ownership test with respect to an SSTB (within the meaning of Section 267(b) or 707(b)) and has shared expenses with the SSTB, including shared wage or overhead expenses, if the gross receipts of the trade or business represent no more than 5 percent of the total combined gross receipts of the trade or business and the SSTB in a taxable year.[144] We suggest the final regulations add an exception for start-ups and clarify the overlapping ownership standard, the application of the rule to trades or businesses with different taxable years and the meaning of "shared expenses."

a. Start-Up Exception

In certain cases, an SSTB may enter a new trade or business not designed to serve the SSTB but that shares overhead with the SSTB either due to the newness of the trade or business or simply for the sake of convenience. While we note that the Preamble does not specify why Treasury chose to articulate the "incidental" rule, we assume that the rule is based on the reasonable presumption that a relatively small business that shares services with a larger business under common ownership likely exists to serve the larger business in some capacity and therefore might properly be thought of as a part of that larger business. This reasoning does not apply to start-ups in genuinely new lines of business "incubated" by larger businesses. For example, a large hospital that generally provides services in the field of health may decide to research or test pharmaceuticals or medical devices (areas excepted from the definition of provision of services in the field of health[145]), with a view toward entering into a significant new line of business. We recommend Treasury consider the effect of the "incidental" rule on start-up businesses with shared expenses, and whether a grace period should apply (*e.g.*, a new trade or business that would otherwise meet the requirements of a trade or business "incidental" to an SSTB will not be treated as such for the first three to five years of its existence).

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[144] Proposed Regulations Section 1.199A-5(c)(3).

[145] *Id.* Proposed Regulations Section 1.199A-5(b)(2)(ii).

b. Clarification of Overlapping Ownership Standard

As discussed above, in Parts III.D.2.b and III.*E*.2.a.2, we believe the standards for common ownership throughout the Proposed Regulations would benefit from clarification and harmonization. We believe that the rules of Overlapping Ownership Requirement under Proposed Regulations Section 1.199A-4, once clarified, would serve as an appropriate standard for measuring common ownership for all Section 199A purposes.

c. Different Taxable Years

The Proposed Regulations do not specify how a taxpayer would test whether a trade or business is incidental to an SSTB in the contexts of two trades or businesses with different taxable years. We suggest Treasury consider clarifying whether this rule applies where the SSTB and the trade or business in question operate on different taxable years and, if so, when the potentially incidental business should be tested.

d. Shared Expenses

The application of the "shared expenses" concept may cause a handful of challenges. First, and most fundamentally, it is not entirely clear what constitutes a "shared" expense. For example, is an expense only shared if each trade or business bears legal liability for the expense? If a qualified trade or business subleases office space from an SSTB, for purposes of local law, both may be legally liable to the landlord, or the qualified trade or business may be liable to the SSTB, who is liable to the landlord. In either of these circumstances, would the fact that both businesses have an obligation with respect to the same property make expenses with respect to such obligation "shared"? It is also unclear whether, if the qualified trade or business is assigned a portion of the SSTB's lease and thereafter rents the office space directly from the landlord, the two businesses would be deemed to share lease expenses for purposes of Proposed Regulations Section 199A-5(c)(3). And, if two businesses lease space in the same facility and the rent charged by the landlord is used in part to maintain common spaces and amenities that are shared by all tenants, an argument could be made that the portion of rent applicable to such maintenance is a "shared" expense. We would welcome clarification of these points.

Second, it appears plausible that shared expenses are intended as a proxy for interrelatedness. If this is the case, we recommend that Treasury consider whether the three-factor test from Proposed Regulations Section 1.199A-4(b)(1)(v), which may more effectively identify businesses with substantial relationships, should be applied in this context as well. Alternatively, we suggest Treasury consider whether a minimum amount of "shared" expenses should be required before rule applies. As drafted, even one dollar of shared expense would be sufficient to cause a qualified trade or business to become an SSTB if the qualified trade or business is sufficiently small (or the SSTB is sufficiently large).

Appendix

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

[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

[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…" <u>and</u> 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

[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

[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. Multiple Trades or Businesses

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;

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

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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 -

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[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

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[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?

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

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

[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.

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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).