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August 8, 2018

M E M O R A N D U M

TO: **CIAB**

FROM: **Scott Sinder**
Aaron Nocjar
Kate Jensen

RE: **Overview of IRS 199A "Pass-Through" Proposed Tax Regulations**

Yesterday, the IRS issued proposed regulations that would implement and interpret the new Section 199A provisions enacted as part of the tax reform act. Section 199A generally allows eligible owners of "pass-through" entities (sole proprietors, LLC and partnerships for example) to take an extra 20 percent deduction from the income they receive from such entities.

The most significant interpretive issue for Council members was the scope of the "Specified Service Trade or Business" ("SSTB") exception to 199A eligibility for higher income earners. In a significant win for The Council, the proposed rules exclude insurance agency and brokerage services from the scope of the term "Brokerage Services," which is one of the core categories of SSTBs under the statute.

"Consulting services," however, also are included within the scope SSTB activities and they are broadly defined to include most consulting services unless they are ancillary to the purchase of a product and no separate fee is paid for those services. Council pass-through members will need to carefully evaluate the extent to which their revenue may be derived from fees for non-placement-related activities that may arguably fall within the ambit of "consulting services" as defined under the proposed regulations.

There are two significant qualifications to the scope of SSTBs that also warrant noting. First, pass-through entity owners who have an aggregate income of less than $157,500 (for individuals) and $315,000 (for married couples filing jointly) are exempt from the SSTB exception. Second, owners of pass-through entities that engage only in a *de minimus*

amount of SSTB activities also are exempt from the SSTB exception – for pass-through entities with gross revenue of less than $25 million, up to 10 percent of their income may be derived from SSTB activities without jeopardizing eligibility for the exception; for those with gross revenue of more than $25 million, up to 5 percent.

A compete analysis of the proposed rules is below. Comments on the proposed rules will be due 45 days from the date on which the proposed rules are published in the Federal Register.

EXECUTIVE SUMMARY

Unlike other recent 2017 Tax Act proposed regulations, the section 199A proposed regulations include a significant amount of interpretive rules (as opposed to merely restating much of the statute in the regulations). The regulations provide interpretive rules (along with illustrative examples) to:

(i) aggregate trades or businesses (but not via the section 469 rules and not merely when common ownership is present);
(ii) ameliorate the third-party-payor issue for the W-2 wages limit (by adopting much of the former section 199 rules);
(iii) define somewhat narrowly many (but not all) of the specifically-listed activities in the SSTB definition (generally helpful for banks, insurance and real estate agents and brokers, although the somewhat broad definitions of consulting and financial services create some uncertainty, and generally unhelpful for financial advisors and veterinarians);
(iv) define narrowly the skills and reputation definition of a SSTB (helpful to the local plumber and HVAC specialist but not as helpful for celebrity endorsers and reality TV stars); and
(v) provide de minimis exceptions for SSTB activities (e.g., consulting embedded within the sale of goods or non-SSTB services).

As expected, the rules also include a number of anti-abuse rules aimed at preventing taxpayers from transacting into section 199A, such as through (i) "crack" or "pack" transactions (e.g., the law firm spinning off its real property and administrative functions), (ii) converting employees to independent contractors only in form, and (iii) using non-grantor trusts to multiply the available taxable income thresholds.

The effective date provisions also contain helpful rules that permit taxpayers to rely immediately on the regulations for the entire 2018 year and, in certain fiscal-year scenarios, to include QBI from pre-2018 periods. However, there also are significant annual reporting obligations imposed on partnerships, S corporations, their owners, non-grantor trusts, and estates, with presumptions against owners/beneficiaries for failures to report.

A brief outline summary of section 199A and a more-detailed outline of how the proposed regulations address significant issues follow.

Section 199A -- In General

- Section 199A was enacted on December 22, 2017 in the 2017 Tax Act (and amended for cooperative issues on March 23, 2018, retroactive to January 1, 2018).
- Comprehensive proposed regulations were released on August 8, 2018.
- Section 199A generally provides a deduction against taxable income (not against gross income or AGI) for individuals, trusts, or estates of up to 20 percent of income from a domestic trade or business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate.
    - Such deduction attempts to bridge the uneven reduction in income tax rates on C corporations (much larger reduction) and on owners of businesses conducted as sole proprietorships, S corporations, and partnerships (much smaller reduction).
- A section 199A deduction is not available for, among other things, wage-type income, investment-type income, or for business income earned through a C corporation.
- In general, a taxpayer's deductible amount with respect to each trade or business is the lesser of
    - (i) 20 percent of the taxpayer's qualified business income (QBI) from such business, or
    - (ii) to the extent the taxpayer's taxable income exceeds certain thresholds with a phase-in amount, the greater of

- (a) 50 percent of the W-2 wages with respect to such business (W-2 wages limit), or
- (b) the sum of 25 percent of such W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property (i.e., generally most depreciable property used in such business that is still within a depreciable period) (UBIA of qualified property limit).

▪ Such deductible amounts for each business are then netted. Note that a deductible amount for a business can be negative (e.g., due to a business generating net losses).

o As an additional limit, a taxpayer's QBI does not include income from specified service trades or businesses (SSTB's) to the extent the taxpayer's taxable income exceeds certain thresholds with a phase-in amount (the SSTB limit).

▪ The definition of an SSTB (via cross-reference to section 1202(e)(3)(A)) is

- (i) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or
- (ii) any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners (the reputation or skill prong), and
- (iii) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

o These taxable income thresholds and phase-in amounts are as follows:

▪ The threshold amount for all taxpayers other than taxpayers filing joint returns is taxable income of $157,500 and for taxpayers filing

joint returns is taxable income of $315,000 (adjusted for inflation in future years). The phase-in amounts of taxable income is $50,000 and $100,000, respectively.

- Section 199A also allows individuals (and some trusts and estates) a deduction of up to 20 percent of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, including qualified REIT dividends and qualified PTP income earned through passthrough entities. This component of the section 199A deduction is not limited by the W-2 wages limit or the UBIA of qualified property limit.
- The section 199A deduction amount of a taxpayer that otherwise would arise from QBI, qualified REIT dividends, and qualified PTP income (the taxpayer's combined qualified business income amount) is then reduced to the extent such amount exceeds an overall taxable income limit. The deduction amount becomes the lesser of
  - (i) the combined qualified business income amount and
  - (ii) an amount equal to 20 percent of the excess (if any) of taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for the taxable year.
- In the partnership and S corporation contexts, section 199A applies at the partner and shareholder levels.
- There also are special rules with respect to cooperatives, trusts, and estates.
- Section 199A applies to taxable years beginning after 2017 and before 2026.

Significant Issues Addressed by the Proposed Regulations

Definition of Trade or Business

- Section 162 standard adopted: The proposed regulations adopt the definition of trade or business from section 162(a), since (according to the preamble) it is derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or

business in the context of a broad range of industries, which will reduce compliance costs, burden, and administrative complexity.

- Rental activities: However, the proposed regulations extend the definition of trade or business for purposes of section 199A beyond section 162 in one circumstance. It is not uncommon that for legal or other non-tax reasons taxpayers may segregate rental or licensed property from operating businesses. One concern was that, in this arrangement, the captive rental/licensing activity might not qualify as a trade or business on its own in many cases. The proposed regulations provide that the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business itself if the rental or licensing and the other trade or business are commonly owned (same group of persons, directly or indirectly, owns 50 percent or more of each business). This rule is intended to allow taxpayers to aggregate their trades or businesses with the associated rental/licensure of property (regardless of otherwise meeting the separate rules for aggregation) and to prevent taxpayers from improperly allocating losses or deductions away from other businesses.

○ SSTB–Operating Rules; Narrowing Definition for Many

- SSTB of partnership and S corporation determined at entity level: The proposed regulations require each partnership or S corporation to determine whether it conducts an SSTB and provide that information to its owners, regardless whether the entity or any owner may have taxable income below the taxable income thresholds. Once determined, such SSTB remains an SSTB and cannot be aggregated with other trades or businesses.

- De minimis exceptions: Taxpayers were concerned that the SSTB exclusion could also capture an otherwise non-SSTB if such trade or business included only a small amount of SSTB activity (e.g., the legal department in a manufacturing company). The proposed regulations attempt to address this concern with two de minimis rules.

- $25M or less gross receipts: A trade or business (before aggregating) is not an SSTB if it has gross receipts of $25M or less in a year and less than 10 percent of the gross receipts of the business is attributable to the performance of services in an SSTB.

- Over $25M gross receipts: A trade or business (before aggregating) is not an SSTB if it has gross receipts of over $25M in a year and less than 5 percent of the gross receipts of the business is attributable to the performance of services in an SSTB.

- Objective/narrower interpretations of specifically-listed SSTB's:

  - Indicated basis for interpretation: The preamble indicates that the definitions of the specifically-listed SSTB's are based on (i) the plain meaning of section 199A, (ii) past interpretations of substantially similar language in other Code provisions (sections 448 and 1202), and (iii) other indicia of legislative intent. However, such definitions are to apply only to section 199A (not also section 1202, which has renewed vitality due to other 2017 Tax Act changes).

  - Licensure is not controlling: The proposed regulations do not adopt a bright-line licensing rule for purposes of determining whether a taxpayer is engaged in a SSTB.

  - Brokerage services: The proposed regulations provide that the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

  - Consulting: The proposed regulations provide that the term performance of services in the field of consulting means the

provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training or educational courses. This determination is made based on all the facts and circumstances of a person's business, including how such person is compensated for the services (i.e., fee (consulting) versus commission (sales)).

  - To address concerns about the customary provision of consulting services in connection with the purchase of goods by customers (or the performance of services that is otherwise not a SSTB), the proposed regulations also provide that the field of consulting does not include consulting that is embedded in, or ancillary to, the sale of such goods (or services), if there is no separate payment for the consulting services.

- Health: Following much of the pre-existing section 448 regulations defining such term, the proposed regulations provide that performance of services in the field of health means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient (e.g., the operation of health clubs or health spas that provide physical exercise or

conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices).

- Law: The proposed regulations provide that the performance of services in the field of law means the provision of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law (e.g., provision of services by printers, delivery services, or stenography services).

- Accounting: The proposed regulations provide that the performance of services in the field of accounting means the provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals in their capacity as such, which includes tax return and bookkeeping services, even though the provision of such services may not require the same education, training, or mastery of accounting principles as a CPA. The field of accounting does not include payment processing and billing analysis.

- Actuarial science: The proposed regulations provides that the term performance of services in the field of actuarial science means the provision of services by actuaries and similar professionals in their capacity as such. The field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

- Performing arts: The proposed regulations provide that the term performance of services in the field of the performing arts means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such.

The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts or persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

- Athletics: The proposed regulations provide that the term performance of services in the field of athletics means the 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 or services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

- Financial services: The proposed regulations provide that financial services mean services typically performed by financial advisors and investment bankers and provides that the field of financial services includes the provision of financial services to clients, including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as the client's agent in the issuance of securities, and similar services. This definition includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals, but does not include taking deposits or making loans.

- Reputation and skill prong: The preamble indicated that Treasury considered and rejected several conceptual approaches to defining the reputation and skill prong of the SSTB definition due to its view that such prong must be interpreted in a manner that is both objective and administrable. The proposed regulations limit the meaning of the reputation or skill prong to fact patterns in which the individual or entity is engaged in the trade or business of: (i) receiving income for endorsing products or services, including a taxpayer's distributive share of income or distributions from an entity for which the taxpayer provides endorsement services; (ii) licensing or receiving income for the use of a taxpayer's image, likeness, name, signature, voice, trademark, or any other symbols associated with the taxpayer's identity, including a taxpayer's distributive share of income or distributions from an entity to which a taxpayer contributes the rights to use the taxpayer's image; or (iii) receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players).

- Investing and investment management: The proposed regulations provide that any trade or business that involves the performance of services that consist of investing and investment management means a trade or business that earns fees for investment, asset management services, or investment management services, including providing advice with respect to buying and selling investments. The performance of services that consist of investing and investment management would include a trade or business that receives either a commission, a flat fee, or an investment management fee calculated as a percentage of assets under management. However, the performance of services of investing and investment management does not include directly managing real property.

- Trading: The proposed regulations provide that any trade or business involving the performance of services that consist of trading means a trade or business of trading in securities, commodities, or partnership interests. Whether a person is a trader is determined taking into account the relevant facts and circumstances, and relevant factors include the source and type of profit generally sought from engaging in the activity regardless of whether the activity is being provided on behalf of customers or for a taxpayer's own account.

- Dealing in securities, partnership interests, and commodities: The proposed regulations provide that the performance of services that consist of dealing in securities (as defined in section 475(c)(2)) means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. However, a taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities for this purpose. The proposed regulations provide analogous definitions for the performance of services that consist of dealing in partnership interests and the performance of services that consist of dealing in commodities (as defined in section 475(e)(2)).

○ Computational Rules; Netting; Losses; Basis Adjustments; Effect on Other Taxes

- Net qualified business loss not taken into account for other tax purposes: If a taxpayer has multiple trades or businesses, the taxpayer must calculate the QBI from each trade or business and then net the amounts. If the net QBI with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year. However, the proposed regulations

provide that this carryover rules does not affect the deductibility of the losses for purposes of other provisions of the Code.

- Silo overall loss from qualified REIT dividends and qualified PTP income: The proposed regulations provide a separate loss carryforward rule to segregate an overall loss attributable to qualified REIT dividends and qualified PTP income from QBI. This is aimed at preventing a taxpayer from losing the benefit of any net positive QBI if the taxpayer also has an overall loss from combined qualified REIT dividends and qualified PTP income. Essentially, qualified REIT dividends and qualified PTP income will be taken into account for section 199A separately from QBI.

- Clarifications when taxable income within phase-in range: The proposed regulations also clarify how QBI, W-2 wages, and UBIA of qualified property should be taken into account when a taxpayer's taxable income exceeds the threshold amount but is still within the phase-in amount range.

    - One notable clarification in the proposed regulations provides that, if a taxpayer has QBI of less than zero from one trade or business, but has overall QBI greater than zero when all of the taxpayer's trades or businesses are taken together, then the taxpayer must offset the net income in each trade or business that produced net income with the net loss from each trade or business that produced net loss before the taxpayer applies the limitations based on W-2 wages and UBIA of qualified property. The taxpayer must apportion the net loss among the trades or businesses with positive QBI in proportion to the relative amounts of QBI in such trades or businesses. Then, for purposes of comparing the taxpayer's QBI with respect to a trade or business against the limitations based on W-2 wages and UBIA of qualified property, the net income with respect to each trade or business (as offset by the apportioned losses) is the taxpayer's QBI with respect to that trade or business. The W-2 wages and UBIA of qualified property from the trades or businesses which produced negative QBI are not otherwise

taken into account and are not carried over into the subsequent year.

- No special outside basis or AAA adjustments: The proposed regulations clarify that a taxpayer whose section 199A deduction arises, in whole or in part, from an interest in a partnership or S corporation does not adjust its tax basis in its partnership interest or S corporation stock for such deduction. An S corporation also does not adjust its accumulated adjustments accounts (AAA).

- No effect on self-employment tax, net investment income tax, or AMT: The proposed regulations clarify that a section 199A deduction has no effect on a taxpayer's self-employment tax (section 1402) or net investment income tax (section 1411), and the section 199A deduction for regular tax purposes is taken into account fully for individual alternative minimum tax purposes.

W-2 Wages Issues Addressed in Taxpayer-Friendly Manner

- Follow Former Section 199 Rules: The proposed regulations on defining W-2 wages largely follow the rules for the domestic production activities deduction of former section 199.

- Third-Party-Payor Wages Qualify: The proposed regulations also address the third-party-payor issue in a taxpayer-friendly manner. Under the proposed regulations, in determining W-2 wages, a person may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the person for employment by the person.

    - Persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

- As a corollary, in such cases, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 (e.g., the professional employer organization) is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person.

- W-2 wages follow allocation of wage expense:

  - Unlike former section 199, the W-2 wage limitation in section 199A applies separately for each trade or business. Accordingly, the proposed regulations provide that, in the case of W-2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined to be in the same proportion to total W-2 wages as the deductions associated with those wages are allocated among the particular trades or businesses.

  - Section 199A(b)(4) also requires that to be taken into account, W-2 wages must be "properly allocable" to QBI. The proposed regulations provide that W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI (e.g., wages attributable to domestic (rather than foreign) activities of a business).

- Special W-2 wage allocation rules for business dispositions: Special W-2 rules are provided in the proposed regulations to allocate W-2 wages among multiple taxpayers during a calendar year, in the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year.

- Proposal to offer former section 199 methods for calculating W-2 wages: A notice of proposed revenue procedure, IRS Notice 2018-64, was concurrently issued with the proposed regulations, which provides three methods for calculating W-2 wages. The three methods in the notice are substantially similar to the methods

provided in Rev. Proc. 2006-47, which were used for purposes of former section 199. The first method (the unmodified Box method) allows for a simplified calculation, and the second and third methods (the modified Box 1 method and the tracking wages method) provide for greater accuracy.

- **UBIA of qualified property**

  - "Acquisition" means "placed in service": The proposed regulations provide that "immediately after acquisition" – the IA in UBIA – shall mean as of the date the property is placed in service. The preamble indicates that this interpretation was made to ensure consistency between purchased and produced property and otherwise reduces compliance costs.

  - Section 734(b) and 743(b) inside basis adjustments do not qualify: Special inside basis adjustments by partnerships via sections 734(b) or 743(b) are not qualified property under the proposed regulations.

  - Bonus depreciation, expensing, tax credits do not affect UBIA: UBIA also is to be determined without regard to the taking of bonus depreciation via section 168, expensing via section 179, or basis adjustments for tax credits.

  - Like-kind exchanges, involuntary conversions, and transferred basis transactions involving qualified property: The proposed regulations generally provide that qualified property acquired in such transactions will have two (or three) separate placed in service dates: one for purposes of determining the UBIA of the property (the date the property is actually placed in service after acquisition/transfer) and either one or two for purposes of determining the depreciable period of such property (to the extent of exchanged/transferred basis in the property, the date the relinquished or transferred property was originally placed in service by the transferor and, to the extent of additional (or excess) basis in the property, the date the property was acquired/transferred). These rules are analogous to pre-existing regulations under section 168.

- Improvements to qualified property treated separately: The proposed regulations provide that, in the case of any addition to, or improvement of, qualified property that is already placed in service by the taxpayer, such addition or improvement is treated as separate qualified property that is placed in service on the date of such addition or improvement. This rule prevents an interpretation that improvements to qualified property would be subject to the same original depreciable period applicable to the underlying property.

- Allocation of UBIA of qualified property of partnerships and S corporations follows allocation of tax depreciation, deemed dispositional gain, or relative number of S shares: The proposed regulations clarify, in general, that each partner's or shareholder's share of the UBIA of qualified property of a partnership or S corporation is an amount that bears the same proportion to the total UBIA of the qualified property as the partner's or shareholder's share of tax depreciation bears to the entity's total tax depreciation for such property for the year. The regulations also provide that UBIA of such property where such property does not produce tax depreciation during the year is to be allocated to partners based on how dispositional gain would be allocated to them and to shareholders based on relative number of shares held in the S corporation.

○ Clarifying what items can be QBI

- The proposed regulations contain several clarifications regarding what types of tax items can qualify as qualified business income (QBI), including: (i) section 751(a) and (b) "hot asset" income can qualify; (ii) guaranteed payments for the use of capital under section 707(c) do not qualify; (iii) section 481 adjustments arising in taxable years ending after December 31, 2017 (positive or negative) attributable to a trade or business can qualify; (iv) previously disallowed losses or deductions attributable to a trade or business that are then allowed in a later year (via the at-risk, passive activity loss, or outside basis limitation rules) can qualify as long as such losses/deductions were not disallowed in pre-2018 years, (v) items giving rise to a net operating loss in the year incurred do not qualify in subsequent years,

unless such items were losses/deductions disallowed by the new section 461(l) business loss limitation; (vi) gain or loss treated as capital gain or loss under section 1231 does not qualify; (vii) gain or loss not treated as capital gain or loss under section 1231 can qualify; (viii) interest income on working capital of a business does not qualify; and (ix) payments/distributions for services under section 707(a) or 707(c) do not qualify, even if such payments/distributions are made from a lower-tier partnership to an upper-tier partnership that does not itself make section 707(a) or 707(c) payments/distributions to its partners.

- Reasonable compensation exclusion not extended beyond S corporation shareholders: The proposed regulations clarify that the statutory exclusion from QBI of reasonable compensation paid from a trade or business in exchange for services will be limited only to the S corporation context. The preamble also explains that, even though employee compensation is expressly excluded from QBI, this reasonable compensation rule is intended to cause employee-shareholders to exclude from their QBI from an S corporation an amount constituting reasonable compensation (if not already actually paid).

○ Rules permit aggregation of trades or businesses within functional and ownership limits

- Aggregation permitted (not required): A significant concern was that a taxpayer that conducted multiple trades or businesses would have its section 199A deduction limited due to the application of the W-2 limit or UBIA of qualified property limit on a business-by-business basis. The proposed regulations permit, but do not require, taxpayers to aggregate if they meet certain requirements focused on the relatedness of the owners of the businesses and of the activities conducted or services or products provided by the businesses.

- Four requirements: The section 469 activity grouping rules were not used. Instead, the proposed regulations create a new aggregation regime, where aggregation is permitted if four requirements are met:

(i) each trade or business must be a section 162 trade or business for purposes of section 199A; (ii) the same group of persons must directly or indirectly own a majority interest (50 percent or more) in each of the businesses for the majority of the relevant taxable year; (iii) no trade or business is an SSTB; and (iv) the taxpayer can establish that the businesses are part of a larger, integrated trade or business (i.e., they provide similar products and services or ones that are customarily provided together (e.g., restaurant and food truck, gas station and car wash), they share common facilities or significant business elements (e.g., common accounting, legal, manufacturing, human resources, IT resources, etc.), or they operate in coordination with each other (e.g., supply chain interdependencies)).

- No entity-level aggregation by partnerships or S corporations. The proposed regulations provide that aggregation is permitted only at the taxpayer level. Partnerships and S corporations will need to compute (and provide its owners with information regarding) QBI, W-2 wages, and UBIA of qualified property for each trade or business.

○ Several Anti-Abuse Rules

- Non-grantor trust anti-abuse rule: The proposed regulations establish anti-abuse rules under section 199A and section 643(f) to prevent taxpayers from establishing multiple non-grantor trusts or contributing additional capital to multiple existing non-grantor trusts in order to avoid federal income tax. This is aimed at taxpayers trying to multiply their otherwise single threshold amount by spreading interests in businesses generating QBI among several non-grantor trusts.

- Qualified property anti-abuse rule: The proposed regulations include an anti-abuse rule that disregards property as qualified property for purposes of the UBIA of qualified property limit if the property is acquired within 60 days of the end of a taxable year and disposed of within 120 days without having been used in a business for at least 45 days, unless the taxpayer can demonstrate that the principal purpose

of acquisition and disposition was a purpose other than increasing the section 199A deduction.

- Qualified REIT dividend anti-abuse rule: The proposed regulations include an anti-abuse rule to prevent dividend stripping and similar transactions related to qualified REIT dividends where the taxpayer does not have economic exposure to the REIT stock for a meaningful period of time.

- SSTB anti-abuse rules: The proposed regulations include another set of anti-abuse rules for purposes of defining a SSTB in an effort to prevent taxpayers from separating out parts of what otherwise would be an integrated SSTB, such as administrative functions, in an attempt to qualify those separated parts for the section 199A deduction.

    - Commonly-owned non-SSTB substantially serving a SSTB: The proposed regulations provide that an SSTB includes any trade or business with 50 percent or more common ownership (directly or indirectly) that provides 80 percent or more of its property or services to an SSTB.

        - The proposed regulations also provide that, if a trade or business has 50 percent or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (causing the related income to be treated as income from an SSTB).

    - Commonly-owned small non-SSTB supported by SSTB: The proposed regulations also provide that, if a trade or business (that would not otherwise be treated as an SSTB) has 50 percent or more common ownership with an SSTB and shared expenses (including wages or overhead expenses) with the SSTB, it is treated an SSTB, if the trade or business represents no more than five percent of gross receipts of the combined business.

- Employee status anti-abuse rules:

  - Employees converting to independent contractors while providing substantially similar services: The proposed regulations provide that, if an employer improperly treats an employee as an independent contractor or other non-employee, the improperly classified employee is in the trade or business of performing services as an employee notwithstanding the employer's improper classification. The preamble states that this issue is particularly important in the case of individuals who cease being treated as employees of an employer, but subsequently provide substantially the same services to the employer (or a related entity) but claim to do so in a capacity other than as an employee.

  - Rebuttable presumption against independent contractor status for former employees: The proposed regulations provide that an individual who was treated as an employee for federal employment tax purposes by the person to whom he or she provided services, and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted only upon a showing by the individual that, under federal tax rules, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

○ Effective Date and Reliance Issues

- General: The regulations generally are proposed to apply to taxable years ending after the date of publication of the final regulations.

However, taxpayers may rely on the proposed regulations, in their entirety, until that date.

- Anti-abuse rules: The anti-abuse rules of the regulations, however, are proposed to apply to taxable years ending after December 22, 2017, the date of enactment of the 2017 Tax Act.

- Non-grantor trust anti-abuse rule: The proposed regulations under section 643, which are intended to prevent abuse of the Code generally through the use of trusts, are proposed to apply to taxable years ending after the date of the publication of such proposed regulations.

- Fiscal year partnerships and S corporations: The proposed regulations provide that, for purposes of determining QBI, W-2 wages, and UBIA of qualified property, if a taxpayer takes into account QBI, W-2 wages, or UBIA of qualified property from a partnership or S corporation 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 taxpayer during the taxpayer's taxable year during which such partnership or S corporation taxable year ends. This rule could permit taxpayers to include in their section 199A deduction computations QBI, W-2 wages, and UBIA of qualified property arising prior to the general effective date of section 199A (taxable years beginning after December 31, 2017).