Defending Liberty
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Section of Taxation

Suite 400
1050 Connecticut Avenue, NW
Washington, DC 20036
202-662-8670
FAX: 202-662-8682
E-mail: tax@americanbar.org

October 12, 2018

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on the Proposed Regulations Regarding the Deduction for Qualified Business Income Under Section 199A

Dear Commissioner Rettig:

Enclosed please find comments with respect to the proposed regulations regarding the deduction for qualified business income under new section 199A. They are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon

Eric Solomon
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
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Scott K. Dinwiddie, Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Holly Porter, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Audrey W. Ellis, Attorney-Advisor, Department of the Treasury
Wendy L. Kribell, Attorney, Office of Associate Chief Counsel, (Passthroughs & Special Industries), Internal Revenue Service

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations Regarding the Deduction for Qualified Business Income Under Section 199A

These comments (the "Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") 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 in response to Proposed Regulations issued on August 16, 2018 under section 199A with respect to changes made by last year's tax legislation (the "Act").[1]

Principal responsibility for preparing these Comments was exercised by Ryan Tucker. Significant contributions were made by Jennifer Alexander, Matthew Lay, Thomas Nichols, Laura Howell-Smith, Allie Petrova, Mark Wilensky, Grace Kim, C. Wells Hall, Robert Box, Martin Culhane, Stephen Looney, Marty Nash, Adam Reid, Lorna Wilson, William Organek, Charles Temkin, Craig Foxgrover, Sandy Xu, Deanna Harris, and David Kahen. The Comments have been reviewed by Beverly Katz, Vice Chair of the Partnerships and LLCs Committee, Todd Keator, Chair of the Real Estate Committee, Adam M. Cohen, Council Director for the Partnerships and LLCs and Real Estate Committees, 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 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 or 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.

Contact: Ryan Tucker
(206) 716-6249
rytucker@deloitte.com

Date: October 12, 2018

[1] 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 (2017) (sometimes referred to as the "Tax Cuts and Jobs Act" or "TCJA").

EXECUTIVE SUMMARY

The Act made substantial changes in the tax rules applicable to the business activities of taxpayers, effective for the current tax year. We commend the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") for their commitment to provide expedited guidance, and we ask that Treasury and the Service consider the following recommendations in the finalization of the Proposed Regulations under section 199A ("Proposed Regulations").[2]

Section 199A provides for a deduction in the calculation of a taxpayer's taxable income for tax years beginning after December 31, 2017. There are several components to computing a taxpayer's section 199A deduction for any taxable year and many issues arise in connection with computing the correct amount of the deduction. Among these are the qualified business income ("QBI") of the taxpayer under section 199A(c), the combined qualified business income amount ("Combined QBI") of the taxpayer under section 199A(b)(1), W-2 wages under section 199A(b)(2)(B)(i) and (ii) and (b)(4)(A), and unadjusted basis immediately after acquisition ("UBIA") of qualified property ("Qualified Property") under sections 199A(b)(2)(B)(ii) and (b)(6). The Proposed Regulations address and clarify many issues raised by section 199A. As discussed in detail below, we believe that clarification or revision of the Proposed Regulations would further assist taxpayers in determining the qualified business deduction under section 199A.

Specifically, we respectfully request that Treasury and the Service provide additional guidance under section 199A to address the following important issues:

I. Comments regarding the determination and allocation of UBIA of Qualified Property.

   A. Certain section 734(b) and section 743(b) adjustments should be considered Qualified Property for purposes of determining UBIA of Qualified Property.

   B. The UBIA of Qualified Property acquired in transactions subject to section 168(i)(7)(B) should generally be determined by reference to the basis of the Qualified Property on the date on which the transferor first placed the Qualified Property into service.

   C. The UBIA of Qualified Property acquired in transactions subject to section 1031 or section 1033 should be determined by reference to the basis of the Relinquished Property on the date on which the Relinquished Property was first placed in service.

[2] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

D. A partnership should allocate the UBIA of its Qualified Property to its partners in the same manner that it allocates section 704(b) depreciation with respect to the Qualified Property.

II. Comments regarding the determination of QBI.

A. Guaranteed payments for the use of capital under section 707(c) should be taken into account in determining the partner's QBI.

B. Certain section 707(a) payments should be taken into account in determining the partner's QBI.

C. Rules should be provided for how previously disallowed losses should be taken into account in determining QBI.

D. Rules should be provided for how net operating losses should be taken into account in determining QBI.

E. Rules should be provided for determining the portion of ordinary income or loss under section 751(a) on the sale of a partnership interest that meets the ECI Requirement.

III. Comments concerning specified service trades or businesses ("SSTBs")

A. Guidance should be provided on the definition of trade or business.

B. To the extent gross receipts from an SSTB field exceed the de minimis threshold, a taxpayer should be allowed to bifurcate its QBI between an SSTB and a qualified trade or business ("QTB"). If such comment is not adopted, the regulations should provide that a business will qualify as a QTB if less than 20% of its gross receipts are attributable to services in an SSTB field.

C. The "Incidental to an SSTB" anti-abuse rule should be removed.

D. The prohibition against aggregating SSTBs should be removed.

E. The definition of the performance of services in the field of athletics should be clarified, such that it does not include the ownership and operation of a professional sports franchise.

IV. Comments regarding the aggregation of trades or businesses

A. Taxpayers should generally be allowed to aggregate commonly controlled trades or businesses.

B. Relevant Passthrough Entities ("RPEs") should generally be allowed to aggregate QTBs.

C. Additional guidance should be provided for purposes of determining whether trades or businesses satisfy the 50% Ownership Requirement.

D. Majority of Taxable Year Requirement should apply to the taxable year of the taxpayer aggregating the trades or businesses.

E. Same Taxable Year Requirement should be removed.

F. If RPEs are allowed to aggregate, they should be allowed to report the aggregated QBI, W-2 wages and UBIA for the aggregated trade or businesses.

V. Miscellaneous comments

A. Ownership attribution rules should be provided with respect to non-grantor trusts.

B. Qualified REIT dividends allocated to an individual by an RPE with a fiscal year beginning before January 1, 2018, and ending after December 31, 2017, should be treated as earned by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

C. Editorial suggestions.

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DISCUSSION

I. Comments Regarding the Determination and Allocation of UBIA of Qualified Property

This portion of these Comments addresses the determination of the UBIA of Qualified Property of an individual or an RPE.

Section 199A(b)(2)(B) provides two limitation amounts that are used to determine the deductible amount with respect to each trade or business of the taxpayer: (i) 50% of W-2 wages with respect to the QTB or (ii) 25% of W-2 wages with respect to the QTB, plus 2.5% of the UBIA of all Qualified Property.

Qualified Property means tangible property of a character subject to the allowance for depreciation under section 167 that meets the following requirements: (i) held by, and available for use in, the QTB at the close of the taxable year, (ii) which is used at any point during the taxable year in the production of QBI and (iii) the depreciable period ("Depreciable Period") for which has not ended before the close of the taxable year.[3]

Depreciable Period means the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of (i) the date that is 10 years after such date or (ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to subsection (g) thereof).[4]

The Proposed Regulations restate the statutory definition of Qualified Property above and provide special rules for identifying Qualified Property.[5] Additions or improvements made to Qualified Property are treated as separate Qualified Property.[6] However, the Proposed Regulations specifically provide that basis adjustments under sections 734(b) and 743(b) are not treated as Qualified Property.[7] An anti-abuse rule also prevents certain property acquired at the end of a year from being treated as Qualified Property.[8]

The Proposed Regulations also restate the statutory definition of Depreciable Period above and provide special rules for determining the Depreciable Period of Qualified Property.[9] The additional first year depreciation provided under section 168(k) or (m) does not affect the applicable recovery period used to determine the Depreciable

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[3] I.R.C. § 199A(b)(6)(A).

[4] I.R.C. § 199A(b)(6)(B).

[5] Prop. Reg. § 1.199A-2(c)(1).

[6] Prop. Reg. § 1.199A-2(c)(1)(ii).

[7] Prop. Reg. § 1.199A-2(c)(1)(iii).

[8] Prop. Reg. § 1.199A-2(c)(1)(iv).

[9] Prop. Reg. § 1.199A-2(c)(2).

Period of Qualified Property.[10] There are also special rules for determining the Depreciable Period of Qualified Property acquired by an individual or RPE in nonrecognition transactions subject to section 168(i)(7),[11] or in nonrecognition transactions subject to sections 1031 or 1033.[12]

The Proposed Regulations also provide a detailed definition of UBIA –

> The term unadjusted basis immediately after acquisition (UBIA) means the basis on the placed in service date of the property as determined under section 1012 or other applicable sections of Chapter 1, including subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), to any adjustments for tax credits claimed by the individual or RPE (for example, under section 50(c)), or to any adjustments for any portion of the basis for which the individual or RPE has elected to treat as an expense (for example, under sections 179, 179B, or 179C). However, UBIA does reflect the reduction in basis for the percentage of the individual's or RPE's use of property for the taxable year other than in the trade or business.[13]

In the case of an RPE, each owner's allocable share of UBIA of Qualified Property is determined in the same manner as the owner's allocated share of depreciation. The Proposed Regulations clarify the rules for allocating an RPE's UBIA of Qualified Property, as discussed below.

A. Whether Section 734(b) and Section 743(b) Adjustments Should Be Included as Qualified Property

1. Background

The Proposed Regulations specifically provide that basis adjustments under sections 734(b) and 743(b) are not treated as Qualified Property.[14] The preamble provides the following discussion with respect to this special rule:

> After the enactment of the TCJA, the Treasury Department and the IRS received comments requesting guidance as to whether partnership special basis adjustments under sections 734(b) or 743(b) constitute qualified property for purposes of section 199A. Treating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property (if, for example, the fair market value of the property has not increased and its depreciable period has not ended). Accordingly, proposed § 1.199A–

[10] Prop. Reg. § 1.199A-2(c)(2)(ii).

[11] Prop. Reg. § 1.199A-2(c)(2)(iv).

[12] Prop. Reg. § 1.199A-2(c)(2)(iii).

[13] Prop. Reg. § 1.199A-2(c)(3).

[14] Prop. Reg. § 1.199A-2(c)(1)(iii).

2(c)(1)(iii) provides that partnership special basis adjustments are not treated as separate qualified property.[15]

2. Recommendation

We recommend that, when finalized, the regulations under section 199A (the "Final Regulations") provide that certain section 734(b) and section 743(b) adjustments made to Qualified Property that do not result in duplication of UBIA can be considered separate Qualified Property for purposes of determining a partnership's UBIA of Qualified Property.

We also recommend that the Final Regulations provide that to the extent the UBIA of Qualified Property is attributable to a section 743(b) adjustment, the UBIA of Qualified Property should be taken into account only by the partner to which the section 743(b) adjustment relates.

3. Explanation

The concern expressed in the preamble regarding "inappropriate duplication" of UBIA of Qualified Property is warranted when the fair market value of the Qualified Property has not increased. In those situations, the section 734(b) and section 743(b) adjustments do not represent additional investment in Qualified Property beyond its UBIA. Instead, the adjustments represent a reinstatement of the basis that was reduced as a result of depreciation.

However, positive section 734(b) and section 743(b) adjustments often do represent additional investment in Qualified Property beyond its UBIA, and that portion ought to be included as Qualified Property. Otherwise, there could be a significant disparity between the UBIA of Qualified Property of a taxpayer who purchases an interest in Qualified Property directly rather than through a partnership.[16]

The portion of a transferee partner's positive section 743(b) adjustment allocated to Qualified Property that can be considered separate Qualified Property should be calculated as the excess of (i) the positive section 743(b) adjustment, plus the transferee's share of the adjusted basis of the Qualified Property, over (ii) the transferee's share of the existing UBIA of the Qualified Property.[17] Additionally, all negative section 743(b)

[15] Preamble to Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40889.

[16] A taxpayer purchasing Qualified Property directly would receive cost basis in the Qualified Property under section 1012. However, a taxpayer purchasing Qualified Property indirectly by purchasing a partnership interest would step into the shoes of the transferor's share of the partnership's tax basis in the Qualified Property and receive a section 743(b) adjustment if the partnership makes a section 754 election.

[17] For this purpose, the transferee's share of the existing UBIA of Qualified Property should be determined based on the partner's relative share of adjusted basis of the Qualified Property (under principles similar to those under Regulation section 1.743-1), instead of being based on depreciation allocations in the year the partnership interest is transferred. This approach would more appropriately address section 743(b) adjustments being made by partnerships that are not "straight up" (*e.g.*, where share of depreciation does not correspond to share of depreciable asset basis), and we do not believe this will make the calculations

adjustments to Qualified Property should reduce the transferee's share of UBIA of the Qualified Property.

Example 1

A and B each contribute $50 million for a 50% interest in PRS, a newly formed partnership. PRS acquires Qualified Property for $100 million. Each year, PRS has taxable income before depreciation of zero, and has $10 million of depreciation expense. After two years, when the Qualified Property has an adjusted tax basis of $80 million and each partner has a tax basis of $40 million in its partnership interest, C purchases B's interest in PRS for $60 million. C has a section 743(b) adjustment of $20 million, allocated entirely to the Qualified Property. Under the approach recommended above, the portion of the section 743(b) adjustment that is be treated as Qualified Property would be determined as follows –

Positive section 743(b) adjustment to Qualified Property	$20 million
Transferee's share of adjusted basis of Qualified Property	$40 million
Subtotal	$60 million
Less: Transferee's share of UBIA of Qualified Property	$(50 million)[18]
Excess treated as Qualified Property	$10 million

Unlike the rule in the Proposed Regulations, this approach would harmonize the determination of the UBIA of Qualified Property of taxpayers that operate their businesses through a partnership with those that operate businesses directly. We note, however, that there are certain situations in which a transferee may purchase a partnership interest late in the Depreciable Period of property held by the partnership. Although the Depreciable Period with respect to any section 743(b) portion of Qualified Property would begin on the date the interest is transferred, the transferee would get credit for the UBIA attributable to the partnership's common basis in Qualified Property for only a short period of time after the transfer. We have considered various remedies for this issue,[19] but recognize the difficulty in establishing a universal rule. Instead, we recommend taxpayers be allowed to seek relief in certain situations so that a partnership

burdensome because partnerships making a section 743(b) adjustment are already applying the rules under Regulation section 1.743-1.

[18] This is 50% of the original UBIA of the Qualified Property of $100 million (*i.e.*, the cost basis that PRS originally took in the Qualified Property under section 1012).

[19] For example, to address situations where a transferee purchases an interest in a partnership that holds Qualified Property with an expiring Depreciable Life, the Final Regulations could provide that the Depreciable Period restarts with respect to the transferee's share of existing UBIA. Applied to Example 1 above, this approach would result in the restart of the Depreciable Period of the transferee's share of existing UBIA of Qualified Property (*i.e.*, $50 million).

could restart the Depreciable Period with respect to the transferee's portion of the Qualified Property with the approval of the Commissioner.

Similarly, the portion of a positive section 734(b) adjustment allocated to Qualified Property that can be considered separate Qualified Property should be calculated as the excess of (i) the positive section 734(b) adjustment, plus the adjusted tax basis of the Qualified Property (including any section 743(b) adjustments allocated to the Qualified Property), over (ii) the existing UBIA of the Qualified Property (including any UBIA attributable to prior section 743(b) adjustments that are treated as Qualified Property).[20] Additionally, all negative section 734(b) adjustments to Qualified Property should reduce the UBIA of the Qualified Property.

Example 2

Assume the same facts as Example 1 above. During year 3, there is common basis depreciation of $10 million and depreciation of $2 million with respect to C's section 743(b) adjustment. At the end of year 3, the partnership allocates a section 734(b) adjustment of $60 million to the Qualified Property. Under the approach recommended above, the portion of the section 734(b) adjustment that can be treated as additional Qualified Property would be determined as follows –

Positive section 734(b) adjustment to Qualified Property	$60 million
Adjusted tax basis of Qualified Property	$70 million
C's remaining section 743(b) adjustment to Qualified Property	<u>$18 million</u>
Subtotal	$148 million

[20] We considered, but rejected, an approach where the portion of the section 734(b) adjustment that is treated as Qualified Property was determined without reference to any partner's section 743(b) adjustment. The purpose of the recommended calculations is to determine the amount by which the total adjusted tax basis in Qualified Property exceeds the UBIA of that Qualified Property at the time of the adjustment. To achieve this purpose, we believe it is necessary to capture both the common basis and the partner specific basis of the Qualified Property. (We note that, if the order of the transactions in Examples 1 and 2 were reversed, the same amount would be treated as UBIA, but because the "excess" would occur as a result of the section 743(b) adjustment, more UBIA would be created as a result of the section 743(b) adjustment as opposed to the section 734(b) adjustment.) Although the recommended approach would not perfectly mirror analogous direct acquisitions of Qualified Property, it is an administrable rule that eliminates potential double counting of UBIA of Qualified Property.

In addition, we believe additional consideration should be given to situations in which a positive section 734(b) adjustment results from a distributee partner taking a basis in distributed property under section 732 that is less than the partnership's adjusted basis in the property immediately before the distribution. *See* I.R.C. § 734(b)(1)(B). Because the UBIA in the distributed property would be reduced under either the existing rule in Proposed Regulation section 1.199A-2(c)(3) or the rule recommended in section I.B. below, a special rule allowing a corresponding increase to the UBIA of remaining partnership property may be warranted, regardless of the amount calculated using the general formula we have recommended.

Less: Existing UBIA of Qualified Property	$(110 million)[21]
Excess treated as Qualified Property	$38 million

Because the recommended calculations consider only the portions of positive section 734(b) and section 743(b) adjustments that cause the adjusted basis of Qualified Property at the time the section 734(b) or section 743(b) adjustment is made to exceed the Qualified Property's existing UBIA, this approach would not result in the duplication of UBIA that Treasury and the Service were aiming to avoid.

Similarly, negative section 734(b) and section 743(b) adjustments ought to reduce the UBIA of Qualified Property. However, unlike positive adjustments, negative adjustments do not represent a restoration of depreciation amounts, so the entire negative section 734(b) or section 743(b) adjustment ought to reduce the UBIA of Qualified Property.[22]

Finally, to the extent UBIA of Qualified Property is attributable to a section 743(b) adjustment, it should only be taken into account by the transferee partner for which the section 743(b) adjustment was made. To the extent UBIA of Qualified Property is attributable to a section 734(b) adjustment, it should be allocated to partners of the partnership under the allocation rules provided in Proposed Regulation section 1.199A-2(a)(3) because it is common basis for all partners. However, section 743(b) adjustments are made with respect to specific partners. Thus, to the extent UBIA of Qualified Property is attributable to a section 743(b) adjustment, it should only be taken into account by the transferee partner for which the section 743(b) adjustment was made.

B. The Determination of UBIA of Qualified Property Acquired in Transactions Subject to Section 168(i)(7)(B)

1. Background

The Proposed Regulations contain a special rule providing that, if an individual or RPE acquires Qualified Property in a transaction described in section 168(i)(7)(B), the individual or RPE must determine the Depreciable Period for the Qualified Property as follows:

- For the portion of the transferee's unadjusted basis in the Qualified Property that does not exceed the transferor's unadjusted basis in such

[21] This amount includes the $100 million of UBIA from the partnership's cost basis on its original acquisition of the Qualified Property and the $10 million from C's section 743(b) adjustment that is considered UBIA of Qualified Property.

[22] We considered whether the recommended rules should only apply to taxable transactions. Because UBIA amounts can be redetermined in nonrecognition transactions even if the approach recommended in the following section is not adopted by the Final Regulations (see Proposed Regulation section 1.199A-2(c)(3) and section I.B. below), and because we believe any negative section 734(b) and section 743(b) adjustments should reduce UBIA, we believe it is appropriate for the proposed rules to apply to both taxable and nontaxable transactions.

property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the Qualified Property in service;[23] and

- For the portion of the transferee's unadjusted basis in the Qualified Property that exceeds the transferor's unadjusted basis in such property, such portion is treated as separate Qualified Property that the transferee first placed in service on the date of the transfer.[24]

For purposes of determining the UBIA of Qualified Property, the basis on the placed in service date is the tax basis determined under the applicable sections of the Code.[25] The preamble to the Proposed Regulations explains that for purposes of determining the UBIA of Qualified Property, the relevant placed in service date will be the date the acquired property is placed in service by the transferee (for instance, the date the partnership places property received in a section 721 transaction in service).[26] In other words, the special rule regarding the placed in service date of property transferred in a non-recognition transaction applies only for purposes of determining the Depreciable Period of the Qualified Property and is not applicable for purposes of determined the Qualified Property's UBIA.

2. **Recommendation**

We recommend that, in order to align the determination of UBIA with the determination of Depreciable Period, the Final Regulations provide that if an individual or RPE acquires Qualified Property in a transaction described in section 168(i)(7)(B), then the UBIA of the Qualified Property is determined by reference to the basis of the Qualified Property on the date on which the transferor first placed the Qualified Property into service (*i.e.*, the transferor's UBIA of the Qualified Property).

To the extent the transferee's adjusted basis in the Qualified Property exceeds the adjusted basis of the Qualified Property on the date on which the transferor first placed the Qualified Property into service (*i.e.*, the transferor's UBIA of Qualified Property), the excess should be considered a separate Qualified Property with a Depreciable Period determined under Proposed Regulation section 1.199A-2(c)(2)(iv)(B).

To the extent the transferor's adjusted basis in the Qualified Property exceeds the transferee's adjusted basis in the Qualified Property, the UBIA determined by the transferee should be reduced.

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[23] Prop. Reg. § 1.199A-2(c)(2)(iv)(A)

[24] Prop. Reg. § 1.199A-2(c)(2)(iv)(B).

[25] Prop. Reg. § 1.199A-2(c)(3). This includes the relevant sections governing the basis of property transferred in section 168(i)(7)(B) transactions (*e.g.*, transactions under sections 332, 351, 361, 721, and 731).

[26] Preamble to Section 199A Proposed Regulations.

3. **Explanation**

By referencing the tax basis calculated by the transferee in a section 168(i)(7)(B) transaction, the Proposed Regulations effectively provide for an adjustment to "unadjusted" basis for depreciation that occurred while the Qualified Property was held by the transferor. This is demonstrated by an example in the Proposed Regulations, where a taxpayer who purchased machinery for $10,000 contributes the machinery to an S corporation when the adjusted tax basis of the machinery is $2,500 (unadjusted basis of $10,000, reduced by $7,500 of depreciation expense).[27] Although $2,500 is the basis of the machinery to the S corporation under section 362, using this amount as the S corporation's UBIA of the machinery is inconsistent with the concept that depreciation does not reduce UBIA.

The better approach for nonrecognition transactions would be to refer to the UBIA of the transferor when determining the UBIA of the transferee. If the transferee's adjusted basis exceeds the transferor's UBIA, then the excess could be considered separate Qualified Property, which would be consistent with the Depreciable Period rule provided by Proposed Regulation section 1.199A-2(c)(2)(iv)(B). If the transferee's adjusted basis in the Qualified Property is less than the transferor's adjusted basis of the Qualified Property, then a special rule should provide for a reduction in the UBIA that carries over from the transferor to the transferee. A limited successor approach in a section 168(i)(7) transaction is consistent with the policy of section 199A, aligns with the Depreciable Period rule, and is a reasonable interpretation of a taxpayer's "unadjusted basis immediately after acquisition," which we believe can reasonably be interpreted to include, in a section 168(i)(7) transaction, the unadjusted basis immediately after the *transferor's* acquisition of the Qualified Property.[28]

The preamble to the Proposed Regulations explains that Treasury and the Service "believe that existing general principles used for transferred basis transactions under §168(i)(7) provide a useful analogy for administrable rules that are appropriate for the purposes of section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them."[29] However, because individuals and RPEs that receive Qualified Property in a transaction described in section 168(i)(7)(B) must already know the transferor's UBIA of the Qualified Property (for purposes of applying section 168 and the special Depreciable Period rule of Proposed Regulation section 1.199A-2(c)(2)(iv)), referencing the

[27] Prop. Reg. § 1.199A-2(c)(4), Ex. (3), 83 Fed. Reg. 40884, 40919 (Aug. 16, 2018).

[28] A transferee often succeeds to the attributes of the transferor nonrecognition transaction. For example, section 168(i)(7)(A) provides that the "transferee shall be treated as the transferor" for purposes of computing depreciation, and Regulation section 1.704-3(a)(8) provides that a transferee succeeds to the status of the transferor for purposes of section 704(c) if such property is received in a nonrecognition transaction.

[29] Preamble to Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40890.

transferor's UBIA of the Qualified Property for purposes of determining the individual's or RPE's UBIA of the Qualified Property would not increase the compliance burden or administrative complexity placed upon the individual or RPE.

C. The Determination of UBIA of Qualified Property Acquired in Transactions Subject to Section 1031 or Section 1033

1. Background

In section 1031 and section 1033 transactions, a taxpayer's basis in the property acquired (the "Replacement Property") is generally determined with reference to property the taxpayer gives up (the "Relinquished Property").

The Proposed Regulations specifically provide that if an individual or RPE acquires Qualified Property in a transaction described in section 1031 or 1033 (*i.e.*, receives Replacement Property that is also Qualified Property), the individual or RPE must determine the Depreciable Period for the Replacement Property as follows:

- The Depreciable Period with respect to the exchanged basis (determined under Regulation section 1.168(i)-6(b)(7)) is determined with reference to the date on which the <u>Relinquished Property</u> was placed into service,[30] and

- The Depreciable Period with respect to the excess basis (determined under Regulation section 1.168(i)-6(b)(8)) is determined with reference to the date on which the <u>Replacement Property</u> is placed into service.[31]

Although the special rule above references the placed in service date of the Relinquished Property for purposes of determining the Depreciable Period of the Replacement Property, it does not address the UBIA of Replacement Property. Therefore, the UBIA of Replacement Property would be determined under the general rule of Proposed Regulation section 1.199A-2(c)(3) as the adjusted tax basis calculated under sections 1031(d) and 1033(b).

2. Recommendation

Similar to our recommendation above concerning section 168(i)(7)(B) transactions, we recommend that the Final Regulations provide that the UBIA of Replacement Property acquired by an individual or RPE in a section 1031 or section 1033 transaction should be determined by reference to the basis of the Relinquished Property on the date on which the individual or RPE first placed the Relinquished Property into service (*i.e.*, the UBIA of the Relinquished Property). Except as provided below, the

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[30] Prop. Reg. § 1.199A-2(c)(2)(iii)(A). Note, that for purposes of determining the Depreciable Period of the Replacement Property, both the exchanged basis and any excess basis is treated as placed in service on the date the Replacement Property is placed into service if an election is made under Regulation section 1.168(i)-6(i)(1) to not apply Regulation section 1.168(i)-6.

[31] Prop. Reg. § 1.199A-2(c)(2)(iii)(B).

Depreciable Period of the Replacement Property should be determined with reference to the date on which the Relinquished Property was placed in service.

To the extent the individual's or RPE's adjusted basis in the Replacement Property exceeds the adjusted basis of the Relinquished Property on the date the Relinquished Property was placed into service (*i.e.*, the UBIA of the Relinquished Property), the excess should be considered separate Qualified Property with a Depreciable Period determined with reference to the date on which the Replacement Property is placed in service. The special rule regarding the Depreciable Period of the "excess basis" should also be modified to be consistent with determination of UBIA.

To the extent the individual's or RPE's adjusted basis in the Relinquished Property exceeds the adjusted basis of the Replacement Property, the UBIA of the Replacement Property determined by the individual or RPE should be reduced. We also recommend that, if a taxpayer enters into an exchange that qualifies as a deferred like-kind exchange under section 1031 in which the Relinquished Property is transferred in one taxable year and the Replacement Property is acquired in the following taxable year, the taxpayer's UBIA for the earlier taxable year should include the UBIA of the Relinquished Property.

3. **Explanation**

The UBIA of Qualified Property is meant to measure an individual's or RPE's investment in Qualified Property *without* adjusting for depreciation. As with section 168(i)(7)(B) transactions, referencing the basis described under sections 1031(d) and 1033(b) for transactions under sections 1031 and 1033, respectively, effectively reduces the UBIA of an individual or RPE by the depreciation that has been taken on the Relinquished Property. This is demonstrated by an example in the Proposed Regulations, where a taxpayer who purchased real property for $1,000,000 exchanges the real property for different real property when the adjusted tax basis of the relinquished real property is $820,482 (unadjusted basis of $1,000,000, reduced by $179,518 of depreciation expense).[32] Although $820,482 is the basis of the replacement real property under section 1031(d), using this amount for purposes of calculating the UBIA of the Replacement Property is inconsistent with the concept that depreciation does not reduce UBIA.

To accurately reflect the investment that an individual or RPE has made in Qualified Property, the UBIA of Replacement Property should be determined with reference to the basis of the Relinquished Property on the first date on which the individual or RPE placed the Relinquished Property into service (*i.e.*, the UBIA of the Relinquished Property).

If the adjusted basis of the Replacement Property exceeds the UBIA of the Relinquished Property, then the UBIA of the Replacement Property should be increased.

[32] Prop. Reg. § 1.199A-2(c)(4), Ex. (2).

It should be noted that the excess of the adjusted basis of the Replacement Property over the UBIA of the Relinquished Property is not the same as the "excess basis" defined by Regulation section 1.168(i)-6(b)(8), which is the amount by which the adjusted basis of the Replacement Property exceeds the "exchanged basis" of the Replacement Property.[33] To ensure that the Depreciable Period of the Replacement Property appropriately matches the time at which the UBIA was determined, Proposed Regulation section 1.199A-2(c)(2)(iii) should also be modified to provide that the Depreciable Period of Replacement Property is generally determined with reference to the first date the Relinquished Property was placed into service. However, the Depreciable Period of the excess amount should be determined with reference to the first date that the Replacement Property was placed into service for the portion of the adjusted basis of the Replacement Property that exceeds the UBIA of the Relinquished Property.

If the adjusted basis of the Replacement Property is less than the adjusted basis of the Relinquished Property, then there should be a reduction to the UBIA that carries over from the Relinquished Property to the Replacement Property.

In addition, if a taxpayer enters into an exchange that qualifies as a deferred like-kind exchange under section 1031 in which the Relinquished Property is transferred in one taxable year and the Replacement Property is acquired in the following taxable year, the taxpayer's UBIA for the earlier taxable year should include the UBIA of the Relinquished Property. This rule would be consistent with Rev. Rul. 2003-56 which applies to a partnership that enters into an exchange that qualifies as a deferred like-kind exchange under section 1031 in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership. The ruling applies the open transaction doctrine, allowing the liabilities of the Relinquished Property to be netted against the liability of the Replacement Property for purposes of section 752. Similarly, where the Relinquished Property is timely replaced, a similar rule should apply for purposes of determining the UBIA for the year the Relinquished Property is transferred, treating the Relinquished Property as continuing to be held by, and available for use in, the trade or business at the close of the taxable year.

D. The Allocation of UBIA of Qualified Property by RPEs

1. Background

Once an RPE determines the UBIA of its Qualified Property, the RPE must allocate the UBIA of Qualified Property to each of its owners. As described above, the

[33] In other words, the definition of "excess basis" captures more than just the portion of the basis in the Relinquished Property that exceeds the UBIA of the Replacement Property. Therefore, the rule for transactions under sections 1031 and 1033 contrasts significantly with the rule for transactions described under section 168(i)(7)(B), which only restart Depreciable Period for the portion of the transferee's UBIA of Qualified Property that exceeds the transferor's UBIA of Qualified Property (not the transferors adjusted basis in the Qualified Property. This inconsistency does not appear to have been intended.

statute provides that each owner's allocable share of UBIA of Qualified Property is determined in the same manner as the owner's allocable share of depreciation.

The Proposed Regulations clarify that each owner's allocable share of UBIA of Qualified Property held by a partnership or S corporation is an amount that bears the same proportion to the total UBIA of Qualified Property as the owner's share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year.[34] If Qualified Property held by a partnership does not produce tax depreciation during the year, then each partner's share of the UBIA of 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 taxable transaction (the "Hypothetical Transaction") for cash equal to the fair market value of the Qualified Property.[35] If Qualified Property held by an S corporation does not produce tax depreciation during the year, each shareholder's share of the UBIA of Qualified Property is determined proportionately based on shares in the S corporation.[36]

2. **Recommendation**

We recommend that the Final Regulations provide that a partnership allocate the UBIA of its Qualified Property to its partners in the same manner as the allocation of section 704(b) depreciation with respect to the Qualified Property. If Qualified Property does not produce section 704(b) depreciation, then the UBIA with respect to that Qualified Property should be allocated in the same manner as either (i) the allocation of section 704(b) depreciation with respect to other Qualified Property, or (ii) the allocation of "bottom line" section 704(b) income or loss, as described in Regulation section 1.704-1(a)(1)(vii).

3. **Explanation**

The approach taken by the Proposed Regulations with respect to the allocation of UBIA of Qualified Property by an RPE (the "Tax Items Approach") would pose significant challenges to partnerships, all of which could be addressed by allocating UBIA of Qualified Property in accordance with section 704(b) items instead of tax items.

The Tax Items Approach would require a separate calculation for each piece of Qualified Property. Section 704(c), which affects the allocation of tax depreciation in situations where there is a difference between section 704(b) basis and tax basis, generally is applied property-by-property.[37] Therefore, the manner in which tax depreciation is allocated can vary for each piece of Qualified Property held by a

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[34] Prop. Reg. § 1.199A-2(a)(3).

[35] *Id.*

[36] *Id.*

[37] Reg. § 1.704-3(a)(2).

partnership. In addition, these calculations could be even more complicated if the traditional method with curative allocations or the remedial method is used.[38] If UBIA of Qualified Property is allocated based on section 704(b) depreciation instead of tax depreciation, then section 704(c) would not be taken into account, meaning that the allocation of Qualified Property would not necessarily need to be done separately for each piece of Qualified Property.[39] The gain on the Hypothetical Transaction would also need be allocated separately for each piece of Qualified Property to properly account for section 704(c). This burdensome property-by-property calculation could be avoided by allowing taxpayers to refer to either (i) the allocation of section 704(b) depreciation of other Qualified Property, or (ii) the allocation of "bottom line" section 704(b) income or loss items under Regulation section 1.704-1(a)(1)(vii), when allocating the UBIA of Qualified Property that does not produce depreciation.

The Tax Items Approach could also produce results that are unintended from a policy perspective. Often times, section 704(c) results in the contributing partner being allocated little or none of the tax depreciation with respect to contributed property. Therefore, little or none of the UBIA of Qualified Property that is contributed to a partnership with a built-in gain would be allocated to the contributing partner. The fact that the contributing partner receives little to no tax depreciation with respect to contributed property is especially problematic considering that the impact of section 704(c) allocations will generally result in the contributing partners receiving a disproportionately large share of the partnership's income. If the contributing partner is allocated a disproportionately large share of the partnership's QBI and is allocated a disproportionately small share of the partnership's UBIA of Qualified Property, then the section 199A deduction available to the contributing partner may be limited even though the non-contributing partners have abundant UBIA of Qualified Property.

We considered whether the fact that a contributing partner may have contributed property with little to no basis is a good policy reason to allocate such partner a disproportionately small share of UBIA of Qualified Property. Because the rules under section 704(c) generally operate to ensure that a contributing partner is recognizing its built-in gain or loss over the life of contributed property, we do not believe limiting a contributing partner's ability to take a section 199A deduction is appropriate. Thus, any policy concerns with allocating UBIA of Qualified Property based on section 704(b) items versus tax items seem unwarranted, especially given the administrative burden resulting from the Tax Items Approach. Accordingly, it would seem more appropriate for partners to share in the UBIA of Qualified Property in the same manner that they share in the economic depreciation of such Qualified Property. For these reasons, we recommend that a partnership's UBIA of Qualified Property be allocated based on

[38] *See* Reg. § 1.704-3(c) and (d), respectively.

[39] However, the UBIA of certain Qualified Property for which section 704(b) depreciation is specially allocated or for which there is no section 704(b) depreciation may still need to be allocated separately.

section 704(b) items, instead of applying the Tax Items Approach adopted in the Proposed Regulations.

II. Comments Regarding the Determination of QBI

This section of the Comments addresses issues with respect to the determination of QBI. Section 199A(c) defines QBI to mean the net qualified items of income, gain, deduction, and loss ("Qualified Items") with respect to a trade or business of a taxpayer.[40] Items of income, gain, deduction, and loss are generally considered Qualified Items to the extent they are (i) effectively connected with the conduct of a trade or business within the U.S. (determined by modifying section 864(c)) (the "ECI Requirement"),[41] and (ii) included or allowed in determining taxable income for the taxable year.[42] However, there are certain items, such as capital gains, that are specifically excluded from the definition of Qualified Items.[43]

A. Whether Guaranteed Payments for the Use of Capital Should be Taken into Account in Determining QBI

1. Background

While section 199A(c)(3) provides the definition of Qualified Items discussed above, section 199A(c)(4) provides rules with respect to "the treatment of reasonable compensation and guaranteed payments" for purposes of section 199A. Specifically, section 199A(c)(4) provides that QBI shall not include (i) reasonable compensation paid to the taxpayer by any QTB of the taxpayer for services rendered with respect to the trade or business,[44] (ii) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business,[45] and (iii) 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.[46] The statute does not exclude from QBI guaranteed payments for the use of capital ("GPUC(s)") under section 707(c).

With respect to GPUCs, however, the Proposed Regulations, provide the following:

> Income attributable to a guaranteed payment for the use of capital is *not considered to be attributable to a trade or business*, and thus is not taken into

[40] I.R.C. § 199A(c)(1).

[41] I.R.C. § 199A(c)(3)(A)(i).

[42] I.R.C. § 199A(c)(3)(A)(ii).

[43] I.R.C. § 199A(c)(3)(B).

[44] I.R.C. § 199A(c)(4)(A).

[45] I.R.C. § 199A(c)(4)(B).

[46] I.R.C. § 199A(c)(4)(C).

> account for purposes of computing QBI; however, the partnership's deduction associated with the guaranteed payment will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes. [47] (Emphasis added).

The preamble to the Proposed Regulations explains this rule as follows:

> Because guaranteed payments for the use of capital under section 707(c) *are determined without regard to the income of the partnership*, [Proposed Regulation section] 1.199A-3(b)(1)(ii) provides that such payments are not considered attributable to a trade or business, and thus do not constitute QBI. However, the partnership's related expense for making the guaranteed payments may constitute QBI if the other requirements are satisfied. [48] (Emphasis added.)

2. **Recommendation**

We recommend that the Final Regulations provide that guaranteed payments for the use of capital under section 707(c) can be treated as a Qualified Item and included in QBI and to the extent of, the partnership's net Qualified Items, determined without regard to the GPUC deduction.

If the Final Regulations continue to exclude guaranteed payments for the use of capital from the determination of QBI, then we recommend that the Final Regulations also exclude from QBI a partnership's expense related to guaranteed payments for the use of capital.

3. **Explanation**

In general, payments to a partner for services or the use of capital that are determined without regard to the income of the partnership are treated as guaranteed payments under section 707(c). While the definition of guaranteed payments necessarily looks to the status of the payee as a partner (*i.e.,* "payments to a partner"), the payment is treated as made to a person who is not a partner for certain purposes (*e.g.*, sections 61(a) and 162(a)).[49]

The preamble to the Proposed Regulations, quoted above, explains that GPUCs are not considered "attributable to a trade or business" because they are not "determined with regard to the income of the partnership." However, the fact that a partner's GPUC is determined without reference to partnership income does not necessarily mean that the GPUC is not attributable to the trade or business.

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[47] Prop. Reg. § 1.199A-3(b)(1)(ii).

[48] Preamble to the Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40891.

[49] I.R.C. § 707(c).

The legislative history of the Internal Revenue Code of 1954[50] indicates that Congress intended to include guaranteed payments "in the partner's gross income" and that guaranteed payments "shall not be considered a distributive share of partnership income or gain."[51] Nevertheless, when Treasury and the Service issued final regulations under Subchapter K following the enactment of the Internal Revenue Code of 1954,[52] Regulation section 1.707-1(c) provided that "guaranteed payments are considered as made to one who is not a member of the partnership, only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses)" and "do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b)," but "for the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income."[53] In addition, whether or not a guaranteed payment is treated as a partner's distributive share for a certain purpose, the guaranteed payment is generally deductible against partnership income (assuming the requirements of section 162(a) and 263 are satisfied).[54]

Moreover, if a partner receives a guaranteed payment from a partnership, the economic arrangement is that the payee partner is entitled to a minimum amount of income from the partnership, without regard to the overall income of the partnership.[55] Thus, the guaranteed payment is an arrangement determining how a partnership's income

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[50] Pub. L. No. 83-591, 68A Stat. 1 (1954).

[51] H.R. Rep. No. 83-1337, at A227; and S. Rep. No. 83-1622, at 387 (reiterating the treatment of guaranteed payments intended by the House and amending the guaranteed payment provisions "to accord the same treatment as that provided in the case of guaranteed salaries to payments for the use of capital").

[52] T.D. 6175, 1956-1 C.B. 211.

[53] Although the provisions of Regulation section 1.707-1(c) are substantially unchanged since 1956, more recent positions taken by the Service are mixed. *See* PLR 8728033 (Apr. 13, 1987) and PLR 8639035 (June 27, 1986) (treating GPUCs as a distributive share of a partnership's rental income for purposes of determining a partner's REIT status); *Mallary v. U.S.*, 238 F. Supp. 87 (1965) (treating a GPUC as a partner's distributive share of oil and gas revenue for purposes of determining a partner's percentage depletion); and *Kampel v. Commissioner*, 72 T.C. 827 (1979), *aff'd,* 634 F.2d 708 (2d Cir. 1980) (treating guaranteed payments as a distributive share, and not earned income, for purposes of the former section 1348 maximum tax on earned income). *Cf. Miller v. Commissioner*, 52 T.C. 752 (1969), and *Carey v. U.S.*, 192 Ct. Cl. 536 (1970) (treating guaranteed payments as earned income, and not distributive share, for purposes of the section 911 foreign earned income exclusion); and GCM 36702 (1976) and GCM 38133 (1979) (treating a GPUC is treated as ordinary interest income to the payee without regard to the partnership's items of income or expense).

[54] I.R.C § 707(c). *See also* Reg. § 1.707-1(c), and the examples thereunder.

[55] Under existing regulations, the amount treated as a guaranteed payment is generally the difference between the minimum "guaranteed" amount and the amount to which the partner is otherwise entitled by reference to partnership income under the partnership agreement. *See* Reg. § 1.707-1(c), Ex. (2); Rev. Rul. 66-95, 1966-1 C.B. 169; and Rev. Rul. 69-180, 1969-1 C.B. 183. However, proposed regulations under section 707 propose to modify Regulation section 1.707-1(c), Example 2 (to provide that the entire minimum amount guaranteed to the partner is a guaranteed payment), obsolete Revenue Ruling 66-95, and revise Revenue Ruling 69-180. REG-115452-14, 80 Fed. Reg. 43652 (Aug. 10, 2015).

or loss is economically shared among its partners and should not alter the total amount of the partnership's Qualified Items available to be allocated to its partners. The following example illustrates this proposition.

Example 3

A and B are equal partners in a partnership with $1,000 of net income (solely comprised of Qualified Items) before any deduction for a $300 GPUC. Partners A and B share equally in all partnership items except for a $300 GPUC paid to partner A. The partnership's payment of the $300 GPUC to partner A gives rise to a deduction against partnership income.[56] After deducting the GPUC, the partnership has $700 of net Qualified Items that are allocated equally to partners A and B. Thus, partner A's total income from the partnership is $650 ($300 GPUC, plus $350 distributive share of net income) and partner B's total income from the partnership is $350 (distributive share of net income).

The policy directive of section 199A is clearly to afford a deduction, subject to limitations at the partner level, equal to 20% of the partnership's net Qualified Items (*i.e.*, 20% of $1,000, or $200). The GPUC does not change <u>the amount</u> of net income earned from the partnership; rather, it affects <u>the manner in which the partners share</u> the partnership's net income. It appears that, as a policy matter, the total income of the partners ($1,000) should be QBI because all of the income relates to the partnership's Qualified Items (before taking into account the GPUC) and section 199A is applied at the partner level. Thus, the GPUC ought to be included in the QBI of A (the payee partner) and the GPUC expense ought to reduce the QBI with respect to each partner's distributive share.

Example 4

A and B are equal partners in a partnership with $200 of net income (solely comprised of Qualified Items) before any deduction for a $300 GPUC. Partners A and B share equally in all partnership items except for a $300 GPUC paid to partner A. The partnership's payment of the $300 GPUC to partner A gives rise to a deduction against partnership income.[57] After deducting the GPUC, the partnership has ($100) of net Qualified Items that are allocated equally to partners A and B. Thus, partner A's total income from the partnership is $250 ($300 GPUC, plus ($50) distributive share of net income) and partner B's total income from the partnership is ($50) (distributive share of net income).

The policy directive of section 199A is clearly to afford a deduction, subject to limitations at the partner level, equal to 20% of the partnership's net Qualified Items (*i.e.*, 20% of $200, or $40). Under the recommended approach,

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[56] Assume for purposes of this example that the deduction criteria under sections 162 and 263 are satisfied and that the deduction is otherwise a Qualified Item for purposes of section 199A.

[57] Assume for purposes of this example that the deduction criteria under sections 162 and 263 are satisfied and that the deduction is otherwise a Qualified Item for purposes of section 199A.

the GPUC would be treated as a Qualified Item to the extent of the partnership's Qualified Items, determined without regard to the GPUC deduction. Thus, $200 of the $300 GPUC would be treated as a Qualified Item.

Example 5

A and B are equal partners in a partnership with $1,200 of net income ($900 of which is comprised of Qualified Items) before any deduction for a $300 GPUC. Partners A and B share equally in all partnership items except for a $300 GPUC paid to partner A. The partnership's payment of the $300 GPUC to partner A gives rise to a deduction against partnership income.[58] After deducting the GPUC, the partnership has $600 ($900 reduced by $300 GPUC deduction) of net Qualified Items that are allocated equally to partners A and B. Thus, partner A's total income from the partnership is $750 ($300 GPUC, plus $450 distributive share of net income) and partner B's total income from the partnership is $450 (distributive share of net income).

The policy directive of section 199A is clearly to afford a deduction, subject to limitations at the partner level, equal to 20% of the partnership's net Qualified Items (*i.e.*, 20% of $900, or $180). Under the recommended approach, the GPUC would be treated as a Qualified Item to the extent of the partnership's Qualified Items, determined without regard to the GPUC deduction. Thus, the $300 GPUC would all be treated as a Qualified Item.[59]

A plain reading of the statute would indicate Congress's intent to include GPUCs as QBI. There is no provision in section 199A that excludes a guaranteed payment (either for services or for the use of capital) from being a Qualified Item. Although guaranteed payments for services can be Qualified Items, they are specifically excluded from QBI under section 199A(c)(4)(B). Notably, there is no exclusion of GPUCs from QBI. This suggests that a GPUC may be QBI because a guaranteed payment may be a Qualified Item,[60] but a guaranteed payment may not be included in QBI if it is paid with respect to services rendered by the partner to the partnership's trade or business.[61] In fact, if *all* guaranteed payments failed to be Qualified Items, then section 199A(c)(4)(B) would be superfluous because QBI only includes Qualified Items. The statutory silence with respect to GPUCs could suggest that Congress had no intention to exclude GPUCs

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[58] Assume for purposes of this example that the deduction criteria under sections 162 and 263 are satisfied and that the deduction is otherwise a Qualified Item for purposes of section 199A.

[59] We note that in Example 5, if the GPUC expense had been apportioned between the Qualified Items and the non-qualified items, we believe it would be appropriate to treat he GPUC as a Qualified Item and included in QBI *in proportion to*, and to the extent of, the partnership's net Qualified Items, determined without regard to the GPUC deduction. Because the Proposed Regulations treat all of the GPUC deduction as reducing Qualified Items, we do not believe the "in proportion to" language is appropriate.

[60] I.R.C. § 199A(c)(3).

[61] I.R.C. § 199A(c)(4)(B).

from QBI because Congress clearly contemplated guaranteed payments under section 707(c) and chose only to exclude from QBI those guaranteed payments that are made for services rendered with respect to the trade or business. [62]

On balance, there are strong arguments that a GPUC is treated as a partner's distributive share, and therefore as the payee partner's allocable share of the partnership's Qualified Items, for purposes of section 199A. We believe treating a GPUC as a Qualified Item to the extent of a partnership's Qualified Items most furthers the intent of section 199A. .[63] Therefore, we recommend that final guidance allow GPUCs under section 707(c) to be a Qualified Item and included in QBI to the extent of the partnership's Qualified Items, determined without regard to the GPUC expense.

If the Final Regulations follow the Proposed Regulations and preclude GPUCs from being included in QBI, then we recommend that the Final Regulations also exclude from QBI any expense related to guaranteed payments for the use of capital. Otherwise, the existence of a GPUC arrangement would reduce (inappropriately, in our view) the section 199A benefit afforded with respect to the QBI of a partnership.[64]

B. Whether Section 707(a) Payments Should Be Taken Into Account in Determining QBI

1. Background

Section 199A(c)(4)(C) provides that "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" shall not be included in QBI.

[62] Congress may have specifically excluded section 707(c) payments for services because, in certain circumstances, section 707(c) payments for services can closely resemble wages paid to an employee, and compensation paid to employees is specifically excluded from QBI. *See* I.R.C. § 199A(d)(1)(B) and Prop. Reg. § 1.199A-5(d). Conversely, section 707(c) payments for the use of capital reflect returns on capital contributions made by the partner receiving the payment. Because section 707(c) payments for the use of capital would not be equivalent to a wage paid to an employee, there does not appear to be the same policy reason for automatically excluding the payments from QBI.

In addition, although a GPUC may, in certain situations, be treated as an interest equivalent, it is not interest and we are not aware of any situation in which it is treated as interest. Rather, a GPUC is income recognized in the partner's capacity as a partner (except for the limited situations described above). Thus, we do not believe the fact that, in certain situations, a GPUC can be treated as an interest equivalent should prevent a GPUC from being treated as a Qualified Item.

[63] I.R.C. § 199A(c)(3).

[64] For example, partners A and B in Example 3 above would each have QBI from the partnership of $350 (for a total of $700), even though the partnership would have total QBI before the GPUC arrangement of $1,000. Reducing the overall section 199A benefit of A and B with respect to the QBI earned by the partnership because they utilize a GPUC to achieve their desired economic arrangement does not appear to be intended from a policy perspective.

The Proposed Regulations provide that QBI does not include any payment described in section 707(a) to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE.[65] The preamble to the Proposed Regulations explains the decision to exclude section 707(a) payments for Services from QBI, as follows:

> Section 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. 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. In addition, . . . to the extent an upper-tier RPE receives a section 707(a) payment, that income should not constitute QBI to the partners of the upper-tier entity.[66]

The preamble requests comments on whether there are situations in which it is appropriate to include section 707(a) payments in QBI.[67]

2. **Recommendation**

We recommend that the Final Regulations under section 199A provide that section 707(a) payments can be included in QBI to the extent that the section 707(a) payments would otherwise be included in QBI.

3. **Explanation**

As described above, the Proposed Regulations appear to exclude section 707(a) payment for services from QBI based on the consideration that a section 707(a) payment is similar to guaranteed payments for services, reasonable compensation, and wages. We agree that a section 707(a) payment could be similar to wage-like payments in situations where the partner performs services in a capacity as an employee of a partnership. In those situations, a section 707(a) payment is similar to wages and thus should not be included in QBI.

However, a section 707(a) payment may represent consideration received by a partner for *any* services performed in a non-partner capacity. For example, an individual partner of a partnership engaged in an engineering trade or business may receive payment for the delivery service the partner provides to the engineering firm through the partner's own delivery company. In that case, we do not believe the section 707(a) payment received by that partner should be treated similarly as wages (*i.e.*, that partner should not be treated as performing services as an employee).

From a policy perspective, a partner who performs services to a partnership in a non-partner capacity should not be disadvantaged as compared to a non-partner who

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[65] Prop. Reg. § 1.199A-3(b)(2)(ii)(J).

[66] Preamble to the Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40893 (Aug. 16, 2018).

[67] *Id.*

performs the same services to the same partnership. Therefore, we recommend that Treasury and the Service clarify in the Final Regulations that section 707(a) payments are included in the partner's QBI to the extent that the partner would otherwise include the income in QBI if received from a third-party. In other words, section 707(a) payments ought to be taken into account in determining QBI to the extent the payments meet the requirements of section 199A(c) and Proposed Regulation section 1.199A-3.

C. How Previously Disallowed Losses Should Be Taken Into Account in Determining QBI

1. Background

Section 199A(c)(3)(A)(ii) provides that items of income, gain, deduction, and loss must be "included or allowed in determining taxable income for the taxable year" in order to be considered Qualified Items" (*i.e.*, in order to be taken into account in determining QBI).

The Proposed Regulations clarify that "[g]enerally, previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI in the current year. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI."[68]

The preamble to the Proposed Regulations explains that "to the extent that any previously disallowed losses or deductions are allowed in the taxable year, they are treated as items attributable to *the* trade or business" (emphasis added).[69] However, this concept is not clearly established by Proposed Regulation section 1.199A-3(b)(iv) and the Proposed Regulations do not provide guidance on how QBI is determined if the taxpayer has previously disallowed losses from multiple section 199A trades or businesses.

2. Recommendation

We recommend that the Final Regulations address how taxpayers should allocate previously disallowed losses or deductions among section 199A trades or businesses. The Final Regulations should also address how taxpayers should determine which portion of the previously disallowed losses were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (as opposed to disallowed losses from taxable years beginning after December 31, 2017). We also recommend that the Final Regulations do so in a manner that minimizes taxpayer burden.

[68] Prop. Reg. § 1.199A-3(b)(1)(iv).

[69] Preamble to the Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40891.

3. **Explanation**

Because losses or deductions that were disallowed in a taxable year beginning after December 31, 2017 are taken into account in determining QBI, it is important to determine to which section 199A trades or businesses the previously disallowed losses relate. It is also important to determine whether previously disallowed losses or deductions relate to taxable years ending before January 1, 2018 (*i.e.*, whether the previously disallowed losses or deductions should be included in QBI at all).

There are specific rules that describe how certain loss limitations operate mechanically. For example, Temporary Regulation section 1.469-1T(f)(2)(i) provides rules for allocating disallowed passive activity loss among section 469 activities. However, because section 199A trades or businesses are determined differently from section 469 activities, the section 469 rules will not sufficiently address the determinations needed to properly apply section 199A. Therefore, guidance should be issued under section 199A to specifically address how taxpayers should make these determinations.

One approach that could reduce the burdensome calculations required of taxpayers that conduct multiple section 199A trades or businesses would be to treat any previously disallowed losses or deductions that relate to taxable years ending after December 31, 2017 as losses from a separate or "notional" trade or business. However, in that scenario, the taxpayer would still need to determine how much of the previously disallowed losses relate to a QTB versus a trade or business that is not qualified.

We do not believe that one approach is clearly preferable to another and therefore are not recommending a specific approach. Instead, we merely recommend that the Final Regulations provide guidance on how taxpayers should trace previously disallowed losses to specific trades or businesses.

With respect to how previously suspended losses should be allocated between pre-2018 and post-2018 taxable years, a "first-in, first-out" approach would be the easiest to apply and is sound from a policy perspective.

D. **How Net Operating Losses Should Be Taken Into Account in Determining QBI**

1. **Background**

As described above, section 199A(c)(3)(A)(ii) provides that items of income, gain, deduction, and loss must be "included or allowed in determining taxable income for the taxable year" in order to be considered Qualified Items.

Newly enacted section 461(l) disallows a non-corporate taxpayer's excess business loss, which is defined as the excess (if any) of the *aggregate deductions* attributable to trades or businesses, over the aggregate gross income or gain attributable to such trades or businesses, plus $250,000 (or $500,000 in the case of a joint return).[70] A disallowed excess business loss is treated as a net operating loss carryover in the following taxable year.[71] Based on the language of section 461(l), it appears that only the *excess deduction items* are disallowed, rather than the *entire* net business loss.[72] Additionally, the section 461(l) limitation applies to all trades or business, regardless of whether such trades or businesses are "qualified" for purposes of the section 199A deduction.

The Proposed Regulations clarify that "[g]enerally, a deduction under section 172 for a net operating loss is not considered with respect to a trade or business and, therefore, is not taken into account in computing QBI."[73] The preamble to the Proposed Regulations explains that this is because net operating losses have generally been included in determining (*i.e.*, reducing) taxable income in the year in which they were incurred,[74] implying that the items comprising the net operating loss have already met the section 199A(c)(3)(A)(ii) requirement and cannot be included in subsequent years.

However, "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."[75] The preamble to the Proposed Regulations explains that this is because the portion of the net operating loss that is disallowed by reason of section 461(l) has not been allowed for purposes of determining taxable income (*i.e.*, has not previously met the section 199A(c)(3)(A)(ii) requirement) and needs to be included in QBI when allowed.[76] Otherwise, that portion of the net operating loss "would permanently escape the QBI rules."[77]

2. **Recommendation**

We recommend that the Final Regulations address how taxpayers should determine the portion of the net operating loss deduction that relates to deductions disallowed by reason of section 461(l). The Final Regulations should also address how taxpayers should determine to which section 199A trades or businesses the deductions that are initially disallowed by section 461(l) relate and to which section 199A trades or businesses the deductions that are subsequently allowed as a net operating loss deduction relate.

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[70] I.R.C. § 461(l)(3)(A).

[71] I.R.C. § 461(l)(2). The precise operation of section 461(l) is unclear.

[72] I.R.C. § 461(l)(3)(A).

[73] Prop. Reg. § 1.199A-3(b)(1)(v).

[74] Preamble to the Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40891.

[75] Prop. Reg. § 1.199A-3(b)(1)(v).

[76] Preamble to the Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40891.

[77] *Id.*

3. **Explanation**

Because the portion of a net operating loss deduction that was previously disallowed under section 461(l) is taken into account in determining QBI in the year in which the net operating loss deduction is allowed, it is important to determine which portion of the net operating loss deduction relates to deductions previously disallowed under section 461(l). It is also important to determine to which section 199A trades or businesses that portion of the net operating loss relate.

There has been no guidance provided with respect to section 461(l), and the rules under section 172 do not sufficiently address the determinations needed to properly apply section 199A. Therefore, guidance should be issued under section 199A to specifically address how taxpayers should make these determinations.

One approach that could reduce the burdensome calculations required of taxpayers that conduct multiple section 199A trades or businesses would be to treat any net operating loss deduction that relates to deductions disallowed by section 461(l) as losses from a separate or "notional" trade or business.[78] However, in that scenario, the taxpayer would still need to determine how much of that portion of the net operating loss deduction should relate to a qualified notional trade or business versus a notional trade or business that is not qualified.

We do not believe that one approach is clearly preferable to another and therefore are not recommending a specific approach. Instead, we merely recommend that the Final Regulations provide guidance on how taxpayers should the section 461(l) portion of net operating loss deductions specific trades or businesses.

With respect to how a net operating loss deduction should be allocated between deductions that are disallowed under section 461(l) and net operating losses that were not disallowed under section 461(l), a "first-in, first-out" approach would be the easiest to apply and is sound from a policy perspective.

E. **The Determination of QBI on the Sale of a Partnership Interest**

1. **Background**

Under section 199A(e)(4)(B), ordinary income described in section 751(a) on the sale of a publicly traded partnership ("PTP") interest is considered qualified PTP income for purposes of determining the section 199A deduction.

[78] The preamble to the Proposed Regulations explains that "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" (emphasis added). Preamble to the Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40891. However, this concept is not clearly established by Proposed Regulation section 1.199A-3(b)(v).

Prior to the publication of the Proposed Regulations, it was unclear whether ordinary income and loss under section 751(a) on the sale of a partnership interest (other than a PTP interest) could qualify for a section 199A deduction. The Proposed Regulations confirmed that ordinary income or loss under section 751(a) is taken into account for purposes of computing QBI.[79] However, the preamble to the Proposed Regulations clarifies that ordinary income or loss under section 751(a) may only constitute QBI if the other requirements of section 199A and the Proposed Regulations are met.[80]

The ECI Requirement under section 199A(c)(3)(A)(i) provides that, for an item to be considered a qualified item for purposes of section 199A, the item must be "effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting 'qualified trade or business (within the meaning of section 199A)' for 'nonresident alien individual or a foreign corporation' or for 'a foreign corporation' each place it appears)." The Proposed Regulations reiterate the rule provided by the statute but use "trade or business" instead of "qualified trade or business," presumably to address the fact that taxpayers can have QBI with respect to SSTBs.[81]

If the language of section 199A(c)(3)(A)(i) is applied literally, it appears that section 864(c)(8)(A) could be read as follows when determining the amount of effectively connected income ("ECI"), and thus QBI, on the sale of a partnership interest: "if a [**trade or business (within the meaning of section 199A)**] owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or a portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under [section 864(c)(8)(B)]." (Emphasis added.)

The determination of the ECI on the sale of a partnership interest under section 864(c)(8) differs from the determination of ordinary income or loss under section 751(a). Section 864(c)(8) simply characterizes a portion of the net gain or loss on the sale of a partnership interest as ECI gain or ECI loss, respectively. Under section 751(a), however, upon a sale of a partnership interest, a taxpayer determines its ordinary income or loss on a hypothetical sale, and that ordinary income or loss can exceed the net gain or loss in the

[79] Prop. Reg. § 1.199A-3(b)(1)(i).

[80] Preamble to the Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40891.

[81] Prop. Reg. § 1.199A-3(b)(2)(i)(A). However, for a taxpayer with taxable income above the threshold amounts provided by section 199A(e)(2), only a portion (or none) of the QBI from SSTBs will be taken into account for purposes of determining the taxpayer's QBI component under the mechanics of Proposed Regulation section 1.199A-1(d)(i).

taxpayer's partnership interest (*i.e.*, the section 751(a) gain or loss is not capped in the same manner as the ECI gain or loss).[82]

2. **Recommendation**

We recommend that the Final Regulations under section 199A provide that the portion of ordinary income or loss under section 751(a) that would meet the ECI Requirement of section 199A(c)(3)(A)(i) is not determined by application of a modified section 864(c)(8). Instead, the Final Regulations should provide that the portion of the section 751(a) gain that meets the ECI Requirement is the ECI gain or loss on 751 property that would be allocated to the taxpayer in the hypothetical sale described in Regulation section 1.751-1(a)(2).

3. **Explanation**

As discussed above, if section 199A(c)(3)(A)(i) is applied literally, the language of section 864(c)(8)(A) is difficult to interpret with the modifications made by section 199(c)(3)(A)(i).[83] Nevertheless the intent of the rule seems to be that, if a gain or loss on the sale of a partnership interest would have been ECI to a foreign individual or corporation, then the gain or loss can be a qualified item. Because the recommendation above approaches the calculations without reference to section 864(c)(8)(A), we have not recommended a solution to the modified section 864(c)(8)(A) language. If the recommended approach above is not adopted, we believe that the Final Regulations should clarify how the modified section 864(c)(8)(A) language should be interpreted.

Under section 864(c)(8)(B), gain or loss on the sale or exchange of a partnership interest is treated as ECI gain or loss to the extent the gain or loss does not exceed:

- In the case of gain on the sale of the partnership interest, (i) the portion of the partner's distributive share of the amount of gain which would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest, or (ii) zero if no gain on such deemed sale would have been so effectively connected.[84]

- In the case of loss on the sale of the partnership interest, (i) the portion of the partner's distributive share of the amount of loss which would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair

[82] In other words, a taxpayer can have ordinary income and capital loss (or ordinary loss and capital gain) on the sale of a partnership interest.

[83] For example, trades or businesses do not own partnership interests; instead, taxpayers conduct trades or businesses through partnerships.

[84] I.R.C. § 864(c)(8)(B)(i).

> market value as of the date of the sale or exchange of such interest, or (ii) zero if no loss on such deemed sale would have been so effectively connected.[85]

Thus, a partner's ECI gain or ECI loss on the sale of a partnership interest cannot exceed that partner's net gain or net loss, respectively, in its partnership interest.

Unlike section 864(c)(8), the amount of ordinary income or loss on the sale of a partnership interest under section 751(a) can exceed the partner's share of net gain on the sale of the partnership interest. More specifically, Regulation section 1.751-1(a)(2) provides that –

> The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (including any remedial allocations under Regulation section 1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest.

As a result of these contrasting approaches, a taxpayer's ordinary income or loss on the sale of a partnership interest can differ significantly from the amount of ECI recognized on the sale of the partnership interest.[86]

There are significant disadvantages in applying section 864(c)(8) for purposes of determining the portion of the section 751(a) gain that meets the ECI Requirement of section 199A(c)(3)(A)(i). As described above, the ordinary income or loss determined under section 751(a) can differ from the portion of the net gain or loss that is treated as ECI. The apparent intent of allowing section 751(a) gains to be includible in QBI is to provide taxpayers with a section 199A benefit to the extent that their gain or loss on the sale of a partnership interest (that relates to a domestic trade or business) is taxable at ordinary, versus capital gain, tax rates. It seems inconsistent with that apparent intention to limit the section 199A benefit to the taxpayer's net gain or loss on the sale of its

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[85] I.R.C. § 864(c)(8)(B)(ii).

[86] We also note that the flush language in section 864(c)(8)(B) is confusing. That language provides that for purposes of section 864(c)(4)(B)(i) and (ii), a partner's distributive share of gain or loss on the deemed sale shall be determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership. We believe this language should be read in the context of the other language in section 864(c)(8)(B) and the partner's distributive share should be equal to the partner's distributive share on a hypothetical sale.

partnership interest if, for example, the application of section 751(a) results in ordinary income and capital loss. This is especially evident in a situation where all of a partnership's operations are ECI (*i.e.*, in that case, the entire ordinary income or loss under section 751(a) ought to be taken into account in determining a selling partner's QBI).

As discussed above, a literal interpretation of section 199A(c)(3)(A)(i) leads to an apparently unintended result. Specifically, to harmonize the portion of a partner's gain or loss that is treated as ordinary income or loss with the portion of the partner's gain or loss that satisfies the ECI Requirement, a special rule that requires a calculation of the ECI gain or loss that the selling partner would be allocated as a result of the hypothetical liquidation described in Regulation section 1.751-1(a)(2) would be an appropriate way to determine the portion of ordinary income and loss under section 751(a) that meets the ECI Requirement.

III. Comments Regarding SSTBs

This section of the Comments address issues arising with respect to SSTBs.

A. The Definition of Trade or Business

1. Background

As described in the preamble, the Proposed Regulations incorporate the rules under section 162 for determining whether a trade or business exists for purposes of section 199A.[87] A taxpayer can have more than one trade or business for purposes of section 162.[88] However, there are no "bright line" rules for purposes of determining whether an activity is considered a trade or business under section 162 or whether multiple activities are separate trades or businesses within the meaning of section 162.

2. Recommendation

We recommend that the Final Regulations provide factors to help determine whether an individual or RPE conducts separate trades or businesses. Such factors may include the maintenance of separate books and records, separate employees, separate bank accounts, different types of businesses, separate management, or separate legal entities. The last factor may result in costly restructuring that we do not believe is necessary for an activity to be respected as a separate trade or business, but it would be far better from a policy perspective than to deny the deduction outright. Therefore, we recommend that a safe-harbor be provided, such that, if separate books and records are maintained and at least one of the other factors is present, the taxpayer *may* treat the activities as separate trades or businesses for purposes of section 199A. In addition, if separate books and records are maintained and substantially all of the factors (*e.g.*, four of the five factors) are present, the taxpayer should be presumed to be in separate trades or businesses. This rebuttable presumption would be in favor of the Service and the

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[87] Preamble to Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40894.

[88] *Id.*

taxpayer would need to overcome the presumption in order to treat multiple activities as a single trade or business.

B. The Effect of the SSTB De Minimis Rule

1. Background

The Proposed Regulations contain several special rules with respect to SSTBs.[89] One of the special rules is a de minimis rule that addresses situations in which a single trade or business has some activities that would be considered SSTB activities and some that would not. The de minimis rule provides the following:

> For a trade or business with gross receipts of $25 million dollars or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a field described in paragraph (b) of this section [an SSTB]. [90]

For trades or business with more than $25 million of gross receipts, the ten percent gross receipts threshold is reduced to five percent.[91] Although the language of the rule itself appears to be a safe harbor, we understand that the rule was intended to be a "cliff" such that exceeding the threshold would cause all the income of the trade or business to be treated as SSTB income.

2. Recommendation

To the extent that in any year the amount of gross receipts from services in an SSTB field exceeds the de minimis threshold, we recommend that the Final Regulations allow the individual or RPE to bifurcate the QBI, W-2 wages, and UBIA of Qualified Property between the gross receipts attributable to services in an SSTB field and the gross receipts that are not attributable to services in an SSTB field, based upon a reasonable method that is consistently applied. However, if 80% or more of the gross receipts of the trade or business are attributable to services in an SSTB field, the entire trade or business should be considered an SSTB.

If a bifurcation approach is not adopted, we recommend that a trade or business be treated as a QTB if less than 20% of its gross receipts are attributable to services in an SSTB field.

3. Explanation

Applying the de minimis rule as a "cliff" is inappropriate, particularly for taxpayers with gross receipts that hover around the de minimis threshold each year. For example, assume an RPE conducts what is typically considered a single trade or business that would be a QTB. In year one, the amount of gross receipts from consulting fees,

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[89] Prop. Reg. § 1.199A-5(c).

[90] Prop. Reg. § 1.199A-5(c)(1)(i).

[91] Prop. Reg. § 1.199A-5(c)(1)(ii).

which are separately billed, is less than the de minimis threshold by an insignificant amount. As a result, all of the income of the RPE qualifies for the section 199A deduction. In year two, the amount of gross receipts from such consulting fees is more than the de minimis threshold by an insignificant amount. Under the Proposed Regulations, none of the income from year two would be eligible for the section 199A deduction. We believe that it would be more appropriate to adopt a bifurcation approach, which would treat a proportionate amount of QBI, W-2 wages, and UBIA of Qualified Property as attributable to an SSTB. Instead of completely denying a section 199A deduction when a taxpayer's business involves both qualified and nonqualified activities, a bifurcation approach would provide a potential section 199A deduction with respect to a taxpayer's qualified activities and prohibit a section 199A deduction with respect to a taxpayer's nonqualified activities.

An approach that bifurcates a trade or business into SSTB and QTB components would also be consistent with the rule provided by Proposed Regulation section 1.199A-5(c)(2)(ii). Under that rule, if a trade or business provides less than 80% of its property or services to a commonly-owned SSTB, then the "portion of the trade or business of providing property or services to the . . . commonly-owned SSTB is treated as part of the SSTB."[92] Because this rule only allows a trade or business to be split into QTB and SSTB components if less than 80% of the property or services of the trade or business is provided to the commonly-owned SSTB,[93] a similar threshold should be established if bifurcation approach is adopted. Therefore, we recommend that if 80% or more of the gross receipts of a trade or business are attributable to services in an SSTB field, the entire business be treated as an SSTB.

If our above recommendations to permit bifurcation is not adopted, we would suggest the threshold amount be set at 20%. Under this approach, if a predominantly qualifying business has less than 20% gross receipts from SSTB activities, the trade or business would be treated as entirely qualifying.

For purposes of determining the predominant characteristic of an entity, other Code sections and regulations generally set the threshold at 20%. For example, section 351(e) and the regulations thereunder provide that, among other things, a corporation that owns more than 80% of certain listed assets that are held for investment is an "investment company." Thus, if more than 80% of the corporation's assets are such assets, the entire corporation is treated as an investment company notwithstanding the fact that up to 20% of its assets are not listed.

In addition, for purposes of determining whether an interest in an entity is a marketable security, section 731(c)(2)(B)(v) and (vi) and the regulations thereunder provide that (i) if 90% or more of the assets of an entity (by value) at the time of a distribution of an interest in the entity consist (directly or indirectly) of marketable

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[92] Prop. Reg. § 1.199A-5(c)(2)(ii).

[93] Under Proposed Regulation section 1.199A-5(c)(2)(i), an SSTB includes any trade or business that provides 80% or more of its property or services to a commonly-owned SSTB.

securities, money, or both, then the entire interest in that entity is a marketable security, and (ii) if less than 90% but 20% or more of the assets of an entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both, then an interest in that entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both.[94] Therefore, if less than 20% of the assets of an entity (by value) in an entity consists of marketable securities, the entire interest in that entity does not constitute a marketable security.[95]

Based on the above, we recommend that the Final Regulations retain a provision that provides a safe harbor rule allowing a de minimis amount of gross receipts from an SSTB activity to not taint income from an otherwise qualified trade or business. However, to the extent that in any year the amount of gross receipts from services in an SSTB field exceeds the de minimis threshold (but are less than 80% of the total gross receipts of the business), the individual or RPE should be allowed to bifurcate the QBI, W-2 wages, and UBIA of Qualified Property between the an SSTB component and a QTB component, based upon a reasonable method consistently applied. If 80% or more of the gross receipts of a trade or business are attributable to services in an SSTB field, then the entire trade or business should be treated as an SSTB.

If the above recommendation is not adopted, we recommend that a trade or business be treated as an SSTB only if 20% or more of the gross receipts of the trade or business are attributable to services in an SSTB field.[96]

C. “Incidental to an SSTB” Anti-Abuse Rule

1. Background

Proposed Regulation section 1.199A-5(c)(3) provides that if a trade or business (that would not otherwise be treated as an SSTB) has both 50% or more common-ownership with an SSTB and shared expenses with the SSTB, including wage or overhead expenses, then the trade or business is treated as incidental to and, therefore, part of the SSTB, if the gross receipts of the trade or business represents no more than

[94] Reg. § 1.731-2(c)(3).

[95] The legislative history to section 351(e) provides that until regulations are issued under section 351(e), the interest in an entity rule of Regulation section 1.731-2 also may be used to determine the extent to which a lower-tier partnership interest is treated as a listed asset for purposes of section 351(e).

[96] We note that the de minimis rule should also be extended to apply in the context of the “services or property provided to an SSTB” anti-abuse rule. As discussed above, if a trade or business provides less than 80% of its property or services to a commonly-owned SSTB, then a proportional amount of the trade or business is treated as part of the SSTB. *See* Prop. Reg. § 1.199A-5(c)(2)(ii). This rule appears to apply even to a de minimis amount of property or services provided to a commonly-owned SSTB. To prevent the application of this rule in non-abusive situations, we recommend that the anti-abuse rule only apply to trades or businesses that provide ten percent or more of their services or property to one or more commonly-owned SSTBs.

five percent of the total combined gross receipts of the trade or business and the SSTB in a taxable year (the "Anti-Abuse Rule").

2. **Recommendation**

Previously, we recommended, among other things, that for purposes of section 199A the government should (i) allow taxpayers to group QTBs for purposes of section 199A consistent with the principles under Regulation section 1.469-4 and (ii) prohibit the disaggregation of an incidental activity with respect to an SSTB from the SSTB (or with respect to a QTB, from the QTB) when the incidental activity either: (i) does not generate any revenue from independent outside third party customers; or (ii) represents no more than the lesser of (A) five percent (or if five percent is deemed too restrictive, ten percent) of gross revenues, W-2 wages, number of employees, unadjusted basis, one or more other objective bases or some combination of such factors or (B) $1 million in gross revenue. Rather than provide rules allowing aggregation or prohibiting disaggregation based upon the principles of Regulation section 1.469-4, the Proposed Regulations provide rules allowing aggregation or prohibiting disaggregation (*i.e.*, the Anti-Abuse Rule) based upon a trade or business standard. Because the Proposed Regulations adopt a trade or business standard, we do not believe the Anti-Abuse Rule is appropriate or needed. If a QTB is appropriately treated as a separate trade or business,[97] disqualifying the income because there are shared expenses with another commonly-owned business seems inappropriate. Such an approach would penalize a taxpayer who operates a QTB in addition to an SSTB as compared to one who operates only a QTB. In addition, as discussed below, applying the Anti-Abuse Rule to determine whether a *trade or business* is treated as incidental to and, therefore, *part of an SSTB* presents significant administrative difficulties for taxpayers. We, therefore, recommend that the Final Regulations under section 199A remove the Anti-Abuse Rule.

If, however, the Anti-Abuse Rule is retained, we make the following recommendations. We recommend that the Final Regulations under section 199A define the terms "gross receipts" and "shared expenses" to provide taxpayers greater clarity whether an item or items constitutes gross receipts and whether a trade or business has shared expenses with an SSTB. We also recommend that the Final Regulations should require appropriate adjustments to avoid double counting the same gross receipts for purposes of applying the Anti-Abuse Rule. Further, we recommend that the Final Regulations provide guidance in determining the appropriate amount of gross receipts to take into account for purposes of the Anti-Abuse Rule where a QTB has common ownership and shared expenses with multiple trades or businesses. Specifically, we recommend that the Final Regulations clarify which businesses are taken into account for purposes of the Anti-Abuse Rule. Finally, we recommend that the Final Regulations modify the Anti-Abuse Rule so that a trade or business to which the Anti-Abuse Rule applies is "treated as a separate SSTB" rather than "treated as . . . part of the SSTB."

3. **Explanation**

[97] Under section 162 principles, as clarified by the Final Regulations.

(a) **Definition of Gross Receipts and Shared Expenses**

As described above, the Anti-Abuse Rule determines whether a trade or business is incidental to an SSTB by comparing the gross receipts of the trade or business to the combined gross receipts of the trade or business and the SSTB. Neither section 199A nor the Proposed Regulations defines the term “gross receipts.” Regulations under other Code sections, however, do define the term. For example, Temporary Regulation section 1.448-1T(f)(2)(iv)(A) provides:

> The term “gross receipts” means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer’s accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221(1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221(2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (*e.g.*, a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.

Defining the term “gross receipts” would provide taxpayers greater clarity in determining whether an item or items constitutes gross receipts. Thus, we recommend that, if the Anti-Abuse Rule is retained, the Final Regulations define the term “gross receipts” either by providing a definition specifically for purposes of section 199A or referencing the definition provided in another regulation.

Additionally, the Anti-Abuse Rule applies where a trade or business has shared expenses with an SSTB, including shared wage or overhead expenses. Neither section 199A nor the Proposed Regulations defines shared expense other than to provide that shared expenses include shared wage or overhead expenses. Defining the term “shared expenses” would provide taxpayers greater clarity on whether a trade or business has a shared expense with an SSTB. Accordingly, we recommend that, if the Anti-Abuse Rule is retained, the Final Regulations define the term “shared expenses” (*i.e.*, define what items constitute an “expense” and when are those items “shared”) for purposes of the Anti-Abuse Rule.

(b) **Double Counting Gross Receipts**

Additionally, various fact patterns can result in a taxpayer counting the same gross receipts more than once for purposes of the Anti-Abuse Rule; however, the Proposed Regulations do not provide rules to avoid double counting gross receipts. For example, the Proposed Regulations do not clarify whether gross receipts attributable to transactions between the trade or business and the SSTB should be taken into account for purposes of applying the Anti-Abuse Rule. Regulations under other Code sections that are applied by reference to aggregate gross receipts, however, do not take into account gross receipts that are attributable to a transaction between certain related persons, when the gross receipts of both related persons would otherwise be included in the aggregate gross receipts. One example is Temporary Regulation section 1.448-1T, which provides rules limiting the use of the cash receipts and disbursements method of accounting by certain taxpayers. Temporary Regulation section 1.448-1T(f)(2)(ii) provides in relevant part that "all persons treated as a single employer . . . shall be treated as one person" and "[g]ross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account . . . " for purposes of determining whether the exception for entities with gross receipts of not more than $5 million applies.[98] A second example is Regulation section 1.263A-3, which provides capitalization rules relating to property acquired for resale. For purposes of determining whether the gross receipts exception for small resellers applies, Regulation section 1.263A-3(b)(3)(i) provides in relevant part that "[t]he gross receipts of a single employer (or the group) are determined by aggregating the gross receipts of all persons (or the members) of the group, excluding any gross receipts attributable to transactions occurring between group members." A third example is Regulation section 1.460-3, which provides rules requiring certain taxpayers to determine the income from a long-term construction contract using the percentage-of-completion method described in Regulation section 1.460-3. In applying the exempt construction contract rules, Regulation section 1.460-3(b)(3)(i) provides that gross receipts should be "determined using the principles of the gross receipts test for small resellers under [Regulation section] 1.263A-3(b)." Thus, Regulation section 1.460-3(b)(3) supports the proposition that gross receipts attributable to transactions between "group members" should be excluded.

The effect of each of these rules is to prevent double counting gross receipts by excluding transactions between related persons that would otherwise meet the definition of gross receipts because those transactions would be reflected in ultimate gross receipts generated by third-party sales. Other fact patterns in addition to related party sales can also result in a taxpayer double counting gross receipts, as illustrated in the following example.

Example 6

An upper-tier partnership ("UTP") conducts a trade or business directly and holds an interest in a lower-tier partnership ("LTP") that also conducts a trade or business. Assume the LTP has gross receipts from third-party sales which is reflected in UTP's distributive share of LTP's income. To the extent

[98] Note that the gross receipts test under section 488(c)(1) has changed to $25 million for taxable years beginning after December 31, 2017.

that UTP's distributive share of LTP's income merely reflects LTP's gross receipts from third-party sales, counting LTP's gross receipts from third-party sales and counting UTP's distributive share of LTP's income as gross receipts would count the same gross receipts more than once. Thus, appropriate adjustments should be made to avoid double counting gross receipts with respect to a partner's distributive share of partnership income, gain, deduction, and loss.

Because gross receipts should not be double counted, we recommend that, if the Anti-Abuse Rule is retained, the Final Regulations provide that taxpayers are required to make appropriate adjustments (*e.g.*, not taking into account transactions between commonly owned trades or businesses, appropriately adjusting a partner's distributive share of partnership income, gain, deduction, and loss) to avoid taking into account the same gross receipts more than once for purposes of applying the Anti-Abuse Rule.

(c) **Comparing the Gross Receipts of a QTB with the Gross Receipts of Multiple Trades or Businesses, Each Having Common Ownership and Shared Expenses**

Further, the Anti-Abuse Rule does not address fact patterns in which a QTB has common ownership and shared expenses with multiple trades or businesses. As described above, Proposed Regulation section 1.199A-5(c)(3) provides that if *a trade or business* (that would not otherwise be treated as an SSTB) has both 50% or more common-ownership with *an SSTB* and shared expenses with *the SSTB*, including wage or overhead expenses, then *such trade or business* is treated as incidental to and, therefore, part of *the SSTB*, if the gross receipts of *the trade or business* represents no more than five percent of the total combined gross receipts of *the trade or business* and *the SSTB* in a taxable year. Thus, the literal language of the Anti-Abuse Rule applies to a single trade or business having common-ownership and shared expenses with a single SSTB to determine whether the single trade or business is incidental and therefore part of the single SSTB. As a result, the application of the Anti-Abuse Rule is not clear where a QTB has common ownership and shared expenses with multiple trades or businesses.

We do not believe common ownership and shared expenses alone is sufficient to warrant application of the Anti-Abuse Rule. We believe, at a high level, that the factors for aggregating businesses in Proposed Regulation section 1.199A-4 should be similar to the factors for applying the Anti-Abuse Rule in Proposed Regulation section 1.199A-5, if retained, but believe the Anti-Abuse Rule should not apply in cases in which there is no abuse. Thus, we believe at least two of the additional factors we describe in clause (iv) below must also be present. Accordingly, we believe the Anti-Abuse Rule, if retained, should only apply to those businesses that (i) have common ownership, (ii) have shared expenses, (iii) satisfy all three of the factors provided in Proposed Regulations section 1.199A-4(b)(1)(v), and (iv) have two or more of the following factors – significant shared employees, no separate management, and operated in the same legal entity.

Once it is determined which businesses must be compared under the Anti-Abuse Rule, the question of how to compare the gross receipts of commonly controlled trades or businesses remains. Specifically, a taxpayer must still determine whether a business-by-business approach (the "Single Comparison Approach") or an aggregation approach (the

"Aggregate Comparison Approach") should be applied. Consider the following example, which illustrates the difference between the Single Comparison Approach and the Aggregate Comparison Approach.

Example 7

> Each of QTB1, SSTB1, SSTB2, and SSTB3 have common ownership and shared expenses. The requirements outlined above in (iii) and (iv), however, are satisfied with respect to QTB1 and SSTB1 and SSTB2, but not with respect to SSTB3. Because the requirements are not satisfied with respect to SSTB3, SSTB3 is not taken into account in applying the Anti-Abuse Rule. Under the Single Comparison Approach, QTB1 would be compared against each of SSTB1 and SSTB2, separately, to determine if the Anti-Abuse Rule applies with respect to either SSTB1 or SSTB2. Under the Aggregate Comparison Approach, QTB1 would be compared against SSTB1 and SSTB2, combined, to determine if the Anti-Abuse Rule applies with respect to the combined gross receipts of SSTB1 and SSTB2.

We see policy reasons for both the Aggregate Comparison Approach and the Single Comparison Approach. We recommend the final regulations make clear which approach should apply.

(d) **Treatment as a Separate SSTB**

Finally, we recommend that, if the Anti-Abuse Rule is retained, the Final Regulations modify the Anti-Abuse Rule so that a trade or business to which the Anti-Abuse Rule applies is "treated as a separate SSTB." As currently drafted, Proposed Regulation section 1.199A-3(c)(3) results in a " . . . trade or business (that would not otherwise be treated as an SSTB) . . . " as being " . . . treated as incidental to and, therefore, *part of the SSTB* . . . " (emphasis added). It is unclear whether a trade or business that is incidental to and, therefore, a part of an SSTB is treated as a separate SSTB itself or deemed to be a part of the SSTB to which it is incidental for all purposes of section 199A. If a trade or business that is incidental to an SSTB were treated as part of the SSTB for all purposes of section 199A, the application of many rules would be unclear – *e.g.*, the operational rules of Proposed Regulation section 1.199A-1. The purpose of the Anti-Abuse Rule appears to be reclassifying a "trade or business (that would not otherwise be treated as an SSTB)" as an SSTB, rather than the aggregation of two trades or businesses into a single trade or business. For these reasons, we recommend that the Final Regulations replace "treated as incidental and, therefore, part of the SSTB*"* with "treated as a separate SSTB." [99]

[99] We also recommend that the rule described in Proposed Regulation section 1.199A-5(c)(2) be similarly modified, regardless of whether the Anti-Abuse Rule is retained. Proposed Regulation section § 1.199A-5(c)(2) provides, in relevant part, that "(i) *[a]n SSTB includes any trade or business* that provides 80 percent or more of its property or services to an SSTB if there is 50 percent or more common ownership of the trades or businesses" and "(ii) If a trade or business provides less than 80 percent of its property or services to an SSTB . . . *that portion of the trade or business* of providing property or services to the 50

D. Aggregation of SSTBs

1. Background

An individual's section 199A deduction is the lesser of (i) Combined QBI or (ii) an amount (the overall limitation) equal to 20% of the excess (if any) of the taxable income of the taxpayer for the taxable year, over the net capital gain (as defined in section 1(h)) of the taxpayer. Combined QBI means the sum of the following components (i) an amount for each trade or business, equal to the lesser of (A) 20% of the taxpayer's QBI with respect to the trade or business or (B) the greater of 50% of the W-2 wages with respect to the trade or business, or the sum of 25% of the W-2 wages with respect to the trade or business, plus 2.5% of the UBIA of Qualified Property. For an individual with taxable income not exceeding a statutory threshold amount,[100] the portion of the taxpayer's section 199A deduction related to QBI is determined by taking into account QBI attributable to an SSTB and without regard to the wage and basis limitation provided in section 199A(b)(2)(B).[101] For a taxpayer with taxable income above the threshold amount, the taxpayer's QBI component is calculated by taking into account the W-2 wages and UBIA of Qualified Property limitations described in Proposed Regulation section 1.199A-1(d)(2)(iv) (the "Wage and Basis Limitation") and by not taking into account QBI attributable to any SSTB.[102]

If an individual's income is above the threshold amount but within the phase-in range, then only the applicable percentage of QBI, W-2 wages, and UBIA of Qualified Property for each SSTB is taken into account for purposes of determining the individual's section 199A deduction (the "SSTB Exclusion").[103] The phase-in range is a range of taxable income of the individual, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus \$50,000 (or \$100,000 in the case of a joint return). The applicable percentage is, with respect to any taxable year, 100% reduced but (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount bears to \$50,000 (or \$100,000 in the case of a joint return).[104] Collectively, QBI, W-2 wages, and UBIA

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percent or more commonly-owned SSTB *is treated as a part of the SSTB*") (emphasis added). Like the Anti-Abuse Rule, the "services or property provided to an SSTB" anti-abuse rule does not appear to aggregate trades or business. Therefore, Proposed Regulation Section 1.199A-5(c)(2)(i) and (ii) should be reworded to clarify that the trade or business providing services is *reclassified* as a separate trade or business, rather than being included in or treated as part of the commonly-owned SSTB that it provides property or services to.

[100] The threshold amount is \$157,500 (or \$315,000 in the case of a joint return), adjusted each year for inflation. I.R.C. § 199A(e)(2) and Prop. Reg. § 1.199A-1(b)(11).

[101] *See* I.R.C. § 199A(b)(3); Prop. Reg. § 1.199A-1(c).

[102] *See* Prop. Reg. § 1.199A-1(b)(2)(i), (d)(2).

[103] I.R.C. § 1.199A(d)(3); Prop. Reg. § 1.199A-1(d)(2)(i).

[104] Prop. Reg. § 1.199A-1(b)(2).

of Qualified Property with respect to a trade or business are hereinafter referred to as the "Reportable Items." If the individual's taxable income exceeds the phase-in range, then none of the individual's share of the Reportable Items for each SSTB is taken into account for purposes of determining the individual's section 199A deduction.[105]

An individual may (but is not required to) aggregate trades or businesses operated directly and the individual's share of Reportable Items from trades or businesses operated through RPEs.[106] However, an individual is permitted to aggregate trades or businesses only if the five requirements described in Proposed Regulation section 1.199A-4(b)(1) are satisfied. First, the same person or groups of persons must own 50% or more of each trade or business to be aggregated (the "50% Ownership Requirement").[107] Second, the 50% Ownership Requirement is met for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income.[108] Third, all of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years.[109] Fourth, none of the aggregated trades or businesses is an SSTB.[110] Fifth, an individual must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger integrated trade or business.[111] These factors, described in Proposed Regulation section 1.199A-4(d)(1)(v), are: (A) the trades or businesses provide products and services that are the same or customarily offered together; (B) 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; and (C) 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).

If an individual chooses to aggregate trades or businesses under the rules of Proposed Regulation section 1.199A-4, the individual must combine the Reportable Items of each trade or business within *any* aggregated trade or business prior to applying the Wage and Basis Limitation.[112] Treasury and the Service have explained that allowing taxpayers to aggregate trades or businesses offers taxpayers a means of combining their trades or businesses for purposes of applying the Wage and Basis Limitations and

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[105] *Id*.

[106] Prop. Reg. § 1.199A-4.

[107] Prop. Reg. § 1.199A-4(b)(1)(i).

[108] Prop. Reg. § 1.199A-4(b)(1)(ii).

[109] Prop. Reg. § 1.199A-4(b)(1)(iii).

[110] Prop. Reg. § 1.199A-4(d)(1)(iv).

[111] Prop. Reg. § 1.199A-4(d)(1)(v).

[112] Prop. Reg. § 1.199A-1(d)(2)(ii).

potentially maximizing the deduction under section 199A.[113] As the preamble notes, if aggregation were not permitted, taxpayers could be forced to incur costs to restructure solely for tax purposes.[114]

2. **Recommendation**

Treasury and the Service requested comments on the aggregation method described in Proposed Regulation section 1.199A-4. As discussed below, we recommend that the Final Regulations under section 199A eliminate the prohibition against aggregating a trade or business that is an SSTB with another trade or business. We further recommend that the Final Regulations provide that the SSTB Exclusion rule must be applied before an individual combines the Reportable Items of aggregated trades or businesses under Proposed Regulation section 1.199A-1(d)(2)(ii).

3. **Explanation**

Section 199A(d)(3) and the SSTB Exclusion rule specify the adverse consequences for taxpayers that conduct or own interests in SSTBs. Where an individual's taxable income is no more than the threshold amount, the SSTB Exclusion Rule does not apply. Where an individual's taxable income is above the threshold amount but within the phase-in range, the SSTB Exclusion applies and only the applicable percentage of Reportable Items for each SSTB is taken into account in determining the individual's section 199A deduction.[115] Where income is above the phase-in range, no benefit is available with respect to an SSTB. As described above, the phase-in range means a range of taxable income of the individual, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus \$50,000 (or \$100,000 in the case of a joint return). The applicable percentage means, with respect to any taxable year, 100% reduced (but not below zero) by a percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount bears to \$50,000 (or \$100,000 in the case of a joint return) (the "Reduction Percentage"). Because the Reduction Percentage numerator is the amount by which the individual's taxable income exceeds the threshold amount and its denominator is \$50,000 (or \$100,000 in the case of a joint return), the Reduction Percentage increases as an individual's taxable income increases. Where an individual's taxable income exceeds the threshold amount by \$50,000 (or \$100,000 in the case of a joint return), the Reduction Percentage would be 100% because both the Reduction Percentage's numerator and denominator would equal \$50,000 (or \$100,000 in the case of a joint return). Because the applicable percentage is 100% reduced (but not below zero) by the

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[113] Preamble to Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40894.

[114] *Id*.

[115] Because the SSTB Exclusion does not apply to taxpayers with taxable income below the threshold amount and, as discussed below, Reportable Items with respect to SSTBs are zero for taxpayers with taxable income above the phase-in range, the prohibition against aggregating SSTBs affects only taxpayers with taxable income above the threshold amounts but within the phase-in range.

Reduction Percentage and the Reduction Percentage increases as an individual's taxable income in excess of the threshold amount increases, the applicable percentage decreases as an individual's taxable income in excess of the threshold amount increases. At the point where an individual's taxable income exceeds the threshold amount by $50,000 (or $100,000 in the case of a joint return), the applicable percentage equals zero percent and none of the Reportable Items for each SSTB are taken into account in determining the individual's section 199A deduction.

Where the SSTB Exclusion applies, only the applicable percentage of Reportable Items for each SSTB is taken into account in determining the individual's section 199A deduction. As described above, the applicable percentage gradually decreases until it reaches zero when the individual's taxable income reaches the upper-limit of the phase-in range and none of the Reportable Items for an SSTB is taken into account in determining the individual's section 199A deduction. We recommend that, when the individual's income is within the phase-in range and only the applicable percentage of Reportable Items is taken into account for purposes of determining the individual's section 199A deduction, the Reportable Items be taken into account for all purposes of section 199A, including the aggregation rules of Proposed Regulation section 1.199A-4.

Prohibiting the aggregation of a trade or business that is an SSTB with another trade or business merely because the trade or business is an SSTB adds an additional adverse consequence for SSTBs that is neither described in nor consistent with the plain language of section 199A. The plain language of section 199A describes both an SSTB and a QTB as a "trade or business" and does not suggest that the definition of "trade or business" for an SSTB is different than the definition of "trade or business" for a QTB. Indeed, inasmuch as section 199A(d)(3)(A)(i) provides that for owners whose income is below or in the phase-in range, "any [SSTB] of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A)," we believe it would be more consistent with the statute to permit these owners the ability to aggregate the SSTBs as if they were QTBs.[116] Because both an SSTB and a QTB are a "trade or business," the rules for aggregating trades or businesses should be the same for an SSTB as a QTB.

Prohibiting the aggregation of a trade or business that is an SSTB with another trade or business merely because the trade or business is an SSTB also is inconsistent with the purpose of the aggregation rule (*i.e.*, it could force taxpayers to incur costs to

[116] In fact, based on the statute, it does not appear that the applicable percentage for taxpayers in the phase-in range prevents the Relevant Items to be treated as from a QTB. Therefore, there is a strong case that the Code permits taxpayers in the phase-in range to aggregate the applicable percentage of Relevant Items from an SSTB, despite the prohibition provided by the Proposed Regulations. Nevertheless, we recommend that the Final Regulations remove the rule preventing individuals from aggregating Relevant Items from SSTBs. Doing so will avoid potential confusion in applying the mechanics of section 199A(d)(3)(A)(i) and confirm that the applicable percentage of Relevant Items from an SSTB are, in fact, treated as attributable to a QTB.

restructure solely for tax purposes).[117] Historically, taxpayers structured trades or businesses based on, *inter alia*, business reasons and local law requirements without regard to the requirements now identified by (or policies that might lie underneath) section 199A or the Proposed Regulations. Before the enactment of section 199A, multiple trades or businesses would commonly be reported to their owners through a single Schedule K-1 or a small number of Schedules K-1. Under the Proposed Regulations, these same trades or businesses are now required to be separately reported and an individual may choose to aggregate and combine those trades or businesses provided that the requirements of Proposed Regulation section 1.199A-4 are satisfied. Thus, the Proposed Regulations would significantly increase the taxpayer's administrative burden. Prohibiting the aggregation of a trade or business that is an SSTB with another trade or business merely because the trade or business is an SSTB, where aggregation would otherwise be appropriate because the other requirements of Proposed Regulation section 1.199A-4 are satisfied, exacerbates the taxpayer's administrative burden. For example, assume an individual is within the phase-in range. The individual operates 30 separate SSTBs and, but for the prohibition against aggregating SSTBs, it would be appropriate to aggregate all 30 SSTBs.

We also believe that the prohibition against aggregating SSTBs is unnecessary. As described above, if an individual chooses to aggregate trades or businesses under the rules of Proposed Regulation section 1.199A-4, the individual must combine the Reportable Items of each trade or business within an aggregated trade or business prior to applying the Wage and Basis Limitation. Because the Proposed Regulations prohibit aggregating a trade or business that is an SSTB with another trade or business, the Proposed Regulations did not need an ordering rule that applies the SSTB Exclusion rule before an individual combines the Reportable Items of aggregated trades or businesses under Proposed Regulation section 1.199A-1(d)(2)(ii). However, if as recommended, SSTBs are permitted to be aggregated, requiring that the SSTB Exclusion be applied before Proposed Regulation section 1.199A-1(d)(2)(ii) would ensure that the appropriate portion of Reportable Items from each SSTB is taken into account when combining aggregated businesses.

We did consider, but rejected, a rule that would allow the aggregation of a trade or business that is an SSTB with another SSTB but not a QTB. For example, assume an individual owns Business A and Business B. Each of Business A and Business B is an SSTB and the individual aggregates Business A and Business B. Thus, the Reportable Items of Business A could be used to claim a section 199A deduction from Business B. However, if Business B were a QTB and an SSTB were prohibited from being aggregated with a QTB, the Reportable Items from Business A could not be used to claim a section 199A deduction from Business B. We rejected such an approach because prohibiting the aggregation of SSTBs is inconsistent with the language of section 199A, overly burdensome, inconsistent with the purpose of the aggregation rules, and

[117] Preamble to Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40894.

unnecessary if the SSTB Exclusion rule applies before an individual combines Reportable Items from aggregated trades or businesses.

For these reasons, we recommend that the Final Regulations (i) eliminate the prohibition against aggregating a trade or business that is an SSTB with another trade or business and (ii) require that the SSTB Exclusion rule must be applied before an individual combines the Reportable Items of aggregated trades or businesses under Proposed Regulation section 1.199A-1(d)(2)(ii).

E. Definition of the Performance of Services in the Field of Athletics

1. Background

An SSTB includes a trade or business involving the performance of services in the field of athletics.[118] Proposed Regulation section 1.199A-5(b)(2)(viii) defines "the performance of services in the field of athletics" for purposes of section 199A as:

> [T]he performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

The definition in the Proposed Regulations appears to limit the performance of services in the field of athletics to the performance of services by those individuals who are actual participants in an athletic event either through engaging in the sport itself or in coaching or managing the individuals who do so. Moreover, the language in the Proposed Regulations specifically excludes from the performance of services in the field of athletics the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public. This narrow definition of the performance of services in the field of athletics is consistent with the definition of the performance of the services in the field of performing arts under both section 448 and the Proposed Regulations. Such definition includes only services performed by those individuals who actually direct, act, sing, or play music during the performance. It does not include services performed by the individuals running lights, by the individuals selling tickets, or by the theater owner.

However, while demonstrating another principle included in both section 199A and the Proposed Regulations, Example 2 in Proposed Regulations section 1.199A-

[118] *See* I.R.C. § 199A(d)(2)(A) (reference to I.R.C. § 1202(e)(3)(A)).

5(b)(3) ("Example 2"), appears to broaden the scope of this definition (and arguably is contrary to it) by treating the owners of a partnership that is in the trade or business of owning and operating a professional sports team as engaged in the performance of services in the field of athletics.[119]

Example 2 provides as follows:

> B is a partner in Partnership, which solely owns and operates a professional sports team. Partnership employs athletes and sells tickets to the public to attend games in which the sports team competes. Therefore, Partnership is engaged in the performance of services in an SSTB in the field of athletics within the meaning of paragraphs (b)(1)(vii) and (b)(2)(viii) of this section. B is a passive owner in Partnership and B does not provide any services with respect to Partnership or the sports team. However, because Partnership is engaged in an SSTB in the field of athletics, B's distributive share of the income, gain, loss, and deduction with respect to Partnership is not eligible for a deduction under section 199A.

This example may lead to confusion regarding the types of activities that constitute the performance of services in the field of athletics, as well as the extent to which income attributable to the operation of a professional sports franchises may be QBI.

2. **Recommendation**

We recommend that the Final Regulations clarify the definition of the performance of services in the field of athletics, such that it does not include the ownership and operation of a professional sports franchise. In our view, although such a franchise employs professional athletes who *are* engaged in the performance of services in the field of athletics, the owners of the franchise themselves are *not* engaged in such services in their capacity as owners.[120] Further, we recommend that the Final Regulations revise Example 2 in Proposed Regulation section 1.199A-5(b)(3) to illustrate the desired point of the example outside the context of the field of athletics. We note that similar clarifications may be needed in the field of performing arts.

3. **Explanation**

We agree that the narrow definition adopted in the Proposed Regulations is consistent with the apparent intent of Congress in denying the section 199A deduction to

[119] The example is also summarized in the Preamble. Prop. Reg. § 1.199A-4, 83 Fed. Reg. 40884, 40898.

[120] In this regard, we note that the inclusion in the definition of an SSTB of businesses described in section 1202(e)(3)(A) (note other sections of 1202(e)(3)) as well as the references to section 448 in the legislative history support the idea that Congress was focused on excluding from the definition of a QTB the type of businesses that either – (i) generate income that is essentially compensation for personal services of the owners; or (ii) generally result in no net income at the entity level when conducted by a corporation because of the payment of salaries to employee-shareholders. The operation of a professional sports franchise is neither of these.

those engaged in an SSTB. However, as noted above, we believe that Example 2 is inconsistent with that narrow scope to the extent that it treats the owners of a partnership that is in the trade or business of owning and operating a professional sports team as engaged in the performance of services in the field of athletics. A professional sports franchise necessarily must employ professional athletes to participate in games or matches that draw fans to purchase tickets, television and radio stations to seek broadcast rights, and the producers of sports memorabilia to license the team name and image. There is no question that payments to the players, coaches, and managers are, with regard to those individuals, income earned in an SSTB either because the income is attributable to – (i) the performance of services as an employee; or (ii) the performance of services in the field of athletics. However, the owner or owners of the franchise itself do not participate in the professional sport in question themselves.[121]

We do not believe the owner of a professional sports franchise should be treated as engaged in a trade or business involving the performance of services in the field of athletics. A contrary interpretation of section 199A like that illustrated by Example 2 focuses only on the phrase "in the field of athletics" rather than the full statutory language, which provides that a section 199A deduction is not available for a trade or business involving *the performance of services in* the field of athletics. We believe the owner of a professional sports franchise is engaged in the trade or business of operating a franchise in much the same manner as the owner of a fast food restaurant franchise is engaged in the trade or business of operating that franchise. Indeed, many – if not most – of the activities involved in operating a sports franchise have little to do with what actually occurs during the limited hours when the athletes employed by the team participate in a game or match. There are multiple activities that must take place "off the field" for the team to succeed financially. In addition to the athletes, the team may employ front office personnel, accounting or legal professionals, scouts, and other employees that never appear on the field or court. If the team also operates the stadium or field in which it plays, it may also employ concession, maintenance, janitorial and other workers necessary for that operation. The athletes, coaches, and managers on the field are necessary to draw fans to the stadium, broadcasters to air the game or match, and sports memorabilia producers to licensing opportunities. In that sense, they are the similar to actors employed by a playhouse or musicians employed by the concert hall as discussed above. Thus, as it relates to the performance of services in the field of athletics, we believe the SSTB Exclusion generally should deny the section 199A deduction only with respect to the income of the athletes or coaches themselves – not to the owners of entities that own and operate a professional sports franchise.

[121] To the extent an athlete, coach or manager is given a profits interest for services, the income allocated to them should not be eligible for a section 199A deduction.

IV. The Aggregation of Trades or Businesses

A. Aggregation of Commonly Controlled Trades or Businesses

1. Background

Proposed Regulation section 1.199A-4(a) provides that an individual or RPE may be engaged in more than one trade or business. Except as provided in this section, each trade or business is a separate trade or business for purposes of applying the limitations described in Proposed Regulation section 1.199A-1(d)(2)(iv). This section of the Proposed Regulations sets forth rules to allow individuals to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of applying the limitations described in Proposed Regulation section 1.199A-1(d)(2)(iv).

The Proposed Regulations generally provide that aggregation is allowed for two or more trades or businesses only if –

i. The same persons directly or indirectly own a majority interest in each of the businesses (*i.e.*, the "50% Ownership Requirement");

ii. The 50% Ownership Requirement is met for the majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income (the "Majority of Taxable Year Requirement");

iii. All of the items related to the trades or businesses are reported on returns with the same tax year (the "Same Taxable Year Requirement");

iv. None of the businesses is an SSTB; and

v. The businesses meet two of following three factors (the "Similar Business Requirement")

  a. The businesses provide products and services that are the same or products and services customarily provided together;

  b. The businesses share facilities or centralized elements; or

  c. The businesses are operated in coordination with, or in reliance on, other businesses in the aggregated group.[122]

Absent satisfaction of these requirements, aggregation is not allowed under the Proposed Regulations. If aggregation is available, the Proposed Regulations provide that it is only available (and must be elected at) the individual taxpayer level. Furthermore, as illustrated in Proposed Regulation section 1.199A-4(d), Example 10, the minority owners

[122] Prop. Reg. § 1.199A-4(b)(1).

of separate trades or businesses may also aggregate if the requirements listed above are met.[123]

2. Recommendation

We recommend that the Final Regulations permit aggregation of trades or businesses that meet the Similar Business Requirement and are commonly controlled even if they do not meet the 50% Ownership Requirement. Alternatively, if some level of minimum common ownership is deemed necessary with respect to commonly controlled businesses, we would recommend common ownership of 20%.

3. Explanation

The aggregation provision of the Proposed Regulations is helpful to taxpayers and will allow for aggregation in many situations. However, we believe that it is unnecessarily restrictive. For instance, assume that RPE1 and RPE2 are limited partnerships that meet the Similar Business Requirement and A is a common general partner. A may own 20% of each RPE but the RPEs do not meet the 50% Ownership Requirement. This is a common result when a general partner forms an RPE and subsequently dilutes its interest as a result of capital infusion for expansion. We believe that to require that taxpayers maintain a minimum investment of 50% in order to be able to aggregate will needlessly hamper expansion and investment.

Instead, we recommend that aggregation also be allowed for trades or businesses that meet the Similar Business Requirement if there is common control of the RPEs by a general partner, a managing member, or controlling shareholder (in the case of an S corporation). When similar businesses are commonly controlled, it is typically because the party with control has certain business expertise that is required by the RPEs, and synergies exist between the businesses. We note that under section 469 the taxpayer considers both common control and common ownership as factors for purposes of aggregation. While the Preamble to the Proposed Regulations concludes that the section 469 passive activity grouping rules are not appropriate because a section 199A deduction is allowed for both passive and active investors, we nevertheless believe that common control is a relevant and important factor for purposes of aggregation section 199A. While we believe businesses that are commonly controlled and meet the Similar Business Requirement should be sufficient for purposes of aggregation, if some minimum level of ownership is deemed necessary we would recommend 20% common ownership.

B. RPE Aggregation Rules

1. Background

In the preamble to the Proposed Regulations, Treasury and the Service requested comments on the proposed approach to tiered structures and the reporting necessary to allow an individual to determine which trades or businesses his or her QBI, W-2 wages,

[123] *See* Preamble to Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40894.

and UBIA of Qualified Property are attributable to for purposes of calculating his or her section 199A deduction.

2. **Recommendation**

We recommend that an RPE, such as a partnership or an S corporation, be allowed to aggregate its trades or businesses held directly or through a multi-tiered structure.[124] If such aggregation is allowed, its partners or shareholders, as the case may be, should be required to report the aggregation consistent with the RPE's reporting. If the RPE does not aggregate its trades or businesses, its respective partners or shareholders should be allowed to make the determination to aggregate the trades or businesses of the RPE. The partner or shareholder could then make a determination to aggregate other trades or businesses with those of the RPE, to the extent such additional aggregation is permitted.

3. **Explanation**

While Proposed Regulation section 1.199A-4(a) acknowledges that an individual or RPE may be engaged in more than one trade or business, the Proposed Regulations permit individuals (and only individuals) to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of applying the limitations described in Proposed Regulation section 1.199A-1(d)(2)(iv). The Proposed Regulations provide that an individual may aggregate trades or businesses only if the individual can demonstrate that the requirements in Proposed Regulation section 1.199A-4(b)(1) are satisfied.

In certain structures (*i.e.*, where an RPE conducts more than one trade or business or owns an interest in another RPE that does, or both), the RPE may have sufficient information to know whether the aggregation requirements are met. For example, assuming the term "person" for purposes of the 50% Ownership Requirement includes an RPE, then if the RPE owned a 50% or more interest in two or more trades or businesses otherwise qualifying for aggregation, it could aggregate those trades or businesses at the RPE level. Conversely, if it did not own 50% or more of such trades or businesses, it would need to determine whether other persons, along with itself, satisfied that test. The same is true with respect to the common control test, if adopted. The RPE would likely be in the best position to know whether the trades or businesses are commonly controlled. The RPE also would be required to determine that the other requirements for aggregation are met.

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[124] Above, we recommend removing the prohibition against individuals aggregating SSTBs. However, if RPEs are permitted to aggregate, we believe there *should* be a rule preventing RPEs from aggregating SSTBs. This is because any aggregation at the RPE level would necessarily occur before the individual applies the SSTB Exclusion rule of Proposed Regulation section 1.199A-1(d)(2)(i), which prohibits items from an SSTB for being taken into account. Thus, if RPEs aggregate QTBs with SSTBs it would be impossible for individuals to exclude the SSTB items.

Prior to the enactment of section 199A, RPEs that have multiple trades or businesses typically did not provide their owners the information necessary to determine whether trades or businesses may be aggregated and requiring them to do so now is likely to be extremely burdensome in many instances. This is especially true for a hedge fund or a private equity fund that can have interests in hundreds of trades or businesses and hundreds of partners. Permitting RPEs to aggregate trades or businesses would help reduce the cost of compliance and also would provide an opportunity to place responsibility for determining aggregation qualification in the hands of the persons who are closest to the information needed for the determination (*i.e.*, the RPE that engages in a trade or business).

If RPEs are permitted to aggregate, the rules similar to the consistency rules provided by the Proposed Regulations should apply.[125] Once an RPE aggregates trades or business that it directly engages in, aggregates some or all of such trades or businesses with trades or businesses that flow up from lower-tier RPEs (including trades or businesses that have already been aggregated), or both, the RPE must consistently report the aggregated group in subsequent tax years. Individual partners or shareholders who receive aggregation information from their RPEs would be required to report consistently such aggregated information in computing their deduction under section 199A. However, such individual partners and shareholders would need to do a separate aggregation eligibility determination if they wished to include in the aggregation other trades or businesses when they compute their section 199A deduction.

If, in a subsequent year, any of the conditions for eligibility to aggregate are no longer met, then aggregation by the RPE would have to cease and the RPE would make a new determination to aggregate if it seeks to aggregate trades or businesses. Additionally, an RPE would be permitted to add a newly created or newly acquired trade or business to an existing aggregated trade or business if the eligibility conditions are satisfied.

C. 50% Ownership Requirement

1. Background

Proposed Regulation section 1.199-4(b)(1)(i) provides that, among other requirements, trades or businesses may be aggregated only if "[t]he same person or group of persons, directly or indirectly, owns 50 percent or more[126] of each trade or business." This provision implies, but does not explicitly specify, that each person within the "group of persons" must own an interest in each of the trades or businesses to be aggregated.

2. Recommendation

[125] *See* Prop. Reg. § 1.199A-4(c)(1).

[126] The preamble refers to "a majority interest," which presumably is intended to correspond with the more specific language in the Proposed Regulations.

We recommend that the Final Regulations explicitly state that a person would not be considered to be part of the relevant "group of persons" that own the trades or businesses sought to be aggregated unless that person actually owns an interest in each such trade or business, whether directly, indirectly through an RPE, or by attribution. In addition, we recommend that the Final Regulations expand the family attribution rules to include all issue (not just children and grandchildren) and all ancestors (not just parents). We also recommend that spouses of such family members, including those who are legally separated, be included. The Final Regulations should make clear that the term "person" in the 50% Ownership Requirement includes partnerships, S corporations, and C corporations.

3. **Explanation**

Although we believe that the rule was intended to require all people considered part of the relevant "group of persons" to own directly, indirectly through an RPE, or by attribution, an interest in each trades or businesses sought to be aggregated, we do not believe the rules are explicit in this regard and would recommend that they be clarified.

In addition, Proposed Regulation section 1.199A-4(b)(3)(ii) provides for attribution from children and grandchildren, as well as parents. Given current and future anticipated actuarial life expectancies, there does not seem to be any policy reason to limit attribution within the same lineage. For example, a taxpayer receiving his or her interest in the family business from a grandparent should be considered to be within the same family grouping, as should interests acquired by great grandchildren.

Proposed Regulation section 1.199A-4(b)(3)(i) provides for attribution to an individual from his or her spouse. However, the Proposed Regulations do not call for any attribution to or from the spouses of other family members. Although not always the case, both sons-in-law and daughters-in-law, as well as other relations by marriage, often become involved in the family business. It seems appropriate for them also to be considered to be part of "[t]he same . . . group of persons" for purposes of this rule. Similarly, we do not believe the fact that one of the members of the family group has been legally separated (but not divorced) should suddenly trigger a wholesale rejiggering of aggregation for purposes of the section 199A deduction. Here again, the likelihood of equity interests being transferred to in-law relatives in order to bring about tax consequences inconsistent with the purposes of this rule is not high.

D. **Majority of Taxable Year Requirement**

1. **Background**

Proposed Regulation section 1.199A-4(b)(1)(ii) provides that the 50% Ownership Requirement discussed in the preceding section must be met "for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income." Alternatively, the common control requirement would have to be satisfied for the majority of the taxable year, if our recommendation above is adopted.

However, it is unclear as to whether the "taxable year" that is being referred to is the taxable year of the individual, estate or trust ultimately taking the section 199A deduction or of the RPE initially reporting the items attributable to such trade or business.

2. **Recommendation**

We recommend that the Majority of Taxable Year Requirement be removed. However, if it is retained, the Final Regulations should make clear that the taxable year of the person making the aggregation determination is relevant for purposes of this test. Thus, if an individual is determining whether he or she (or it, in the case of an estate or trust) is eligible to aggregate two or more trades or businesses, then the taxable year of that individual should be considered. On the other hand, if an aggregation determination is being made by an RPE, then this requirement should be applied with respect to the taxable year of the RPE, and then again at the individual level if additional aggregation is sought.

3. **Explanation**

This requirement would only be relevant for RPEs, inasmuch as sole proprietorships, by definition, would automatically satisfy the 50% Ownership Requirement in all instances. From a policy perspective we do not believe that the requirement is necessary and believe that taxpayers should be able aggregate any portion of the taxable year in which they satisfy the aggregation requirements, understanding that it may impose some additional reporting burdens on RPEs.

We believe that the Majority of Taxable Year Requirement unavoidably causes a certain amount of undercoverage and overcoverage. Allowing aggregation for a full taxable year, when the 50% Ownership Requirement has only been met for 51% of that taxable year obviously includes overcoverage, whereas undercoverage is obviously implicated if the percentage were only 49%. Alternatively, simply requiring that the 50% Ownership Requirement needs to be met for any period to which aggregation is intended to apply might prove to be more workable. Closely held businesses are likely to constitute the large majority of businesses to which this requirement would otherwise apply, and changes in control of such businesses rarely occur without a great deal of consideration. As a consequence, allowing individuals and RPEs to aggregate two or more trades or businesses only for the portions of taxable years in which the 50% Ownership Requirement is met will typically not be unduly burdensome, and would involve no inadvertent overcoverage or undercoverage.

If despite our recommendation to the contrary, the Majority Taxable Year Requirement is retained, the language should be adjusted to make it clear that (i) it is to apply on an annual basis to the "items attributable to each trade or business to be aggregated" for each respective taxable year of the individual or RPE applying the aggregation rule under the Final Regulations and (ii) all such items are to be "reported on [the] return with the same taxable year" of the ultimate owner actually aggregating the trades or businesses for purposes of the section 199A deduction on that return.

E. Same Taxable Year Requirement

1. Background

Proposed Regulation section 1.199A-4(b)(1)(iii) provides that aggregation will be allowed only if "[a]ll of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years." The policy rationale underlying this requirement is not clear and there is some ambiguity as to whether the Same Taxable Year Requirement under this provision should be applied at the individual level or at the RPE level, or both. Also, the literal language of the provision could be interpreted to be much more restrictive than appears to have been intended.

2. Recommendation

We recommend that the Final Regulations remove this requirement. If it is retained, it should be clarified to confirm that the Same Taxable Year Requirement should be applied at the same level as the underlying aggregation determination is being made.

3. Explanation

It is not clear why this requirement is essential. The rules with respect to the selection of taxable years provide only limited flexibility to vary from a calendar taxable year in the first instance.[127] Moreover, for example, if a group of entrepreneurs owns and operates a manufacturing business through an S corporation with a calendar taxable year, and the S corporation rents the real estate at which such manufacturing business is operated from a commonly owned partnership that has elected a September 30 taxable year under section 444, it is not clear to us why those two businesses should not be able to be aggregated under the Final Regulations. The ability to elect a non-calendar taxable year is limited and the deposit required under section 7519 with respect to it is significant. Thus, we believe that aggregating trades or businesses with different taxable years would not result in abuse.

In the event that the Same Taxable Year Requirement is retained in the Final Regulations, we recommend that the provision be clarified to eliminate certain ambiguities. First, it should be made clear that "the same taxable year" on which the items attributable to a trade or business "are reported" is a reference to the specific individual or RPE on whose return the separate trades or businesses are to be aggregated. Depending upon precisely what this requirement is designed to accomplish in the Final Regulations, there could be circumstances where this requirement is satisfied with respect to, for example, one individual taxpayer, and not another. Second, the language stating that "[a]ll of the items for each trade or business" must be reported on returns with the same taxable year is presumably itself applied separately with respect to each taxable

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[127] *See* I.R.C. §§ 1378, 706(b), 644(a), 441(i).

year of each such trade or business. The current "[a]ll of the items" language could be interpreted to require that all items for all years must be so reported.

F. Reporting Requirements

1. Background

Proposed Regulation section 1.199A-4(b)(2) provides that, for trades or businesses directly operated by an individual, such individual must compute QBI, W-2 wages and UBIA of Qualified Property "for each trade or business before applying these aggregation rules."[128] Moreover, under Proposed Regulation section 1.199A-6(b)(3)(i)(A), each RPE "must separately identify and report on the Schedule K-1 issued to its owners . . . [e]ach owner's allocable share of QBI, W-2 wages, and UBIA of [Q]ualified [P]roperty," irrespective of whether such trade or business constitutes an SSTB.

2. Recommendation

We recommend that RPEs not be required to calculate and report QBI, W-2 wages, and UBIA with respect to trades or businesses not effectively connected with the United States, which are not eligible for such deduction in any event. Moreover, we recommend that an RPE not be required to segregate and separately report those components for each and every one of its QTBs if, as recommended above, the RPE is allowed to and does aggregates them. In addition, even if an RPE does not aggregate its trades or businesses, we believe an RPE should be allowed to report QBI, W-2 wages and UBIA of Qualified Property on an aggregate basis, except for owners as to which it is aware (or should be aware) that segregated information will have an impact upon ultimate tax liability. We also recommend that the rule under Proposed Regulation section 1.199A-6(b)(3)(iii) be clarified such that the failure to report W-2 wages or UBIA of Qualified Property (as one may not be relevant to an RPE and therefore not reported) will not result in *all* items of QBI, W-2 wages and UBIA being presumed to be zero. Finally, we recommend that a return be considered substantially complete even if an RPE chooses not to report QBI, W-2 wages and UBIA.

3. Explanation

We believe that few, if any, taxpayers will decide not to aggregate trades or businesses when allowed to do so. This is because the Proposed Regulations require that the losses from trades or businesses generating net losses are automatically netted with the income from profit-making trades or businesses, regardless of whether such trades or

[128] *See also* Prop. Reg. §1.199A-4(c)(2) (describing the required annual disclosures for individuals desiring to aggregate trades or businesses under the Proposed Regulations and stating that the Commissioner may disaggregate such businesses in the event of any failure to make such disclosures).

businesses qualify for aggregation.[129] Thus, the negative consequence of netting would be unavoidable, and the other consequences of aggregation (*i.e.*, allowing "excess" W-2 wages and UBIA of one trade or business to be used to increase the section 199A deduction limitation for another trade or business) would generally be favorable.[130] As a result, it will almost always be reasonable for an RPE to assume that its ultimate owners will elect to aggregate whenever possible, even if such aggregation is not allowed at the RPE level. In fact, making any portion of the aggregation rules optional in these circumstances is likely to be more of a trap for the unwary, rather than giving flexibility to taxpayers.

Moreover, calculating and reporting separate segmented information for each trade or business will involve significant compliance effort at both the RPE and owner level, often in circumstances where such compliance would not be undertaken in the absence of this requirement. RPEs often report all of their trade or business activities as single line items on Schedule K-1. In many cases, this avoids cumbersome and otherwise unnecessary allocation of revenues and costs attributable to multiple lines of business. With respect to owners that ultimately aggregate such separate trades or businesses, all of the effort and cost involved in separately reporting the section 199A components for each trade or business would be unnecessary.

With regard to the provision of information by an RPE that aggregates two or more trades or businesses, including aggregating a trade or business that it engages in directly with one or more trades or businesses of a lower-tier RPE (including trades or businesses of the lower-tier RPE that have already been aggregated by the lower-tier RPE), the information to be provided by the RPE should include, on or with the Schedule K-1, basic information concerning the aggregation, such as:

- For each set of aggregated trades or businesses, the RPE should provide a clear corresponding schedule of the aggregated QBI, W-2 wages, and UBIA, as well as any relevant SSTB determinations and the names of any lower-tier RPEs that provided Schedule K-1 information that was taken into account in the RPE's aggregation determination.

- With regard to each trade or business that is not aggregated, consistent with the reporting rules in the Proposed Regulations, the RPE should provide a schedule of corresponding QBI, W-2 wages, and UBIA, as well

[129] Prop. Reg. § 1.199A-1(d)(2)(iii).

[130] Segregating business enterprises into separate components could have beneficial consequences if the intent was to segregate SSTBs and qualifying business activities. However, unless the Final Regulations are modified (as recommended above), SSTBs are specifically precluded from being aggregated with qualifying business activities to begin with under the aggregation rule in the Proposed Regulations. *See* Prop. Reg. § 1.199A-4(b)(1)(iv). Also, QBI simply does not include any gross income, gain, deduction or loss to the extent that such items are not effectively connected with the conduct of a trade or business within the United States. *See* Prop. Reg. § 1.199A-3(b)(2)(A).

as any relevant SSTB determinations, including all such information reported to it by another RPE.

Consistent with the rules for annual individual disclosure in Proposed Regulation section 1.199A-4(c)(2), an RPE that aggregates trades or businesses would need to provide information on any aggregation done at its level, by providing similar information.

In addition, there is some uncertainty as to whether Proposed Regulation section 1.199A-6(b)(3)(iii) requires the reporting in all cases of both W-2 and UBIA (even though one may not be relevant to a particular RPE) and that failure to report either W-2 wages or UBIA will result in *all* items of QBI, W-2 wages and UBIA being presumed to be zero. We do not believe this is the intention and recommend that the rule be clarified. Also, in certain situations, the cost of reporting QBI, W-2 wages and UBIA may exceed the benefits of doing so. There is concern that the decision not to report such items will cause the return to not be considered substantially complete. We recommend that Proposed Regulation clarify that if an RPE choose not to report QBI, W-2 wages, and UBIA that even though the regulations deem such amounts not reported to be zero, the return will not be considered substantially complete. We do not believe this was intended and recommend that the rule be clarified.

V. Miscellaneous Comments

A. Ownership Attribution Rules with respect to Non-grantor Trusts

1. Background

In general, QBI, W-2 wages, and UBIA of Qualified Property are determined separately in respect of each trade or business of a taxpayer, and the limits based on W-2 wages and UBIA of Qualified Property are then applied to the taxpayer's QBI for each trade or business in determining the taxpayer's deduction under section 199A. The Proposed Regulations allow individuals to elect to aggregate trades or businesses, and then treat the aggregate as a single trade or business for purposes of applying the limitations based on W-2 wages and UBIA of Qualified Property.[131]

References to "an individual" include references to a trust other than a grantor trust to the extent the deduction under section 199A is determined by the trust.[132] Consistent with this rule, Example 14 of Proposed Regulation section 1.199A-4(d) describes a situation in which a trust wholly owns three limited liability companies and the businesses of the three limited liability companies meet the aggregation requirements of Proposed Regulation section 1.199A-4(b)(1). The example concludes that the trust can aggregate the three limited liability companies for purposes of applying Proposed

[131] Prop. Reg. § 1.199A-4(b)(2).

[132] Prop. Reg. § 1.199A-1(a)(2); Prop. Reg. § 1.199A-6(d).

Regulation section 1.199A-1(d). In addition, Example 1 of Proposed Regulation section 1.199A-6(d)(3)(vi) states (in paragraph B) that the trust in that example has properly aggregated a bakery conducted directly by the trust (through a limited liability company owned by it) with a restaurant operated by a partnership in which the trust has a 25% interest, but does not discuss the analysis on the basis of which aggregation was determined to be appropriate.

One of the requirements to aggregate under Proposed Regulation section 1.199A-4 is that the same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business to be aggregated (*i.e.*, the 50% Ownership Requirement).[133] The Proposed Regulations include a family ownership attribution rule that is applied for purposes of determining whether the 50% Ownership Requirement is satisfied. The Proposed Regulations do not, however, include a clear ownership attribution rule regarding whether the beneficiary or beneficiaries of a trust may or must be viewed as owning interests in a trade or business owned by the trust, for purposes of determining whether the 50% Ownership Requirement is satisfied.

2. **Recommendation**

We recommend that the Final Regulations provide ownership attribution rules to properly apply the section 199A aggregation rules to trusts.

3. **Explanation**

The necessity of ownership attribution rules with respect to trusts can be illustrated by a situation similar to the circumstances described in Example 9 of Proposed Regulation section 1.199A-4(d), where G owns 80% of the stock in S1 (an S corporation) and 20% of the capital and profits in each of LLC1 and LLC2 (each a partnership for tax purposes). In that example, B, G's son, owns a majority of the interests in LLC2, and M, G's mother, owns a majority of the interest in LLC1. B has no interests in LLC1 or S1, and M has no interest in LLC2 or S1. The example concludes in part that, taking family attribution into account, G may aggregate his interests in LLC1, LLC2, and S1. If the facts were changed slightly so that the majority interest in LLC2 were owned by a trust (other than a grantor trust) of which B is the sole beneficiary (rather than by B), and that the majority interest in LLC1 were owned by a trust (other than a grantor trust) of which M is the sole beneficiary (rather than by M), it is unclear under the Proposed Regulations whether G could aggregate his interests in LLC1, LLC2, and S1, as a single trade or business. We believe aggregation in situations similar to the example should be permitted.

If a trust has only one beneficiary, we believe it would be appropriate to have a rule similar to that of section 318(a)(2)(B)(i) that would attribute ownership of the interest in a business owned by the trust to the trust's beneficiary, for purposes of determining whether the 50% Ownership Requirement is met. Similarly, if a trust has

[133] Prop. Reg. § 1.199A-4(b)(1)(i)).

multiple beneficiaries but each beneficiary is to receive a fixed percentage of all distributions by the trust, an interest in a business owned by such a trust should be attributed to the trust's beneficiaries in proportion to those percentages. However, where a trust has multiple beneficiaries and the trustee has broad discretion in respect of allocating distributions among the beneficiaries, it may be difficult to set forth an administrable rule that would be helpful in respect of aggregation. Consideration might be given to concluding that the 50% Ownership Requirement is met in circumstances where the trustee has discretion in allocating distributions (attributable to a business in which the trust owned an interest) among the beneficiaries of the trust, where the relationship between each potential beneficiary and the other owner or owners of the business is such that, if ownership is attributed from the trust to any of its beneficiaries, ownership will be further attributed from that beneficiary to the other owners in a manner that will cause the 50% Ownership Requirement to be met.

We note that the last sentence of Proposed Regulation section 1.199A-6(d)(1) raises additional uncertainty. It provides: "[f]or purposes of this section and §§ 1.199A-1 through 1.199A-5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items." Taking into account the look-through operating rule with respect to RPEs in Proposed Regulation section 1.199A-4(b)(2), this sentence might be interpreted to support ownership attribution from a trust to its beneficiaries for purposes of meeting the 50% Ownership Requirement only where a trust allocates all of its QBI and other items to its beneficiaries. It is unclear, however, whether this sentence is intended to have such a consequence under the aggregation rules (although this interpretation does seem to be supported by the statement in paragraph B of the example in Proposed Regulation section 1.199A-6(d)(3)(vi) to the effect that the trust in that example properly aggregated two related businesses in which it had interests). Even if that consequence is intended, a rule causing the ability to aggregate or the scope of aggregation to vary from year to year depending on whether and how QBI or other items are allocated by a trust to its beneficiaries in each year would be difficult to administer. We therefore suggest that the same attribution result should apply for purposes of the aggregation election even if a trust allocates none of its QBI and other items to beneficiaries in a particular taxable period, so long as the beneficiaries of the trust and their shares of distributions to be made by the trust are readily ascertainable from the trust agreement.

B. Qualified REIT Dividends Allocated by Non-calendar Year RPEs

1. Background

The preamble to the Proposed Regulations explains that "there is no statutory requirement under section 199A that a qualified item arise after December 31, 2017."[134] Proposed Regulation section 1.199A-1(f)(2) provides:

> For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's tax year in which or with which such RPE's taxable year end.

2. **Recommendation**

We recommend that the Final Regulations clarify that, for purposes of determining qualified REIT dividends, a rule similar to that provided in Proposed Regulation section 1.199A-1(f)(2) apply such that qualified REIT dividends allocated by an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, is treated as having been earned by the individual during the individual's taxable year which or with which such RPE taxable year ends.

C. **Editorial Suggestions**

1. **Background**

The language of several provisions of Proposed Regulation section 1.199A-4 could be clarified in order to better accomplish the intended results.

2. **Recommendation**

(a) If the Same Taxable Year Requirement is retained, the language should be adjusted to make it clear that (i) it is to apply on an annual basis to the "items attributable to each trade or business to be aggregated" for each respective taxable year of the individual or RPE applying the aggregation rule under the Final Regulations and (ii) all such items are to be "reported on [the] return with the same taxable year" of the ultimate owner actually aggregating the trades or businesses for purposes of the section 199A deduction on that return.

(b) The phrase "trades or" should be inserted immediately prior to the word "businesses" in the language corresponding to Proposed Regulation section 1.199A-4(b)(1)(v)(C).

(c) The phrase "50% or more of the capital or profits" should be substituted for the phrase "more than 50% of the capital and profits" in Example 2 in Proposed Regulation section 1.199A-4(d) in order to correspond with

[134] Preamble to Section 199A Proposed Regulations, 83 Fed. Reg. 40884, 40903.

Proposed Regulation section 1.199A-4(b)(i). For the same reason, the phrase “50% or more of the issued and outstanding shares” should be substituted for the phrase “more than 50% of the stock” in Example 6 in Proposed Regulation section 1.199A-4(d).

(d) The word “and” should be inserted after the comma and immediately before the phrase “L owns” in the third line of Example 11 in Proposed Regulation section 1.199A-4(d).

(e) With respect to Example 12 in Proposed Regulation section 1.199A-4(d), (i) the phrase “that engages in” should be inserted in lieu of the second comma and (ii) the sentence “[u]nder paragraph (b)(1)(v) of this section, L is only able to show [that] the operations of PRS1and PRS2 are operated in reliance [upon] one another under paragraph (b)(1)(v)(C) of this section,” should be included in the “Facts” section of the example, rather than in the “Analysis” section.

(f) The word “it” should be substituted for the word “is” in the fifth line of the Analysis section of Example 14 in Proposed Regulation section 1.199A-4(d).