

**Section of Taxation**

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June 18, 2018

David Kautter  
Acting Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20024

Re: Comments Concerning the Scope of a Specified Service Trade or Business within  
the Meaning of Section 199A

Dear Acting Commissioner Kautter:

Enclosed please find the second installment of a larger project by the American Bar Association Section of Taxation (the "Section") to provide comments on changes made by the 2017 tax legislation in anticipation of forthcoming guidance from the Service on section 199A ("Comments"). These Comments address the need for published guidance with respect to the scope of a specified service trade or business within the meaning of section 199A. They are submitted on behalf of the Section and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section will be pleased to discuss the Comments with you or your staff.

Sincerely,



Karen L. Hawkins  
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
Thomas West, Tax Legislative Counsel, Department of the Treasury  
Krishna P. Vallabhaneni, Deputy Tax Legislative Counsel, Department of the Treasury  
Audrey W. Ellis, Attorney-Advisor, Department of the Treasury  
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**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION**

**Comments Concerning the Specialized Service  
Trade or Business Activities for Purposes of Section 199A**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Comments are part of a larger project undertaken by the Section of Taxation (the “Section”) to provide comments on the changes made by last year’s tax reform legislation (the “Act”).<sup>1</sup> Because of the need for guidance, the Internal Revenue Service’s expedited regulation process, and the fact that these Comments deal with a fundamental issue in interpreting new section 199A, these Comments are being submitted as part of the Section’s general comments relating to section 199A and in response to requests by the Department of the Treasury and the Internal Revenue Service for comments on needed guidance under the Act.

Principal responsibility for preparing these Comments was exercised by C. Wells Hall III, Martin A. Culhane and Robert E. Box, Jr. The Comments have been reviewed by Beverly Katz, Vice Chair of the Partnerships and LLCs Committee, Robert Honigman, Chair of the Real Estate Committee, Adam M. Cohen, Council Director for the Partnerships and LLCs Committee and Real Estate Committee, Ronald A. Levitt, Council Director for the S Corporations and Closely Held Business Committees, and Jeanne Sullivan of the Section’s Committee on Government Submissions.

Although members of the Section of Taxation who participated in preparing these comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member of the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 18, 2018

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<sup>1</sup> An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054.

## EXECUTIVE SUMMARY OF RECOMMENDATIONS

These Comments address the need for published guidance with respect to the scope of a specified service trade or business (“SSTB”) within the meaning of section 199A.<sup>2</sup> This new section applies to tax years beginning after December 31, 2017.<sup>3</sup>

We respectfully request that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issue guidance under section 199A to address the following issues:

1. Guidance which provides clear guidelines for determining whether income derived from a specific trade or business is domestic qualified business income (“QBI”) under section 199A.
2. Consistent with the foregoing, guidance is needed to clarify whether income generated from the business lines identified in the comments below qualify as QBI under section 199A.
3. We recommend that Treasury and the Service publish a list of business types that are treated as SSTBs, or not SSTBs, and clear and objective criteria that will be used to evaluate trades or businesses as SSTBs or not SSTBs.
4. Guidance is needed to clarify whether those trades or businesses included in sections 1202(e)(3)(B) through (E), but not specifically included in the cross reference in section 199A(d)(2) to section 1202(e)(3)(A) and its other list of specified services businesses, are eligible for the benefits of section 199A.
5. Guidance is needed to clarify that the types of “financial services” businesses precluded from qualifying for the section 199A deduction include only those businesses providing services where the service component of the business is the primary business of the taxpayer, without the need for significant physical or intangible property to provide the products or services.
6. Guidance is needed to clarify that the reputation and skill clause of the SSTB definition (i) applies only where the service component is the primary business of the taxpayer and the principal asset of the business is the reputation or skill of its owners and employees; and (ii) is limited to specialized service and skill businesses, rather than applying to service businesses generally.

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<sup>2</sup> References to “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

<sup>3</sup> P.L. 115-97, § 11011(a).

## COMMENTS

### I. Background

The Act made substantial changes in the tax rules applicable to the business activities of taxpayers, effective for the current tax year. We commend Treasury and the Service for their commitment to provide expedited guidance, and we provide the following recommendations for consideration in the upcoming guidance relating to section 199A.

Section 199A generally provides an individual, trust, or estate a deduction equal to 20% of the individual's QBI from a pass-through entity in calculating taxable income for tax years beginning after December 31, 2017. Section 199A(c)(1) defines QBI as the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business ("QTB") of the taxpayer. Section 199A(d)(1) defines QTB to mean any trade or business other than a specified service trade or business ("SSTB") or the trade or business of performing services as an employee.

Section 199A(d)(2)(A) and (B) define a specified service trade or business as any trade or business that:

(A) Is described in section 1202(e)(3)(A) (applied without regard to the words 'engineering, architecture,') or would be so described if the term "employees or owners" were substituted for "employees" therein; or

(B) Involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

Thus, a business is an SSTB if it falls within a modified version of section 1202(e)(3)(A) or it involves the performance of services that consist of certain investing and investment management activities, trading, or dealing in securities, partnership interests, or commodities. As a result, an SSTB is defined for purposes of section 199A as any trade or business involving (i) the performance of services in the fields of health,<sup>4</sup> law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services<sup>5</sup> (collectively, the "Listed Businesses"); (ii) any trade or business where the principal asset of such trade or

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<sup>4</sup> A similar list of service trades or business is provided in section 448(d)(2)(A) and Regulation section 1.448-1T(e)(4)(i). For purposes of section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. *See* Reg. §1.448-1T(e)(4)(ii).

<sup>5</sup> The determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). Reg. § 1.448-1T(e)(4)(iv).

business is the reputation or skill of one or more of its employees or owners (the “Catchall Reputation and Skill Clause”); or (iii) 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 <sup>6</sup> (the “Additional Excluded Businesses”).

Section 199A does not cross reference the four other subparagraphs in section 1202(e)(3) – *i.e.*, subparagraphs (B) through (E) – that expand on the types of businesses ineligible for the benefits of section 1202 to:

- (B) any banking, insurance, financing, leasing, investing, or similar business,
- (C) any farming business (including the business of raising or harvesting trees),
- (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under sections 613 or 613A, and
- (E) any business of operating a hotel, motel, restaurant, or similar business.

Section 199A guidance is urgently needed in 2018 so taxpayers can properly estimate their 2018 tax liability. Conscientious taxpayers expect to make estimated tax payments, make required tax distributions from pass-through entities for the purpose of funding estimated tax payments, avoid underpayment penalties, and avoid overpaying estimated taxes (where the overpayment could otherwise have been reinvested in the business and fulfill the intent of section 199A). Prompt guidance will provide certainty to taxpayers and their advisors and allow them to meet realistic expectations in funding their tax liability under the new rules.

## **II. Discussion**

### **A. Scope of Specified Service Trades or Businesses**

The most critical issue for which guidance is needed is how section 199A(d)(2) is to be applied in determining whether a trade or business is eligible for the benefits of section 199A. At a minimum, we recommend that Treasury and the Service confirm that trades or businesses are eligible for the benefits of section 199A unless specifically included in the cross reference in section 199A(d)(2)(A) to section 1202(e)(3)(A), or in section 199A(d)(2)(B)’s list of specified service businesses. If that is not the interpretation intended by Treasury and the Service, then is imperative that administrative guidance provide clear guidelines for determining whether income derived from a specific trade or business is QBI.

We further recommend that Treasury and the Service publish a list of business types that are treated as SSTBs or not SSTBs, as well as clear and objective criteria that will be used to evaluate trades or businesses as SSTBs or not SSTBs. For example, such guidance could address whether income generated from the following businesses qualify as QBI under section 199A:

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<sup>6</sup> For this purpose, a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (I.R.C. § 475(c)(2) and I.R.C. § 475(e)(2), respectively).

1. An insurance agency selling insurance products to customers.
2. A real estate brokerage firm that has employees selling real estate.
3. A mortgage brokerage business that obtains mortgages for its customers.
4. An ambulatory surgical center, dialysis center, or lithotripsy center operated in a separate entity where the owners/doctors only receive the so-called “facility or technical” fee from the centers for the patients’ use of the centers. The medical practice (a completely separate entity) which employs the doctors is paid separately for the doctor’s professional services.
5. A community or commercial bank operated as an S corporation, engaged in the commercial banking business and, among other things, accepting deposits and making loans.
6. An investment bank engaged in the business of advising clients on the purchase and sale of businesses, performing valuation services, etc.
7. A hotel, motel, or similar short-term lodging business.
8. A restaurant, fast food, catering, or similar business.
9. A barbershop or beauty salon.
10. A payroll service, employee benefit administration, or similar business.

Several of the businesses listed above were explicitly included from the list of businesses ineligible under section 1202, but were not excluded from section 199A(d)(2)(A) by cross reference to section 1202(e)(3)(A). Specifically, the section 199A(d)(2)(A) cross reference does not cover the other four subparagraphs in section 1202(e)(3) – *i.e.*, section 1202(e)(3)(B) through (E):

- (B) any banking, insurance, financing, leasing, investing, or similar business,
- (C) any farming business (including the business of raising or harvesting trees),
- (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under sections 613 or 613A, and
- (E) any business of operating a hotel, motel, restaurant, or similar business.

Thus, it is reasonable to conclude that these four types of businesses are not SSTBs and should generate QBI, except to the extent they were expressly included in subparagraph (A) of section 1202(e)(3) or involve the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities (*i.e.*, activities covered by section 199A(d)(2)(B)). The businesses described in subparagraphs

(C), (D) and (E) of section 1202(e)(3) are sufficiently dissimilar from the trades or businesses described in section 1202(e)(3)(A) such that we believe that they should qualify for section 199A treatment. We recommend guidance confirming this point.

In contrast, the businesses described in section 1202(e)(3)(B), consisting of “banking, insurance, financing, leasing, investing or similar businesses,” face the potential argument that the omission of subparagraph (B) in the section 199A(d)(2)(A) cross reference does not mean that these activities may generate QBI under section 199A in light of the Additional Excluded Businesses provision in section 199A(d)(2)(B). We believe that such an argument is too expansive. First, the term “investing” in subparagraph (B) was expressly overridden by its inclusion in the Additional Excluded Businesses listed in section 199A(d)(2)(B). “Banking, insurance, financing and leasing,” however, are not part of the list of Additional Excluded Businesses. Further, had Congress intended to cover these businesses, the cross reference in section 199A(d)(2)(B) simply could have included section 1202(e)(3)(A). Thus, it appears reasonable to assume that Congress did not intend to exclude them from section 199A eligibility.

There is some question, however, about whether “banking, insurance, financing or leasing” businesses fall within the prohibited “financial services” or “brokerage services” businesses included in the section 1202(e)(3)(A) cross referenced Listed Businesses. Although the field of “financial services” could be broadly defined to include such businesses as commercial banks, investment banks, insurance firms, and leasing firms, only a limited class of service businesses in the enumerated fields are included in section 1202(e)(3)(A) and thus excluded from section 199A treatment.

We believe that the general concept of “financial services” should not swallow up the more specific “banking” business that was not specifically incorporated by cross reference. Rather, banking should be treated in the same manner as farming, mining, oil and gas production, and operating hotels and restaurants under general principals of statutory construction. Those rules require, if possible, that every word and every provision of a statute is to be given effect. They provide that a statute (or portion thereof) should not be interpreted in a manner that causes it to duplicate another provision or to have no consequence. Applying these rules of statutory construction to section 1202(e)(3), we believe that the businesses described in section 1202(e)(3)(B) are not included in section 1202(e)(3)(A).

A narrow interpretation of “financial services” is consistent with two private letter rulings (“PLRs”) interpreting the scope of section 1202(e)(3)(A) in the context of trades or businesses in the field of “health.” In one of the PLRs,<sup>7</sup> a health-related business that provided research, development, testing, manufacturing and commercialization of drugs for pharmaceutical companies was not excluded from section 1202 status when it utilized its own physical and intangible property to supply its products and services. Similarly, in the other PLR,<sup>8</sup> a business that provided testing services and lab reports at the request of physicians was not precluded from 1202 treatment. Neither health-related business addressed in the private letter rulings was directly involved in the diagnosis or treatment of patients by licensed professionals, nor did the

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<sup>7</sup> PLR 201436001 (September 5, 2014).

<sup>8</sup> PLR 201717010 (April 28, 2017).

business receive revenue that was earned in connection with patient medical care. These rulings under section 1202 are consistent with the regulations promulgated under section 448, which provide that the performance of services in the field of health under that section means the provision of medical services by physicians, nurses, dentists and other similar health care professionals,<sup>9</sup> each of which requires a professional license to perform such services under state law.

We suggest that a similarly narrow view of the types of “financial services” businesses precluded from qualifying for section 199A should focus on only businesses providing services where the service component of the business is the primary business of the taxpayer and the principal asset of the business is the reputation and skill of its employees and owners. Generally, these businesses require certain professional licenses or certifications, and, in certain cases, without the need for significant physical or intangible property to provide their products or services. For example, the significant capital requirements and array of financial products provided by a commercial banking business, should be distinguished from the services provided by a stock broker, a certified financial planner, or similar adviser.

#### **B. Scope of the Reputation and Skill Clause.**

The reputation and skill of the owner or owners may be a critical factor contributing to the success of many businesses, not just service businesses. However, we believe that the “Catchall Reputation and Skills Clause” of the definition of SSTB should be read narrowly to target only service businesses similar to Listed Businesses in section 1202(e)(3)(A), and should not apply to service businesses generally.

Although the Catchall Reputation and Skills Clause of section 199A (*i.e.*, via the cross reference to section 1202(e)(3)(A), with modifications) includes any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its “employees or owners,” the reputation and skills provision of section 1202(e)(3)(A) includes “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,” without reference to “owners” of the trade or business. Therefore, it would appear that the interpretation of the phrase “reputation and skill” should be consistent for both provisions, provided that the reputation and skill of an owner would be relevant (even if the owner was not an employee).

The businesses listed in 1202(e)(3)(A) have the common characteristic that the service component is the primary business of the taxpayer. For these businesses, it would not be appropriate or consistent with the intent of section 199A to permit taxpayers to convert income normally treated as salary, wages, or self-employment income to QBI. However, this concern should not be expanded to deny the benefits of section 199A to income from businesses which clearly qualify for the section 199A deduction.

The court in *John P. Owen v. Commissioner*<sup>10</sup> examined the reputation and skills clause of section 1202(e)(3)(A). In that case, the taxpayer owned two corporations—an insurance-

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<sup>9</sup> See Reg. §1.448-1T(e)(4)(ii).

<sup>10</sup> 103 T.C.M. (CCH) 1135, 2012 T.C.M. (RIA) 2012-21.

related business that created financial products and sold insurance known as Family First Insurance Services (“FFIS”) and a business that sold prepaid legal service policies, including estate planning services known as Family First Advanced Estate Planning (“FFAEP”). When Mr. Owen sold both businesses he claimed a capital gain deferral under section 1045 on the portion of the gain related to FFAEP.<sup>11</sup> The section 1045 deferral claim required the Tax Court to analyze whether the stock in FFAEP was “qualified small business stock” under section 1202(c) and whether the exclusions of section 1202(e)(3)(A) – in particular, the exclusion for service businesses “where the principal asset of such trade or business is the reputation or skill of one or more of its employees” – applied to FFAEP. The Tax Court in *Owen* found that FFAEP was a qualified small business under section 1045 and rejected the government’s argument that FFAEP was not qualified because one of the principal assets of FFAEP was the skill of Mr. Owen. The Tax Court acknowledged that Mr. Owen and his partner were responsible for the success of both FFIS and FFAEP, but held that the “principal asset” of both FFIS and FFAEP was the training and organizational sales structure that used independent contractors, including Mr. Owen and his partner “in their commission-sales hats,” who sold the policies that earned the premiums. Ultimately, the Tax Court in *Owen* found that section 1045 did not apply to the sale of FFAEP because the stock reinvestment in another company did not meet the relevant statutory criteria.

Narrowly construing the words “the principal asset of such trade or business” is appropriate when applying the Catchall Reputation and Skills Clause. The statutory language uses the word “the” – not “a” or “one of the” – meaning that the skill or reputation of the owner or employee must be the most significant value driver in the business before the catchall might apply. Webster’s New Collegiate Dictionary defines “principal” as “first in rank, authority, importance or degree.” Consistent with the Tax Court in *Owen*, a skilled owner with a strong reputation should not, in and of itself, automatically disqualify a business from QBI treatment. A business where the skilled owner is supported by a strong supporting cast of employees and contractors, or where a significant amount of tangible or intangible assets and intellectual property are employed in providing the services, should prevent disqualification of the business under the Catchall Reputation and Skills Clause. Indeed, we believe it would be proper to apply the Catchall Reputation and Skills Clause only in the situation where the business would no longer be viable if the skilled owner or employee was no longer involved in the business.

The Service has examined the reputation and skills clause of section 1202(e)(3)(A) in the two PLRs mentioned above. In the first PLR,<sup>12</sup> the Service addressed the issue of 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). The Service found that the business was not disqualified under section 1202(e)(3)(A), 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:

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<sup>11</sup> A similar claim for FFIS raised in pre-trial motions was abandoned prior to trial.

<sup>12</sup> PLR 201436001 (September 5, 2014).

[S]ection 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, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners).

More recently, the Service examined the application of the reputation and skills clause of section 1202(e)(3)(A) to a medical laboratory company.<sup>13</sup> There the taxpayers owned stock in a company that used certain proprietary technologies for the precise detection of a certain medical condition. The company was the only party that could legally perform the testing and its expertise was limited to its patented testing. Also, the company maintained a research division to develop additional uses for its proprietary technology. The company analyzed the results of the testing and then prepared laboratory reports for doctors and other healthcare providers. The information provided in the laboratory report generally included a summary of what was tested for and detected. The reports did not reach a diagnosis or recommend treatment. The company's sole function was to provide healthcare providers with a copy of its laboratory report, and it received compensation for reporting the results of the tests to healthcare providers.

The laboratory director was required to be an M.D., D.O., or a Ph. D. under federal law, but only reviewed results for quality control and assurance. The company's other laboratory personnel were not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority. The company's employees were well educated and received up to one year of training to perform the proprietary testing.

As it did in the earlier PLR, the Service ruled in the more recent PLR that the company's trade or business did not involve the performance of services in the field of health, nor was the principal asset of the trade or business the reputation or skill of one or more of its employees under section 1202(e)(3)(A). The Service's analysis focused on the fact that the company's sole function was to provide healthcare providers with laboratory reports, not to make diagnosis or treatment recommendations.

Because section 199A incorporates only section 1202(e)(3)(A) by cross reference, dealing with businesses involving professional services and other individual skills, and not the other subsections of section 1202(e)(3) (*i.e.*, (B) through (E)), it would appear that the reputation and skill clause of the SSTB definition was intended to apply only where the service component is the primary business of the taxpayer and the principal asset of the business is the reputation or skill of its owners and employees. Thus, we recommend that the reputation and skill clause be limited to specialized service businesses similar to the Listed Businesses, rather than to service businesses generally.

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<sup>13</sup> PLR 201717010 (January 23, 2017).

Examples of cases where the principal asset of a service business may be the reputation and skill of its owners and where guidance should be provided to taxpayers include barbers, hairdressers, plumbers, carpenters, celebrity chefs, tattoo artists, manicurists, and even architects and engineers. While these businesses are not included as Listed Businesses, the determination of whether the reputation and skill of employees and owners is the principal asset of the business might depend on a facts and circumstances analysis. Taxpayers would benefit from objective guidelines that they can rely upon in making the facts and circumstances analysis.

Since the foregoing lists are not all inclusive and it is impossible to identify each and every line of business that may or may not be covered by the Catchall Reputation and Skill Clause, we recommend that the initial guidance permit taxpayers to apply such guidance to their facts and circumstances and rely in good faith on such guidance and the facts of each case for tax years prior to the finalization of proposed or final regulations containing additional examples and guidelines. This will ensure that taxpayers who should benefit from section 199A will be entitled to the deduction from QBI as intended by Congress, without concern for a potential expansion of the Catchall Reputation and Skill Clause by the Service during the examination process.