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Proposed Regulations under Section 199A

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On August 16, 2018, the Internal Revenue Service (the "IRS") and the Department of Treasury ("Treasury") published in the *Federal Register* proposed regulations under section 199A (the "Proposed Regulations"). The Proposed Regulations provide guidance useful in determining whether and to what extent an individual (including a trust or estate) is entitled to a deduction under section 199A (the "Section 199A Deduction") with regard to trade or business income earned through a sole proprietorship, partnership, or S corporation.

Although the Proposed Regulations generally are proposed to be effective when finalized, it is clear that taxpayers may rely on the Proposed Regulations until final regulations are issued. However, certain rules that the IRS and Treasury feel address abuses of section 199A are proposed to be effective retroactive to the date of section 199A's enactment. For both of these reasons, a basic overview of section 199A and the provisions of the Proposed Regulations is warranted. In this article, we provide the necessary overview of the statute and the Proposed Regulations and certain implications for taxpayers. We then turn our attention to provisions in the Proposed Regulations that resolve issues raised by the language of section 199A itself. In doing so, we focus on provisions that likely will be welcomed by taxpayers because they favorably resolve certain uncertainties raised by the statutory language. However, we also focus on areas—including the anti-abuse rules mentioned above—that take a less taxpayer-favorable approach.

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Overview of Section 199A[1]

The 2017 Act contains new section 199A, which generally allows individuals (including for this purpose trusts and estates) a deduction for a tax year in an amount equal to the lesser of —

- The combined qualified business income amount of the taxpayer; or
- An amount equal to 20 percent of the excess (if any) of the taxable income of the taxpayer for the tax year, over the net capital gain of the taxpayer for the tax year.

For this purpose, section 199A(b) defines the term "combined qualified business income amount" with respect to a tax year as an amount equal to the deductible amounts with respect to each "qualified trade or business" ("QTB") carried on by the taxpayer, plus 20 percent of the aggregate amount of the qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

A QTB of the taxpayer is any trade or business other than a "specified service trade or business" or "SSTB" (the "SSTB Exclusion") or the trade or business of performing services as an employee.[2] The deductible amount with respect to each QTB carried on by a taxpayer generally is subject to the following "Limitations," which are the lesser of—

- An amount equal to 20 percent of the taxpayer's qualified business income with respect to the QTB, or
- The greater of—
  - 50 percent of the W-2 wages paid with respect to the QTB (the "Wage Limitation");[3] or
  - The sum of 25 percent of the W-2 wages with respect to the QTB plus 2.5 percent of the unadjusted basis (determined immediately after an acquisition) of all qualified property (the "Wage and Basis Limitation").[4]

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[1] This article only considers certain federal tax issues relating to section 199A and the Proposed Regulations. There may be numerous state and local tax issues (including, but not limited to, whether the Section 199A Deduction is even allowed for state or local tax purposes) as well. For advice with regard to these issues, please consult with a state and local tax specialist. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] The SSTB Exclusion does not apply to a taxpayer whose taxable income does not exceed threshold. Specifically, the exclusion does not apply to an individual taxpayer with taxable income (from all sources, not just from the business at issue) of less than $157,500 for individuals and $315,000 for joint filers (the "Threshold Amount"). A phase out applies to the next $50,000 of taxable income (for individuals) and $100,000 (for joint filers). These amounts are adjusted for inflation. In certain portions of this article, we may assume that an individual's taxable income exceeds the Threshold Amount.

[3] For this purpose, "W-2 wages" generally means amounts paid to an employee under section 6051(a)(3) and (a)(8). This includes the total amount of wages (as defined in section 3401(a), as well as the total amount of elective deferrals, the compensation deferred under section 457, and the amount of designated Roth contributions.

[4] Like the SSTB Exclusion, the Limitations do not apply to a taxpayer whose income does not exceed the Threshold Amount.

Section 199A(c) defines "qualified business income" ("QBI") for any tax year as the net amount of qualified items of income, gain, deduction, and loss with respect to any QTB of the taxpayer; QBI does not include any qualified REIT dividends or qualified publicly traded partnership income (which are separately eligible for the 20 percent deduction without regard to the Limitations).

"Qualified items of income, gain, deduction, and loss" generally means items of income, gain, deduction, and loss to the extent these items are effectively connected with the conduct of a trade or business within the United States (determined under a modified version of section 864(c)) and included or allowed in determining taxable income for the tax year. However, the term "qualified items of income, gain, deduction, or loss" does not include items of investment-type income specifically listed in the statute, including:

- Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss
- Any dividend, income equivalent to a dividend (other than certain patronage dividends paid by a cooperative organization), or payment in lieu of dividends described in section 954(c)(1)(G)
- Any interest income other than interest income that is properly allocable to a trade or business
- Any item of deduction or loss properly allocable to any of the listed excluded items[5]

Under this definition, qualified income items included in calculating the ordinary operating income of a trade or business generally are included in qualified business income unless they fall into one of the categories specifically described.

Section 199A(d)(1) defines a QTB as any trade or business other than an SSTB or the trade or business of performing services as an employee. For this purpose, section 199A(d)(2) defines an SSTB as any trade or business that—

> (A) Is described in section 1202(e)(3)(A) (applied without regard to the words 'engineering, architecture,') or would be so described if the term "employees or owners" were substituted for "employees" therein; or
>
> (B) Involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

[5] Qualified business income does not include—(1) reasonable compensation paid to the taxpayer by any QTB of the taxpayer for services rendered with respect to the trade or business; (2) any section 707(c) guaranteed payment paid to a partner for services rendered with respect to the trade or business; and (3) 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.

After considering and applying the modifications described above, the definition of an SSTB is—

- 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 any trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners, and

- 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)).

Definition of a Trade or Business

The availability of a Section 199A Deduction generally is determined on the basis of an individual trade or business. Prior to publication of the Proposed Regulations, commentators requested guidance regarding the meaning of "trade or business" for section 199A purposes. As recommended by many, in the Proposed Regulations the IRS and Treasury generally define "trade or business" for section 199A purposes consistent with the meaning of that phrase under section 162(a). However, the Proposed Regulations extend that definition in one respect. Specifically, solely for purposes of section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled (within the meaning of Proposed Regulation section 1.199A-4(b)(1)(i), discussed below).[6]

It is easy to see why the IRS and Treasury essentially adopted the section 162(a) definition of a trade or business for purposes of section 199A. As section 162(a) and section 199A both relate to whether and to what extent a deduction is available with regard to a taxpayer's activities, it seems likely that Congress intended the section 162(a) definition to govern the determination. Moreover, when faced with the daunting task of interpreting a rather complicated statute in a relatively short period of time, it makes sense from an administrative perspective to rely on existing law (rather than to create an entirely new set of rules).

That being said, the adoption of the section 162 definition of a trade or business may not provide the level of clarity that taxpayers would prefer. The Proposed Regulations make two things clear:

- The initial determination of whether and to what extent a Section 199A Deduction is available generally is made on the basis of an individual trade or business; and

- One entity (such as an S corporation or a partnership) may have more than one trade or business.

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[6] Two businesses are commonly controlled under this standard if he same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business, meaning in the case of a trade or business owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of a trade or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership. Although it is not entirely clear from the regulatory language, it appears that this ownership must exist for the majority of the tax year in question.

Determining whether one entity has just one or more than one trade or business may be a difficult endeavor. In the preamble to the Proposed Regulations (the "Preamble"), the IRS notes that the definition of a trade or business for purposes of section 162(a) as having been developed through 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." Although it is true that a significant number of section 162(a) authorities exist, the vast majority of these authorities relate to whether an activity of a taxpayer is a trade or business at all—not whether the taxpayer's activities give rise to more than one trade or business. On the latter issue, the guidance available is much more limited.

Some existing guidance on whether a taxpayer has more than one trade or business may provide clarity for taxpayers whose operations included two or more businesses that previously were conducted in separate entities. For example, an S corporation that historically conducted one trade or business that acquires the operations of another corporation as a result of a statutory merger may have little difficulty in establishing that two trades or businesses exist, particularly if the two operations activities continue to have different employees, different customers, and separate books and records. That may be useful to the corporation if, for example, the S corporation's historical activity is an SSTB and the acquired operations are not.

Absent the existence of an SSTB, however, treatment of two activities as one trade or business generally is beneficial to a taxpayer because it allows QBI and the Limitations to be determined on an aggregate basis, which may allow excess wage expense or unadjusted basis in qualified property associated with one activity to offset QBI with respect to another. Although the Proposed Regulations do provide for aggregation of trades or businesses in certain situations (see discussion below), if those rules do not apply the determination of whether activities are one trade or business or separate trades or businesses may become important.

Further, note that the Proposed Regulations provide for aggregation in certain situations only at the individual level. A passthrough entity directly or indirectly owned by an individual is required to report all the information necessary for each individual to determine whether and to what extent a Section 199A Deduction is available; that information must be reported on a trade or business basis by the entity engaged in the trade or business.[7] Thus, a passthrough entity must determine whether it has a single or multiple trades or businesses, regardless of whether the aggregation rules apply. This determination may require a significant investment of time on the part of the entity and add to the complexity of determining whether and to what extent a Section 199A Deduction is available.[8]

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[7] This article does not contain a detailed discussion of the specific reporting requirements that are required for partnership's and S corporations that have direct or indirect individual owners (which would include all S corporations and many partnerships). However, these requirements may be extensive. Moreover, the requirements raise questions as to which determinations may be treated as a "partnership-related item" for purposes of the new rules applicable to partnership audits.

[8] Ironically, the Proposed Regulations listed the avoidance of complexity as one reason for providing aggregation only at the individual level. See further discussion of this point below.

Impact of the Deduction and the Definition of QBI

The Proposed Regulations clarify the impact of the Section 199A Deduction in many respects. First, although it seemed relatively clear from the statutory language itself, to remove any doubt the Proposed Regulations specifically provide that the Section 199A Deduction is not available in calculating a taxpayer's—(1) self-employment income; or (2) net investment income tax under section 1411. Further, the Proposed Regulations (like the statute itself) apply the Section 199A Deduction at the partner level. Thus, the Proposed Regulations confirm that the Section 199A Deduction has no effect on a partner's outside basis in its partnership interest, nor does it affect a shareholder's basis in S corporation stock or the S corporation's accumulated adjustments account.

The regulations also clarify the interaction of the Section 199A Deduction with the alternative minimum tax rules. Specifically, the Proposed Regulations provide that, for purposes of determining alternative minimum taxable income under section 55, QBI is determined without regard to any adjustments under the alternative minimum tax rules. Further, the Proposed Regulations confirm that a Section 199A Deduction does not result in an individual being subject to the alternative minimum tax.[9]

The Proposed Regulations also provide further guidance on the definition of QBI for purposes of the Section 199A Deduction. Specifically, the Proposed Regulations clarify or provide that QBI includes—

- Ordinary income recognized by a partner under section 751(a) or (b), but only if the other requirements for treatment as QBI are satisfied; and
- Section 481 adjustments, but only if the other requirements for treatment as QBI are satisfied and the income (or deduction) relates to a section 481 deduction arising in a tax year ending after December 31, 2017 (i.e., a year with respect to which section 199A applies).

Further, the Proposed Regulations provide that losses suspended under section 465, section 469, section 704(d), or section 1366(d) are included—(1) in the calculation of QBI only in the year those losses are included in calculating the individual's income; and (2) only if the losses were disallowed in a tax year to which section 199A applied (i.e., losses disallowed in a tax year beginning before January 1, 2018, do not reduce QBI if they are included in calculating a taxpayer's income in a later year). Finally, the Proposed Regulations provide that individual net operating losses ("NOLs") that were not allowed in calculating an individual's income are not included in calculating QBI because those losses would have reduced QBI in the year they were allowed in computing the NOL. In contrast, if a loss is not allowed for a particular year under section 461(l) (and thus was not included in calculating an individual's NOL for that year), the Proposed Regulations provide that the loss *is* taken into account in the year allowed.[10]

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[9] In addition, the Proposed Regulations discuss the impact of taking a Section 199A Deduction on an individual's potential liability for an understatement penalty under section 6662(d)(1). That section defines a substantial understatement of income tax as an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. Consistent with a change to section 6662 enacted with section 199A, the Proposed Regulations provide that, if an individual claims a Section 199A Deduction, the understatement penalty applies at five percent (rather than the usual 10 percent).

[10] Section 461(l) was enacted at the same time as section 199A, and generally limits a taxpayer (other than a corporation's) deduction for an excess business loss for a tax year to $250,000 ($500,000 for married filing jointly).

The Proposed Regulations also provide specific guidance regarding the types of items that do *not* constitute QBI (and thus are not included in income when determining the amount of a Section 199A Deduction). As noted above, QBI generally does not include certain investment type items of income, such as capital gains or interest income. As expected, the Proposed Regulations clarify that section 1231 gains and losses are not included in QBI if they are characterized as capital gains or losses; in contrast, ordinary income or loss under section 1231 generally is QBI if other requirements are satisfied. Further, the Proposed Regulations reiterate the statute and provide that interest income is QBI only if it is properly allocable to a trade or business. In this regard, the IRS and Treasury concluded that interest on working capital and reserves not allocable to a trade or business because are essentially investment interest, and thus do not constitute QBI. However, interest received on accounts or notes receivable for goods or services provided by the trade or business are QBI if the other requirements for QBI treatment are satisfied.

The Proposed Regulations also contain rules for determining whether payments made by a partnership to a partner are QBI for the recipient. Specifically, the Proposed Regulations do not treat guaranteed payments paid by a partnership to a partner for the use of capital as QBI. This treatment may be appropriate if the capital used by the partnership is cash, so the guaranteed payment appears to be a substitute for interest. However, if interest was paid to partner that could demonstrate the interest was allocable to a trade or business, the interest presumably would be QBI. There does not seem to be a similar ability with regard to a guaranteed payment paid with respect to cash contributed to a partnership. Moreover, if the guaranteed payment is made for the use of property other than cash contributed to the partnership, it may be more similar to another type of income. For example, if the property with respect to which the guaranteed payment is made was a building, the payment may be more similar to rental income. As a policy matter, it does not seem that type of guaranteed payment should be excluded from QBI.

The treatment of guaranteed payments for capital is similar to the treatment of guaranteed payments or section 707(a) payments paid by a partnership to a partner for services. As noted above, QBI generally does not include compensatory type payments. Consistent with that, the statute the Proposed Regulations provide that guaranteed payments or section 707(a) payments paid by a partnership to a partner for services do not constitute QBI. In each case, however, any deduction attributable to the payment may reduce the QBI of the relevant trade or business. Further, the Proposed Regulations clarify that a guaranteed payment made by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment, and thus is not QBI of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient.

The treatment of guaranteed payments for services as not constituting QBI was provided by section 199A itself, and thus the IRS and Treasury had no “wiggle room” for providing that those types of payments were QBI. However, with regard to section 707(a) payments for services, the statutory language did not mandate the treatment of those payments, but rather gave the IRS and Treasury regulatory authority to determine when treatment of those payments as other than QBI was appropriate. The IRS seems to have decided that all such payments are excluded from QBI. Query whether that is the appropriate result in certain contexts.

For example, assume that A, an individual, owns a landscaping business that provides mowing and other related services to customers. A also owns an interest in a partnership that owns an office building surrounded by landscaping that needs professional attention to maintain. If the partnership hires A's landscaping business to provide that service, then payments made to A presumably would be section 707(a) payments to A for services. It is unclear why such a payment made to A would be excluded from QBI, when payments made by other customers for the same services presumably would be included in QBI. In light of this and similar situations, it would not be surprising to see comments made with regard to this provision in the Proposed Regulations.

Planning Point

In any case, the treatment of section 707(a) and section 707(c) payments may cause partners to look for ways to have these payments (or similar payments) treated as QBI. If a partnership is in a trade or business that generates QBI, a partner's distributive share of the partnership's income may be eligible for the Section 199A Deduction. To improve its ability to take a Section 199A Deduction, a partner may decide to alter its arrangement with the partnership, such that the partner receives an increased share of the partnership's income or a preferred return of the partnership's net income. Although that may increase the amount of the partner's Section 199A Deduction, it also increases the economic risk associated with the payment, as it now becomes subject to whether the partnership has net income.[11]

The Wage and Wage and Basis Limitations

As described above, an individual's Section 199A Deduction may be limited by either the Wage Limitation or the Wage and Basis Limitation. Both limitations raised a number of questions addressed by the IRS and Treasury in the Proposed Regulations.

W-2 Wages

In defining "W-2 wages" for purposes of both the Wage Limitation and the Wage and Basis Limitation, the IRS and Treasury did as expected and adopted several positions taken with regard to wages in the regulations issued under former section 199 (which was repealed by the legislation that included section 199A).[12] Specifically, the Proposed Regulations generally provide that wages paid to a particular employee are treated as W-2 wages of the common law employer of that employee with respect to the services provided. Under this rule, wages in form paid by a "paymaster" entity are not treated as wages of that entity if paid to an individual that not a common law employee of the paymaster. In contrast, if a payroll entity *is* the common law employer of employees leased to a related

[11] A partner and a partnership contemplating a revision in this manner should also consider the potential application of the so-called "fee waiver" regulations proposed by the IRS and Treasury under section 707 in 2015. *See* Notice of Proposed Rulemaking, 80 Fed. Reg. 43,652 (July 23, 2015).

[12] Concurrent with the issuance of the Proposed Regulations, the IRS and Treasury also released Notice 2018-64, 2018-34 I.R.B., which provides three methods for calculating an employee's W-2 wages. The methods described are substantially similar to those provided for determining W-2 wages under section 199 in Rev. Proc. 2006-47, 2006-2 C.B. 869.

operating entity, then W-2 wages paid to the employee are treated as those of the payroll entity rather than the operating entity.

After the entity to which the W-2 wages “belong” is identified, the W-2 wages may need to be further allocated to particular trades or businesses of the entity if the entity operates multiple trades or businesses. Here, the Proposed Regulations provide that W-2 wages of an entity that are allocable to more than one trade or business are allocated between them in proportion to the manner in which the federal tax deduction with respect to the W-2 wages is allocated. Similarly, a partner’s or S corporation shareholder’s share of W-2 wages of a partnership or S corporation is determined in accordance with the allocation of the wage expense.

<u>Planning Point</u>

With regard to a partnership, this means that special allocations of W-2 wage expense may result in a partner having a larger share of W-2 wages than the partner’s overall share of the partnership’s income. This could prove useful in situations in which some (but not all) of the partners in the partnership have taxable income below the Threshold Amount. Note, however, that the special allocations must be respected for federal tax purposes (i.e., have substantial economic effect under section 704(b) or be in accordance with the partners’ interests in the partnership).

The Proposed Regulations also provide rules for determining the amount of an entity’s W-2 wages for years during which there is an acquisition or disposition of all or a major portion of a trade or business (or of a major portion of a separate unit of a trade or business that causes more than one individual or entity to be the employer of the acquired trade or business). In such a situation, the Proposed Regulations provide that the wages of the employees are allocated based on the period during which each employee was employed, regardless of which method is used to report the employee’s wages on the Form W-2.

Unadjusted Basis Immediately after Acquisition (UBIA)

As noted above, the Wage and Basis Limitation limits an individual’s QBI deduction with respect to the sum of 25 percent of the W-2 wages with respect to the QTB plus 2.5 percent of the unadjusted basis (determined immediately after an acquisition) of all qualified property (which the IRS and Treasury refer to as “UBIA”). "Qualified property" generally means, with respect to any QTB for a tax year tangible, depreciable property that is—

- Held by, and available for use in, the QTB at the close of the tax year;
- Used at any point during the tax year in the production of qualified business income; and
- The depreciable period for which has not ended before the close of the tax year. For this purpose, the term "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—(1) the date that is 10 years after such date, or (2) 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 section 168(g)).

o General Rules

The Proposed Regulations contain many useful clarifications with regard to UBIA. First, the Proposed Regulations confirm that the phrase "immediately after acquisition" means the date on which property is placed in service.[13] Second, the regulations clarify that a taxpayer's decision to take bonus depreciation with regard to property does not affect the property's applicable recovery period. Further, UBIA generally equals the taxpayer's basis of property determined under section 1012 or other provisions (subchapter C, subchapter K, etc.), but is determined without regard to adjustments under section 1016, for tax credits, or for section 179 or for adjustments made to the basis of the assets of a partnership under either section 734 or section 743. Finally, the Proposed Regulations provide an anti-abuse rule pursuant to which the basis of property generally is not included in UBIA if a taxpayer acquires the property within 60 days of the end of tax year and disposes of it within 120 days unless the property was used in the trade or business for at least 45 days before being disposed of; in such a case, the basis may be included in UBIA if the taxpayer demonstrates that the principal purpose of the acquisition and disposition was not to increase the Wage and Basis Limitation. Because of its anti-abuse nature, the latter rule is proposed to be effective as of the date of section 199A's enactment.

<u>Planning Point</u>

If the Proposed Regulations are finalized without change, taxpayers should consider section 199A when planning for the acquisition of a portion of a business operated in partnership form and for the disposition of assets. For instance, it may be advantageous to purchase (or be treated as purchasing) assets of a partnership rather than an interest in the partnership. Further, it may be beneficial to delay the disposition of an asset with UBIA until after the end of the tax year.

o Nonrecognition Exchanges

The Proposed Regulations also provide rules that may be controversial relating to the determination of a taxpayer's recovery period and UBIA with respect to assets received in certain nonrecognition exchanges, such as a contribution of property to a corporation subject to section 351 or a contribution of property to a partnership subject to section 721. In these situations, for purposes of determining the depreciable period of the property for the corporation or partnership, the portion of the transferee's basis in the property that equals the transferor's basis therein is treated as placed in service when the property was placed in service; any excess basis is treated as placed in service on the date of the

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[13] In this regard, the Proposed Regulations follow section 168(i)(6) and treat improvements as separate property.

transfer. In the case of a like-kind exchange under section 1031, similar rules apply to a taxpayer's exchanged basis and excess basis.[14]

However, a different set of rules applies in determining the UBIA of the property received in the nonrecognition exchange. Specifically, the UBIA of the property is determined on the date that the acquired property is placed in service by the transferee. The IRS and Treasury appear to have adopted the rules regarding the determination of the depreciable period to prevent the manipulation of the depreciable period of property through transactions with related parties. While that concern is understandable, the IRS and Treasury also seem to have determined that a nonrecognition exchange is an "acquisition" of property for purposes of determining UBIA. In combination, these two rules provide the worse possible scenario for a partnership or corporation receiving property in a nonrecognition exchange—(1) the depreciable period with respect to contributed property generally carries over (and thus will reduce the period during which the property is included in the UBIA of the trade or business operated by the partnership or S corporation; and (2) the only basis that is included in UBIA is the basis in the property existing at the time of the transfer.

To illustrate the application of these rules, assume that A, an individual, acquires for $100 Asset A, an asset that is qualified property and depreciable using straight-line depreciation over a five-year useful life for $100. A uses the asset in a QTB. For purposes of determining the trade or business's UBIA with respect to Asset A, the property has a $100 unadjusted basis and a depreciable period of ten years (i.e., the greater of its five-year useful life and ten years). A's trade or business depreciates the property for two years. Although this depreciation reduces A's actual tax basis in the property to $60, it does not affect the UBIA with respect to it. Thus, at the end of the two-year period, A's depreciable period with respect to the property has eight years remaining and the UBIA in the property is $100.

At the beginning of the third year, A contributes Asset A to X, a newly formed S corporation, in exchange for all the outstanding stock in X; X continues to use Asset A in the same trade or business, now operated by A through X, rather than directly. Assume that no gain or loss is recognized on the exchange pursuant to section 351. In this case, X's depreciable period with respect to Asset A will be the eight years remaining in A's depreciable period. However, X's UBIA of the property will not equal A's $100 UBIA. Rather, it will equal A's $60 adjusted tax basis in the Asset A.

As the example illustrates, the Proposed Regulations essentially eliminate a portion of the basis in qualified property from the calculation of UBIA with regard to the trade or business. This seems like a rather draconian result, particularly when the property is used in the same trade or business before and after the transfer. The rationale for this rather harsh result is unclear. The IRS and Treasury could easily have adopted principles like those in section 168(i)(7), which provides that in the case of property transferred in a section 351 or section 721 exchange, the transferee is effectively treated for depreciation purposes as the transferor with regard to the transferee's basis in the property that is equal to the transferor's basis therein. Applying these principles, the IRS and Treasury presumably could

[14] A special rule applies if a taxpayer makes an election not to apply section 1.168-6. In such case, then the taxpayer's basis and depreciable period with respect to the property begins when the taxpayer places the replacement property in service.

have concluded that a transferee's recovery period and its UBIA in transferred property carried over from the transferor (at least to the extent of the transferor's basis in the property).

Instead of doing so, the IRS and Treasury appear to have focused on the treatment of the nonrecognition transaction as an "acquisition" for purposes of section 199A. By adopting this focus, the IRS may have felt bound to look only to the corporation's or partnership's property at the time it was acquired. However, this is arguably contrary to the Proposed Regulations conclusion that a property's UBIA is determined on the date the property was placed in service, because property transferred in a section 351 or section 721 transaction generally is treated as placed in service on the date the transferor placed it in service.

Again, it is unclear why the IRS and Treasury chose this path. At first blush, it may be because the government did not feel that it was appropriate for partners or shareholders other than the transferor of property to reap the benefit of the "excess" UBIA (the difference between the transferor's UBIA and the transferor's actual tax basis at the time of the transfer). However, that does not account for why the same rule would apply in the context of a section 351 contribution to a wholly owned corporation or to a section 1031 exchange. Moreover, if that was the concern, it could have been addressed by providing that the excess UBIA was only included in determining the allocable share of UBIA of the transferring partner or shareholder. It seems likely the IRS and Treasury will receive comments critical of this provision prior to adoption of final regulations.

Planning Point

If the Proposed Regulations are finalized without change, a taxpayer with a qualified trade or business should consider any impact on the amount of its Section 199A Deduction before transferring property in a nonrecognition exchange. For instance, if qualified property is held in a disregarded entity that becomes a partnership with the admission of an additional partner under Revenue Ruling 99-5 or becomes classified as an S corporation as the result of certain elections, what appears to be simple changes in who operates the trade or business may inadvertently reduce the amount of any Section 199A Deduction available with respect to the trade or business.

- ### Partner's or Shareholder's Share of UBIA

As noted above, the Section 199A Deduction may be available with regard to a partner's or S corporation shareholder's share of income of a trade or business operated by a partnership or an S corporation. Section 199A(f)(1)(A)(iii) provides that each partner or shareholder is treated as having UBIA in an amount equal to the partner's allocable share of the UBIA. For this purpose, the partner's or shareholder's allocable share of UBIA is determined in the same manner as the partner's or shareholder's allocable share of depreciation.

The Proposed Regulations clarify the manner of determining a partner's or shareholder's allocable share of depreciation for this purpose. Specifically, a partner's allocable share of UBIA generally is an amount that bears the same proportion to total UBIA as a partner's or a shareholder's share of tax depreciation bears to the entity's total tax depreciation attributable to the property for the year (the "general depreciation rule"). However, a partner's allocable share of depreciation with respect to property that does not give rise to depreciation (i.e., is still in the section 199A "recovery period" but has been fully depreciated for federal tax purposes) is based on how gain with respect to property would be allocated under section 704(b) and section 704(c) if property were sold (the "exception"). In both cases, special allocations of depreciation or gain to a partner may affect the partner's relative shares of depreciation (and thus the partner's relative shares of UBIA).

When read together, the general depreciation rule and the exception create some uncertainty. The general depreciation rule appears to provide that a partner's allocable share of depreciation is determined by reference to a ratio calculated as the total amount of tax depreciation allocated to the partner for the tax year over the total amount of the partnership's tax depreciation for the year; that ratio is then multiplied by the partnership's total UBIA for the year. In other words, the determination appears to be made not on a property by property basis, but rather as a percentage of total depreciation with respect to all of the partnership's assets. If that is the case, then it is unclear when and how the second part of the rule applies.

Under the exception, however, a partner's allocable share of depreciation "with respect to property that does not give rise to depreciation" is based on how tax gain would be allocated if the property were sold. This language implies a property by property determination with regard to assets that are still in the recovery period but no longer giving rise to tax deprecation. When read with the general rule, it is unclear how to apply the rules when a partnership has several assets that have UBIA, all but one of which are still being depreciated for tax purposes. Because at least some of the assets of the partnership are still giving rise to tax depreciation deductions, is a partner's allocable share of depreciation calculated and that ratio applied to the partnership's total UBIA? This reading seems to make the most sense, as it would apply the exception only in cases in which it was necessary to do so because there was no other way to calculate the necessary ratio.

Alternatively, is the one asset that is no longer being depreciated for tax purposes "separated from the pack," with a partner's share of UBIA with regard to that one asset determined separately from the determination with respect to the other assets? If the latter is the case, why did the IRS feel the need to provide a different rule for that property, as opposed to using the ratio determined in the aggregate with respect to other assets? Regardless, the Proposed Regulations create an interesting situation as it relates to depreciable section 704(c) property contributed to a partnership with a built-in gain. While that property is actually being depreciated, a disproportionately large amount of tax depreciation may be allocated to the non-contributing partner; as a result, the non-contributing partner's share of UBIA for those tax years may be disproportionately high. However, when the property is fully depreciated for tax purposes, a disproportionately large amount of the gain with respect to the property will be allocated to the contributing partner. Thus, the partner's relative shares of the partnership's UBIA will "flip" in the first year during which there is not tax depreciation with respect to the property.

Planning Point

For taxpayers that have a qualified trade or business, the allocation of depreciation with respect to qualified property may affect the amount of the Section 199A Deduction for individual partners. Special allocations of book income under section 704(b), tax allocations under section 704(c), and fair market value determinations may all affect the section 199A outcome and thus should be considered in connection with the formation and operation of the partnership.

The determination of an S corporation shareholder's allocable share should be easier, given that no special allocations of income or deduction are permitted. However, the Proposed Regulations provide uncertainty in this regard as well. Under the Proposed Regulations, an S corporation shareholder's allocable share of depreciation is based on the ratio of the number of shares owned by the shareholder divided by the total number of shares in the S corporation. Although this calculation will be simple if there are no changes in stock ownership during the year, the rule does not seem to provide a method for making the calculation when shares change hands during the tax year. In these situations, the S corporation rules generally apply a per share/per day rule for allocating the income, gain, loss, and deduction of the S corporation (although a closing of the books may be used in certain situations). It seems that a more accurate calculation of an S corporation shareholder's allocable share of depreciation should use a ratio determined as the S corporation shareholder's allocable share of income (or loss) of the S corporation divided by the total income (or loss) of the S corporation for the year. Given the inability of an S corporation to make special allocations, that ratio would take into account changes in share ownership during the year and should also provide the appropriate policy result. Thus, in this regard, the Proposed Regulations appear to have made the determination of an S corporation shareholder's allocable share of depreciation more difficult that it needs to be.

Aggregation of Separate Trades or Businesses

The Proposed Regulations make clear that QBI and the Limitations are calculated on a basis of an individual trade or business. Although the Proposed Regulations clearly indicate that one entity may be in more than one trade or business, the Preamble indicates that the converse generally is not the case. Specifically, in the Preamble the IRS and Treasury state their view that one trade or business generally may not be operated through more than one entity. This view raises issues in situations in which wages or basis are in one entity that does not create a lot of income, while a related entity has a lot of income but not a lot of wages or basis.

The most common example of this situation likely is a payroll entity that employs the employees necessary for a related operating business, and then leases those employees to the related operating entity at a cost-plus margin. In that case, the payroll entity may have a substantial amount of W-2 wages, but very little income. In contrast, the operating entity may have a significant amount of income, but no W-2 wages. In light of this and similar situations, commentators had suggested that the IRS and Treasury permit the aggregation of trades or businesses (including those operated by different entities) relying on the grouping rules of section 469 relating to passive losses. In the Preamble, the IRS specifically rejected this approach. Instead, the Proposed Regulations provide that an individual taxpayer—not a partnership or an S corporation—may (but does not have to) aggregate trades or businesses, but only if certain requirements are met. Specifically, aggregation is allowed for two or more trades or businesses only if:

1) None of the businesses is an SSTB;
2) The same persons directly or indirectly own a majority interest in each of the businesses (in this regard, it is not clear whether "indirect" ownership allows an individual to look through a corporation to its shareholders);
3) All the items related to the trades or businesses are reported on returns with the same tax year; and
4) The businesses meet two of three factors that establish what the IRS thinks of as a symbiotic relationship between the businesses. Specifically, the trades or businesses must satisfy two of the following:
    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.

Absent satisfaction of these requirements, aggregation is not allowed under the Proposed Regulations—even if the wages paid arguably directly relate to the income produced.

<u>Planning Point</u>

The Proposed Regulations did not adopt the aggregation standards of section 469. As a result, common control is not relevant in determining whether businesses may be aggregated. Thus it is important to ensure that common ownership is maintained to the extent that the taxpayer desires to aggregate the trades or businesses for purposes of section 199A.

It is important to note that, if aggregation is available, it is only available (and must be elected at the individual taxpayer level. Thus, a partnership or S corporation engaged in multiple trades or businesses (or owning interests in multiple entities each in a trade or business) may not choose to aggregate trades or businesses. Instead, the entity—including an upper-tier holding company—has to report the relevant items from each trade or business separately. It is then up to the individual to determine whether and to what extent it can aggregate (and whether it wants to aggregate). Under these rules, it is easy to foresee significant additional compliance costs for passthrough entities in certain situations, as the entities will be required to provide the information necessary for their individual partners to determine whether they can aggregate—that's in addition to the information that partnerships and S corporations are already required to provide with regard to QBI, UBIA, and W-2 wages.

Although it does seem to increase complexity, individual aggregation also creates flexibility, as individual members of the same passthrough entities are not required to aggregate in the same manner (or to aggregate at all). Further, if the majority owners of one or more trades or businesses may aggregate the trades or businesses, the Proposed Regulations allow the minority owners of the those trades or businesses to aggregate—apparently regardless of whether the majority owners aggregate or aggregate in a different manner.

Once made, a decision to aggregate is binding. Thus, if an individual decides to aggregate certain businesses, the individual generally must consistently report the businesses as aggregated in future years. The Proposed Regulations allow newly formed or acquired entities to join an aggregated group, and for trades or businesses that no longer qualify for aggregation to drop out. If an individual aggregates businesses, individual must report its aggregation to the IRS annually. The Proposed Regulations grant the IRS the authority to disaggregate trades or businesses if the reporting requirement is not met.

Specified Service Trades or Business

One area relating to the availability of a Section 199A Deduction that required significant clarification in the Proposed Regulations was the definition of an SSTB. As described above, income of an SSTB generally is not QBI (and thus not eligible for the Section 199A Deduction) unless an individual taxpayer has taxable income above the Threshold Amount. Moreover, none of the W-2 wages or UBIA of an SSTB may be taken into account by an individual with taxable income above the Threshold Amount. For this purpose, section 199A(d)(2) defines an SSTB as—

- 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 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, and

- 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)).

Items Attributable to an SSTB

The Proposed Regulations provide that if a trade or business is an SSTB, none of the income from that trade or business allocable to an owner (even a passive owner) with taxable income above the Threshold Amount generally is QBI. Application of this rule is illustrated by a curious example. Specifically, the Proposed Regulations contain an example in which a partnership owns and operates a professional sports team. The partnership employs athletes and sells tickets to the public for games in which the team competes. In the example, the IRS and Treasury conclude that the partnership is an SSTB because it is in the field of athletics. Thus, none of its income is eligible for the Section 199A

Deduction in the hands of a partner with taxable income above the Threshold Amount—even if that partner is a passive investor in the partnership that does not perform services in the field of athletics itself. Although this example illustrates an important point, it appears to be inconsistent with the definition of the performance of services in the field of athletics set forth in the Proposed Regulations. We focus on that discrepancy below.

Under the Proposed Regulations, a determination as to whether a trade or business operated by a partnership or S corporation is an SSTB is made by the entity itself. The entity then discloses that information to its owners. In making this determination, the entity must consider several rules contained in the Proposed Regulations. Under the Proposed Regulations, income from an SSTB generally is "bad" income, even if it is derived from an activity that is not itself an SSTB. So, if a trade or business is an SSTB, the "taint" applied to SSTB income and other items applies to all the items of the trade or business.

The Proposed Regulations do provide a de minimis rule pursuant to which a trade or business is not an SSTB if it provides only a small amount of services in a specified activity. Specifically, a trade or business is not an SSTB if less than five percent (10 percent in the case of a trade or business with gross receipts of $25 million or less) of its gross receipts are attributable to the performance of services in an SSTB (the "De Minimis Threshold"). This rule may prove quite useful for trades or businesses that generally are not in a SSTB, but do (as a necessary part of the trade or business) provide limited services in a prescribed field (such as limited consulting services or the like). Note, however, that in determining whether the five or 10 percent of gross receipts standard is met, the performance of any activity "incident" to the actual performance of services in the field is considered the performance of services in that field.[15]

Although the de minimis rule may be favorable, the Proposed Regulations provide other rules that may cause what appears to be a qualified business to be treated as an SSTB. To put this in context, the exclusion of "bad" income from an SSTB from the Section 199A Deduction raises the question of whether you can separate good income from bad either by arguing that one entity has two separate trades or businesses or through restructuring by transferring one trade or business into another entity. Consider an example in which a building is owned by a partnership that operates a medical practice. The offices of the practice are on the ground floor of the building, but the remaining space in the building is leased to other, unrelated businesses. In that case, the question is whether the "good" rental income may be separated from the "bad" income from the medical practice, such that the individual owners of the practice are eligible for the Section 199A Deduction with respect to the rental income.

Dividing the ownership of the building and the practice between two separate entities would seem to establish that they are two separate trades or businesses under the Proposed Regulations (although it would require the entity owning the building to lease a portion of the building to the entity operating the

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[15] The regulatory language itself does not shed light on the meaning of the word "incident" for this purpose (but as discussed below do provide rules treating "incidental" trades or businesses as part of an SSTB. It is not clear whether "incident" for purposes of the 10 (or five) percent standard has the same meaning.

medical practice). However, the IRS and Treasury were aware that taxpayers were considering restructuring for this purpose. In response, the IRS and Treasury included what they view as anti-abuse rules in the Proposed Regulations. These rules, which are proposed to be effective on the date of enactment of section 199A, provide that an SSTB includes any trade or business that provides 80 percent or more of its property or services to an SSTB with 50 percent or more common ownership.[16]

Failure to reach the 80 percent level does not mean a taxpayer is in the clear. Rather, if a trade or business provides less than 80 percent of its property or services to a commonly owned SSTB, then a proportionate amount of the income is treated as part of the SSTB. Applying that rule to the example, if the building and the medical practice are split between commonly owned entities, then if 80 percent or more of the building is leased to the medical practice, all the rental income will be bad. On the other hand, if 30 percent of the building is from leasing part of the building to the medical practice, then 30 percent of the rental income will be treated as bad income from an SSTB.

These rules will limit the ability to successfully separate a good trade or business from an SSTB. Further, if separation into two or more entities would accomplish the desired result, it may be difficult for entities—particularly regulated entities—to restructure into separate entities. In these cases, the only remaining option appears to be developing an argument that the activities are two separate trades or businesses relying on the authorities in section 162(a); that may involve looking at whether there are separate books and records, separate customers and employees, a lack of interdependence in operations, and other factors.

Planning Point

Although the de minimis rule is favorable because it prevents a de minimis amount of SSTB activity from tainting an otherwise qualified trade or business, under the Proposed Regulations once the amount of SSTB activity exceeds the De Minimis Threshold, it appears the result is that the entire trade or business is an SSTB. Thus, it is important to identify any amount of income of the trade or business derived from activity that is an SSTB, determine whether it is (or is expected ever to be) in excess of the De Minimis Threshold and, if so, consider whether it is possible to separate the activities into two trades or business that are then not subject to the mandatory aggregation rules perhaps by directly billing to customers rather than providing goods or services to a related entity.

[16] For this purpose, common control includes direct or indirect ownership by related parties within the meaning of section 267(b) or section 707(b). This standard may be different than the standard for determining whether aggregation is permitted, as that standard looks to whether the majority of the interests in an entity are owned directly or indirectly by the same persons or groups of persons.

Clarification Regarding Listed Fields

As described above, section 199A defines an SSTB as—(1) 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 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, and (2) 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)) (the "Specified Fields"). The Proposed Regulations provide clarifications with regard to the Specified Fields.

First, section 199A specifically references section 1202(e)(3)(A) and the legislative history accompanying enactment of section 199A refers to similar language in section 448; the Preamble provides that guidance under these Code sections was informed by interpretations of those provisions when appropriate. However, the Preamble clearly indicates the government's intent that the guidance on these issues in the Proposed Regulations applies only to section 199A and not to section 1202 or section 448. Guidance under section 199A applies for its purposes only, and not for section 448 or section 1202. The specific definitions of the performance of services in the Specified Fields are described below.

1) Health

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.

2) Law

The provision of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. The term does not include services that do not require skills unique to the field of law.

3) Accounting

The provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals in their capacity as such. The term includes the performance of services within the common understanding of accounting, 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 certified public accountant). However, the performance of services in the field of accounting does not include payment processing and billing analysis.

4) Actuarial science

The provision of services by actuaries and similar professionals in their capacity as such. The term 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.

5) Performing arts

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

6) Athletics

The performance of services in the field of athletics includes 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. However, it 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.

This definition of the performance of services in the field of athletics is similar to that of the performance of services in the performing arts (i.e., it appears to limit an SSTB to a business conducted by individuals who actually participate in an athletic completion, be it athletes, coaches, or managers. This is consistent with the interpretation of the field of performing arts under section 448. Under this definition, many practitioners anticipated that an individual athlete may not be allowed a Section 199A Deduction with respect to its income attributable to participation in his or her sport (either because it is paid to the athlete as an employee or flows through a passthrough entity set up by the athlete to receive those wages). However, the same practitioners may have concluded that the owners of a sports franchise should be eligible for the Section 199A Deduction because the owners themselves are not involved in the performance of services in the field of athletics. Rather, they are in the trade or business of operating a sports franchise, which involves only “off the field” activities.

This definition of the performance of services in the field of athletics appears to be contrary to an example provided in the Proposed Regulations (and described in the Preamble). As noted above, the Proposed Regulations contain an example in which a partnership owns and operates a professional sports team. The partnership employs athletes and sells tickets to the public for games in which the team competes. In the example, the IRS and Treasury conclude that the partnership is an SSTB because it is in the field of athletics. Thus, none of its income is eligible for the Section 199A Deduction in the hands of a partner with taxable income above the

Threshold Amount. This example is either—(1) inconsistent with the definition of the field of athletics in the Proposed Regulations; or (2) an indication that the IRS and Treasury did not appreciate the manner in which many professional sports teams are owned and operated.

The definition of the field of athletics appears to be directed at those that actually participate in a sport; those participants generally do not own an interest in the partnership or S corporation operating the sports franchise. Rather, the actual players generally receive wages from the sports franchise. Moreover, the example appears to be based on a belief that the income of a sports franchise is attributable only to ticket sales. In actual fact, ticket sales may represent a small portion of the income of a sports franchise. Many—if not all—of those franchises derive the majority of their income from broadcast revenues, licensing, advertisement, concessions, and other sources. In light of this, it is likely the IRS will receive comments regarding the example and its apparent inconsistency with the regulatory definition of the field of athletics.

7) Consulting

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. However, the term does not include the performance of services other than advice and counsel, nor does it include consulting that is embedded in, or ancillary to, the sale of goods if there is no separate payment for the consulting services.

8) Financial services

The provision of services typically performed by financial advisors and investment bankers, including the provision to clients of financial services such as 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. The term 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.

The clarification of financial services in the Proposed Regulations eliminated uncertainty for S corporation banks and their shareholders. Section 1202(e)(3)(A) (the primary basis of the definition of an SSTB under section 199A) includes any trade or business involving he performance of services in the field of "financial services." However, section 1202(e)(B)—which is not referenced by section 199A—includes the trade or business of "banking." Applying ordinary rules of statutory construction, it appeared that "banking" was not included in financial services. However, the specific clarification by the Proposed Regulations should provide more certainty.

9) Brokerage services

The provision of 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.

10) Investment and investment management

The performance of services in a trade or business consists of investment and investment management includes 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. This includes 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. The performance of services of investing and investment management does not include directly managing real property.

11) Trading

A trade or business is in the performance of services in a trade or business of trading if it earns fees for investment, asset management services, or investment management services including providing advice with respect to buying and selling investments. This includes 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, it does not include the performance of services of investing and investment management does not include directly managing real property.

12) Dealing in securities, partnership interests, or commodities

A trade or business of dealing in securities, partnership interests, or commodities means regularly purchasing the relevant asset from *and* selling the relevant asset 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.[17] For this purpose, 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.

The final category of business included in the definition of an SSTB is a trade or business the principal asset of which is the skill or reputation of one or more of its owners or employees. Prior to publication of the Proposed Regulations, many practitioners worried that a broad interpretation of this rule could result in treatment as an SSTB of virtually any business operated in the name of an owner or employee, or any business that was successful as a result of the personal reputation or skill of an owner. This could

[17] Note that the highlighted "and" differs from the "or" that appears in the same place in the section 475(c) definition of a "dealer in securities." Presumably, this difference was deliberate and therefore significant.

result in the denial of a Section 199A Deduction to businesses such as a “Joe the Plumber” or “Mom and Pop’s Corner Store” that Congress likely intended to be eligible for the deduction.

In the Preamble, the government expresses its view that this rule was intended to describe a narrow set of trades or businesses not otherwise enumerated. In light of this view, the IRS and Treasury limit the meaning of the “reputation or skill” clause to fact patterns in which an individual or passthrough entity is engaged in the trade or business of—(1) receiving income for endorsing products or services (including an individual’s share of income or distributions from a passthrough entity for which the individual provides endorsement services); (2) licensing or receiving income for the use of an individual’s image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual’s identity (including an individual’s distributive share of income or distributions from a passthrough entity to which an individual contributes the rights to use the individual’s image); or (3) 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).

This interpretation of the language in section 199A significantly limits the number of businesses that should be concerned about being ineligible for the Section 199A Deduction under this provision. However, it also raises certain questions. The Proposed Regulations appear to provide that a trade or business is an SSTB under the limited meaning of the reputation or skill clause only with respect to the individual that actually endorses a product, licenses its image or other symbols, or receives appearance of other fees for performances. This seems directly contrary to the determination and treatment of an SSTB in other situations. To put it in context, consider an example provided in the Proposed Regulations.

In Example 9 of Proposed section 1.199A-5(b)(3), J (a well-known actress) enters into a partnership with a shoe company. J in which J contributes her likeness and the use of her name to the partnership in exchange for a 50 interest in the capital and profits of the partnership and a guaranteed payment. In the example, the IRS and Treasury conclude that J’s trade or business consisting of the receipt of the partnership interest and the corresponding distributive share with respect to the partnership interest for J’s likeness and the use of her name is an SSTB. By its very wording, the example seems to treat J as in the trade or business of receiving a partnership interest and the corresponding distributive share of the partnership’s income and other items in exchange for use of her likeness and name.

This contrasts to the apparent treatment under the Proposed Regulations of other types of SSTBs. Consider a situation in which A, an individual, is a member of a partnership composed of a number of attorneys engaged in the practice of accounting. A received his interest in (and continues to be allocated income of) the partnership as a result of his performance of services for the partnership as well as a relatively small investment of capital. In such a situation, the Proposed Regulations appear to provide that the determination of whether the partnership’s trade or business is an SSTB is made at the partnership level and, if so, income and other items of the partnership would not be calculated in calculating A’s eligibility for a Section 199A Deduction (assuming A’s taxable income is above the Threshold Amount)—regardless of whether A continues to perform services on behalf of the partnership or whether A is even an accountant or performs accounting related services.

In contrast, whether a business operated by a passthrough entity is an SSTB because its primary asset is the reputation or skill of one or more employees appears to be determined at the owner level. Thus, income of a partnership attributable to the manufacturing of shoes (which ordinarily would be QBI and potentially eligible for the Section 199A Deduction) becomes ineligible for the deduction in an owner's hands apparently because the owner is treated as being in the trade or business of receiving a partnership interest (and an allocation of partnership income) for use of its likeness.

Trade or Business as an Employee

QBI also does not include the trade or business of performing services as an employee. The Proposed Regulations provide that an individual is an employee for this purpose if the individual is an employee under common law and statutory rules for determining the employee-employer relationship. The Proposed Regulations specifically provide that an employer's treatment of a service provider by an employer as something other than an employee for employment tax purposes does not affect this determination. Thus, if a service provider should be properly classified as an employee under common law and statutory rules but is treated by an employer as an independent contractor, the service provider will be treated as an employee regardless of the employer's treatment.

The Proposed Regulations go even further in distinguishing between an employee and an independent contractor. Specifically, if an employer improperly treats an individual service provider as an independent contractor, the employee is in the trade or business of employee regardless of the employer's improper treatment. Further, if a former employee is later treated as other than an employee (e.g., an independent contractor, the service provider's income is presumed to be earned as an employee; that presumption may be rebutted by the individual by showing that, under federal tax law, regulations and principles (including the common-law employee classification rules), the individual is performing services in a capacity other than as an employee. Because of their anti-abuse nature, the rules relating to the treatment of employees and independent contractors are proposed to be effective as of the date of section 199A's enactment.

Conclusion

This article is intended to provide an overview of section 199A statute, highlighting certain rules in the Proposed Regulations and their implications. However, the Proposed Regulations are still relatively new, so no doubt new issues and interpretations will arise. There is every indication that the IRS and Treasury intend to finalize the regulations prior to the end of 2018 or shortly thereafter. Thus, taxpayers will need to consider the current Proposed Regulations in their federal tax planning, but will also need to keep watch for any changes that are made in the final regulations, other guidance, and the 2018 forms in the near future.

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