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Preamble to Proposed Section 199A Regulations

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 199A and 643 of the Code.

I. Section 199A

Section 199A was enacted on December 22, 2017, by §11011 of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-97 (TCJA), and was amended on March 23, 2018, retroactively to January 1, 2018, by §101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141, (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026.

Section 199A provides a deduction of up to 20 percent of income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate (section 199A deduction). The section 199A deduction may be taken by individuals and by some estates and trusts. A section 199A deduction is not available for wage income or for business income earned through a C corporation. For taxpayers whose taxable income exceeds a statutorily-defined amount (threshold amount), section 199A may limit the taxpayer's section 199A deduction based on (i) the type of trade or business engaged in by the taxpayer, (ii) the amount of W-2 wages paid with respect to the trade or business (W-2 wages), and/or (iii) the unadjusted basis immediately after acquisition (UBIA) of qualified property held for use in the trade or business (UBIA of qualified property). These statutory limitations are subject to phase-in rules based upon taxable income above the threshold amount.

Section 199A also allows individuals and some trusts and estates (but not corporations) 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 W-2 wages or UBIA of qualified property.

The section 199A deduction is the lesser of (1) the sum of the combined amounts described in the prior two paragraphs or (2) 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.

Additionally, section 199A(g) provides that specified agricultural or horticultural cooperatives may claim a special entity-level deduction that is substantially similar to the domestic production activities deduction under former section 199.

Finally, the statute expressly grants the Secretary authority to prescribe such regulations as are necessary to carry out the purposes of section 199A (section 199A(f)(4)), and provides specific grants of authority with respect to: The treatment of acquisitions, dispositions, and short-tax years (section 199A(b) (5)); certain payments to partners for services rendered in a non-partner capacity (section 199A(c)(4)(C)); the allocation of W-2 wages and UBIA of qualified property (section 199A(f)(1)(A) (iii)); restricting the allocation of items and wages under section 199A and such reporting requirements as the Secretary determines appropriate (section 199A(f)(4)(A)); the application of section 199A in the case of tiered entities (section 199A(f) (4)(B)); preventing the manipulation of the depreciable period of qualified property using transactions between related parties (section 199A(h)(1)); and determining the UBIA of qualified property acquired in like-kind exchanges or involuntary conversions (section 199A(h)(2)).

II. Section 643

Part I of subchapter J of chapter 1 of the Code provides rules related to the taxation of estates, trusts, and beneficiaries. For various subparts of part I of subchapter J, sections 643(a), 643(b), and 643(c) define the terms distributable net income (DNI), income, and beneficiary, respectively. Sections 643(d) through 643(i) (other than section 643(f)) provide additional rules. Section 643(f) grants the Secretary authority to treat two or more trusts as a single trust for purposes of subchapter J if (1) the trusts have substantially the same grantors and substantially the same primary beneficiaries and (2) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1 of the Code. Section 643(f) further provides that, for these purposes, spouses are treated as a single person.

Explanation of Provisions

The purpose of these proposed regulations is to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 199A. These proposed regulations contain six substantive sections, §§1.199A-1 through 1.199A-6, each of which provides rules relevant to the calculation of the section 199A deduction. Additionally, the proposed regulations would establish anti-abuse rules under 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, including abuse of section 199A. This Explanation of Provisions describes each of the proposed regulation sections in turn.

I. Proposed §1.199A-1: Operational Rules

Section 1.199A-1 of the proposed regulations (proposed §1.199A-1) provides guidance on the determination of the section 199A deduction. For simplicity, the proposed regulations use the term individual when referring to an individual, trust, estate, or other person eligible to claim the section 199A deduction. The term relevant passthrough entity (RPE) is used to describe passthrough entities that directly operate the trade or business or pass through the trade or business' items of income, gain, loss, or deduction from lower-tier RPEs to the individual.

Proposed §1.199A-1(b) contains definitions applicable for section 199A and §§1.199A-1 through 1.199A-6. Proposed §1.199A-1(c) provides guidance on the computation of the section 199A deduction for individuals with taxable income at or below the threshold amount. Proposed §1.199A-1(d) provides guidance on the computation of the section 199A deduction for individuals with taxable income above the threshold amount, including individuals with taxable income within a phase-in range above the threshold amount. Proposed §1.199A-1(e) provides special rules related to the section 199A deduction.

A. Defined Terms

Defined terms in proposed §1.199A-1(b) include aggregated trade or business, applicable percentage, phase-in range, qualified business income (QBI), QBI component, qualified PTP income, qualified REIT dividends, reduction amount, RPE, specified service trade or business (SSTB), threshold amount, total QBI amount, UBIA of qualified property, and W-2 wages.

Proposed §1.199A-1(b) also defines trade or business for purposes of section 199A and proposed §§1.199A-1 through 1.199A-6. Neither the statutory text of section 199A nor the legislative history provides a definition of trade or business for purposes of section 199A. Multiple commenters stated that section 162 is the most appropriate definition for purposes of section 199A. Although the term trade or business is defined in more than one provision of the Code, the Department of the Treasury (Treasury Department) and the IRS agree with commenters that for purposes of section 199A, section 162(a) provides the most appropriate definition of a trade or business. This is based on the fact that the definition of trade or business under section 162 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. Thus, the definition of a trade or business under section 162 provides for administrable rules that are appropriate for the purposes of section 199A and which taxpayers have experience applying and therefore defining trade or business as a section 162 trade or business will reduce compliance costs, burden, and administrative complexity.

The proposed regulations extend the definition of trade or business for purposes of section 199A beyond section 162 in one circumstance. 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 under proposed §1.199A-4(b)(1)(i). It is not uncommon that for legal or other non-tax reasons taxpayers may segregate rental property from operating businesses. This rule allows taxpayers to aggregate their trades or businesses with the associated rental or intangible property under proposed §1.199A-4 if all of the requirements of proposed §1.199A-4 are met. In addition, this rule may prevent taxpayers from improperly allocating losses or deductions away from trades or businesses that generate income that is eligible for a section 199A deduction.

B. Computation of the Section 199A Deduction for Individuals With Taxable Income Below the Threshold Amount

1. Basic Computational Rules

An individual with income attributable to one or more domestic trades or businesses, other than as a result of owning stock of a C corporation or engaging in the trade or business of being an employee, and with taxable income (before computing the section 199A deduction) at or below the threshold amount, is entitled to a section 199A deduction equal to the lesser of (i) 20 percent of the QBI (generally defined as the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business of the taxpayer) from the individual's trades or businesses plus 20 percent of the individual's combined qualified REIT dividends and qualified PTP income or (ii) 20 percent of the excess (if any) of the individual's taxable income over the individual's net capital gain. Proposed §1.199A-1(c) contains guidance on calculating the amount of the deduction in these circumstances. If an individual's combined QBI is negative or combined qualified REIT dividends and PTP income is less than zero, proposed §1.199A-1(c)(2) provides rules for the carryover of the losses.

2. Carryover Loss Rules for Negative Total QBI Amounts

If an individual has multiple trades or businesses, the individual must calculate the QBI from each trade or business and then net the amounts. Section 199A(c)(2) provides that, for purposes of section 199A, 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. Proposed §1.199A-1(c)(2)(i) repeats this rule and provides that the section 199A carryover rules do not affect the deductibility of the losses for purposes of other provisions of the Code.

3. Carryover Loss Rules if Combined Qualified REIT Dividends and Qualified PTP Income is Less Than Zero

One commenter stated it was not clear whether, if a taxpayer has an overall loss from combined qualified REIT dividends and qualified PTP income (because a loss from a PTP exceeds REIT dividends and PTP income), the negative amount should be netted against any net positive QBI (regardless of source), or whether the negative amount should be segregated and subject to its own loss carryforward rule distinct from but analogous to the QBI loss carryforward rule. Section 199A contemplates that qualified REIT dividends and qualified PTP income are computed and taken into account separately from QBI and should not affect QBI. If overall losses attributable to qualified REIT dividends and qualified PTP income were netted against QBI, these losses would affect QBI. Therefore, a separate loss carryforward rule is needed to segregate an overall loss attributable to qualified REIT dividends and qualified PTP income from QBI. Additionally, commenters have expressed concern that losses in excess of income could create a negative section 199A deduction, a result incompatible with the statute. Accordingly, proposed §1.199A-1(c)(2)(ii) provides that if an individual has an overall loss after qualified REIT dividends and qualified PTP income are combined, the portion of the individual's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. In addition, the overall loss does not affect the amount of the taxpayer's QBI. Instead, such overall loss is carried forward and must be used to offset combined qualified REIT dividends and qualified PTP income in the succeeding taxable year or years for purposes of section 199A.

C. Computation of the Section 199A Deduction for Individuals With Taxable Income Above the Threshold Amount

Proposed §1.199A-1(d) addresses the calculation of the section 199A deduction for individuals with taxable income above the threshold amount. All of the rules relating to the REIT/PTP component of the section 199A deduction applicable to individuals with taxable income at or below the threshold amount also apply to individuals with taxable income above the threshold amount. The QBI component of the section 199A deduction, however, is subject to limitations for individuals with taxable income exceeding the threshold amount. These limitations include the exclusion or reduction of items from an SSTB and limitations based on the W-2 wages of the trade or business or a combination of the W-2 wages and the UBIA of qualified property. Proposed §1.199A-1(d) provides guidance on the application of these limitations.

Proposed §1.199A-1(d)(2)(i) addresses the limitation or exclusion from QBI for SSTBs. SSTBs are specified service trades or businesses as defined in section 199A(d)(2) and proposed §1.199A-5 (see part V. of the Explanation of Provisions). If an individual's taxable income is above the threshold amount but within the phase-in range then the individual must calculate an applicable percentage that limits the QBI, W-2 wages, and UBIA of qualified property from an SSTB that are used to calculate the individual's section 199A deduction. If the individual's taxable income is above the phase-in range, then no amount of QBI, W-2 wages, or UBIA of qualified property from an SSTB can be used by the individual in calculating the individual's section 199A deduction.

Proposed §1.199A-1(d)(iv) addresses the limitations on QBI based on W-2 wages and UBIA of qualified property. An individual must determine the W-2 wages and the UBIA of qualified property attributable to each trade or business contributing to the individual's combined QBI under the rules of proposed §1.199A-2. The W-2 wages and UBIA of qualified property amounts are compared to QBI in order to determine an individual's QBI component for each trade or business.

After determining the QBI for each trade or business, the individual must compare 20 percent of that trade or business' QBI to the alternative limitations for that trade or business. The limitation to which the 20 percent of QBI is compared is the greater of 50 percent of the W-2 wages attributable to the trade or business or 25 percent of those W-2 wages plus 2.5 percent of the UBIA of qualified property for that trade or business. If 20 percent of the QBI of the trade or business is greater than the relevant alternative limitation, the QBI component is limited in the calculations under the proposed regulations to the amount of the alternative limitation. If an individual's taxable income is within the phase-in range and 20 percent of QBI is greater than either of the limitation amounts, the individual's QBI component for the trade or business is instead equal to 20 percent of QBI reduced by the reduction amount as described in proposed §1.199A-1(d)(iv)(B).

One commenter noted that, if combined QBI from all of an individual's trades or businesses is greater than zero, but the individual's QBI from one or more trades or businesses is less than zero, the mechanics of how the loss should be offset against the QBI income for purposes of calculating the section 199A deduction are unclear. How such a loss is allocated matters in situations in which an individual has taxable income above the threshold amount and more than one trade or business with positive QBI. The commenter suggested that a "netting" approach best reflects Congress's intent, and that the absence of a netting approach would lead to inconsistent and counterintuitive results that Congress did not intend. The Treasury Department and the IRS agree that a netting approach is contemplated by the carryforward rule of section 199A(c)(2) and is necessary to ensure results consistent with the intent of section 199A. Accordingly, proposed §1.199A-1(d) (iii) provides that, if an individual has QBI of less than zero from one trade or business, but has overall QBI greater than zero when all of the individual's trades or businesses are taken together, then the individual 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 individual applies the limitations based on W-2 wages and UBIA of qualified property. The individual 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 applying the limitation based on W-2 wages and UBIA of qualified property, the net gain or 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 taken into account for purposes of proposed §1.199A-1(d) and are not carried over into the subsequent year. The Treasury Department and the IRS request comments on the approach described above.

D. Special Rules

Proposed §1.199A-1(e) incorporates special rules contained in sections 199A and 6662. Section 199A(f)(1) provides that in the case of a partnership or S corporation, section 199A is applied at the partner or shareholder level. The proposed regulations provide that the section 199A deduction has no effect on the adjusted basis of the partner's interest in the partnership. With respect to S corporations, the section 199A deduction has no effect on the adjusted basis of a shareholder's stock in an S corporation or the S corporation's accumulated adjustments account.

The proposed regulations provide that the deduction under section 199A does not reduce net earnings from self-employment under section 1402 or net investment income under section 1411. Therefore, both sections 1402 and 1411 are calculated as though there is no section 199A deduction.

Section 199A(f)(1)(C) provides that if in the case of a taxpayer with QBI from within the Commonwealth of Puerto Rico, if such income is taxable under section 1 for a taxable year, then for purposes of determining QBI of such individual for such taxable year, the term "United States" shall include the Commonwealth of Puerto Rico. Proposed §1.199A-1(e)(3) repeats this statutory language.

Section 199A(f)(2) provides that for purposes of determining alternative minimum taxable income under section 55, QBI shall be determined without regard to any adjustments under sections 56 through 59. To clarify that the section 199A deduction does not result in individuals being subject to the alternative minimum tax, proposed §1.199A-1(e)(4) provides that, for purposes of determining alternative minimum taxable income under section 55, the deduction allowed under section 199A(a) for a taxable year shall be equal in amount to the deduction allowed under section 199(A)(a) in determining taxable income for that taxable year.

Section 6662(a) provides a penalty for an underpayment of tax required to be shown on a return. Under section 6662(b)(2), the penalty applies to the portion of any underpayment that is attributable to a substantial understatement of income tax. Section 6662(d)(1) defines substantial understatement of income tax, which is generally an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. Section 6662(d)(1)(C) provides a special rule in the case of any taxpayer who claims the deduction allowed under section 199A for the taxable year, which requires that section 6662(d)(1)(A) is applied by substituting "5 percent" for "10 percent." Proposed §1.199A-1(e)(5) cross-references this rule.

Section 199A(b)(7) provides that in the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the amount determined under section 199A(b)(2) with respect to such trade or business shall be reduced by the lesser of (A) 9 percent of so much of the qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such cooperative, or (B) 50 percent of so much of the W-2 wages with respect to such trade or business as are so allocable. Proposed §1.199A-1(e)(6) repeats this statutory language.

II. Proposed §1.199A-2: Determination of W-2 Wages and the UBIA of Qualified Property

As described in part I.C. of this Explanation of Provisions, if an individual's taxable income exceeds the threshold amount, section 199A(b)(2)(B) imposes a limit on the section 199A deduction based on the greater of either (i) the W-2 wages paid, or (ii) the W-2 wages paid and UBIA of qualified property attributable to a trade or business. This part of this Explanation of Provisions describes the rules in proposed §1.199A-2 regarding the determination of W-2 wages and UBIA of qualified property.

A. W-2 wages Attributable to a Trade or Business

The W-2 wage rules of proposed §1.199A-2 generally follow the rules under former section 199. Section 199, which was repealed by the TCJA, provided for a deduction with respect to certain domestic production activities and contained a W-2 wage limitation similar to the one in section 199A. The legislative text of the W-2 wage limitation in section 199A is modeled on the text of former section 199, and both taxpayers and the IRS have developed experience in applying those

W-2 wage rules for over a decade. The regulations under former section 199 provided rules to determine W-2 wages, which provide a useful starting point in developing the W-2 wage rules under section 199A, including rules on the definition of W-2 wages, wages paid by persons other than the common-law employer, and methods for calculating W-2 wages.

The Treasury Department and the IRS have received comments concerning whether amounts paid to workers who receive Forms W-2 from third party payors (such as professional employer organizations, certified professional employer organizations, or agents under section 3504) that pay these wages to workers on behalf of their clients and report wages on Forms W-2, with the third party payor as the employer listed in Box c of the Forms W-2, may be included in the W-2 wages of the clients of third party payors. In order for wages reported on a Form W-2 to be included in the determination of W-2 wages of a taxpayer, the Form W-2 must be for employment by the taxpayer. The regulations under former section 199, specifically §1.199-2(a)(2), addressed this issue, providing that, since employees of the taxpayer are defined in the regulations as including only common law employees of the taxpayer and officers of a corporate taxpayer, taxpayers may take into account wages reported on Forms W-2 issued by other parties provided that the wages reported on the Forms W-2 were paid to employees of the taxpayer for employment by the taxpayer.

Proposed §1.199A-2(b)(2)(ii) provides a rule for wages paid by a person other than the common law employer that is substantially similar to the rule in §1.199-2(a)(2). Specifically, the proposed regulations provide that, 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. In such cases, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that 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. Under this rule, persons who otherwise qualify for the deduction under section 199A are not limited in applying the deduction merely because they use a third party payor to pay and report wages to their employees. However, with respect to individuals who taxpayers assert are their common law employees for purposes of section 199A, taxpayers are reminded of their duty to file returns and apply the tax law on a consistent basis.

Unlike former section 199, the W-2 wage limitation in section 199A applies separately for each trade or business. Accordingly, proposed §1.199A-2 provides 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. W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI.

Additionally, proposed §1.199A-2(b)(4) restates the rule of section 199A(f)(1)(A)(iii), which provides that, in the case of a trade or business conducted by an RPE, a partner's or shareholder's allocable share of wages must be determined in the same manner as the partner's allocable share or a shareholder's pro rata share of wage expenses.

Consistent with section 199A(b)(5) and the legislative history of the TCJA, which direct the Secretary to provide rules for applying the W-2 wage limitation in cases in which the taxpayer acquires, or disposes 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 during the year, proposed §1.199A-2(b)(2)(iv)(B) provides rules that apply in the case of an acquisition or disposition of a trade or business. See Joint Explanatory Statement of the Committee of Conference, 38. Specifically, proposed §1.199A-2(b)(2)(iv)(B)(1) provides that, 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, the W-2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2. For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in proposed §1.199A-2(b).

A notice of proposed revenue procedure, Notice 2018-64, 2018-35 IRB ____, which provides three methods for calculating W-2 wages is being issued concurrently with this notice of proposed rulemaking. The three methods in the notice are substantially similar to the methods provided in Rev. Proc. 2006 -47, 2006-2 C.B. 869, for purposes of calculating "paragraph (e)(1) wages" (that is, wages described in §1.199-2(e)(1) issued under former section 199). The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide for greater accuracy.

B. The UBIA of Qualified Property

Section 199A(b)(2)(B)(ii) provides an alternative deduction limitation based on 25 percent of W-2 Wages with respect to the qualified trade or business and 2.5 percent of the UBIA of qualified property. Proposed §1.199A-2 restates the statutory definitions under the qualified property rules, and provides additional guidance.

1. General Definition of UBIA of Qualified Property

Proposed §1.199A-2(c)(1) restates the definition of qualified property in section 199A(b)(6)(A), which provides that "qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, a trade or business at the close of the taxable year, and which is used in the production of QBI, and for which the depreciable period has not ended before the close of the taxable year. Proposed §1.199A-2(c)(2) also restates the definition of depreciable period in section 199A(b)(6)(B), which provides that "depreciable" period means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of the application of section 168(g).

Because the applicable recovery period under section 168(c) of the property is not changed by any additional first-year depreciation deduction allowable under section 168, proposed §1.199A-2(c)(2)(ii) also clarifies that the additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or section 168(m)) does not affect the applicable recovery period under section 168(c).

Proposed §1.199A-2(c)(3) provides a definition of UBIA. The Treasury Department and the IRS believe that existing general principles used to define "unadjusted basis" in §1.263(a)-3(h)(5) provide a reasonable basis for an administrable rule that is appropriate for the purposes of section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. In addition, the Treasury Department and the IRS believe that "immediately after acquisition" means as of the date the property is placed in service because section 199A provides that "qualified property" must be used in the production of QBI. In order to be used in the production of QBI, the qualified property necessarily must be placed in service. Determining UBIA as of the date the property is placed in service ensures consistency between purchased and produced qualified property, and reduces compliance costs, burden, and administrative complexity because taxpayers are already required to determine that amount. Accordingly, proposed §1.199A-2 provides that the term "UBIA" means the basis as determined under section 1012 or other applicable sections of chapter 1, including subchapter O (relating to gain or loss on dispositions of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), any adjustments for tax credits claimed by the taxpayer (for example, under section 50(c)), or any adjustments for any portion of the basis for which the taxpayer has elected to treat as an expense (for example, under sections 179, 179B, or 179C). Therefore, for purchased or produced qualified property, UBIA generally will be its cost under section 1012 as of the date the property is placed in service. For qualified property contributed to a partnership in a section 721 transaction and immediately placed in service, UBIA generally will be its basis under section 723. For qualified property contributed to an S corporation in a section 351 transaction and immediately placed in service, UBIA generally will be its basis under section 362. Further, for property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death under section 1014. However, proposed §1.199A-2(c)(3) provides that UBIA does reflect the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business.

2. Partnership Special Basis Adjustments

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

Accordingly, proposed §1.199A-2(c)(1)(iii) provides that partnership special basis adjustments are not treated as separate qualified property.

3. Property Transferred With a Principal Purpose of Increasing Section 199A Deduction

Qualified property includes depreciable property used during the taxable year in the production of QBI and held by, and available for use in, the trade or business at the close of the taxable year. However, it would be inconsistent with the purposes of section 199A to permit trades or businesses to transfer or acquire property at the end of the year merely to manipulate the UBIA of qualified property attributable to the trade or business. Therefore, pursuant to the authority granted to the Secretary under section 199A(f)(4), proposed §1.199A-2(c)(1)(iv) provides that property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the section 199A deduction.

4. Like-Kind Exchanges and Involuntary Conversions

Section 199A does not provide rules to determine UBIA for qualified property in the case of an exchange of property under section 1031 (like-kind exchange) or involuntary conversion under section 1033. However, section 199A(h)(2) specifically instructs the Secretary to do so. The Treasury Department and the IRS believe that existing general principles used for like-kind exchanges and involuntary conversions under §1.168(i)-(6) provide a useful analogy for administrable rules that are appropriate for the purposes of section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. Accordingly, proposed §1.199A-2 (c)(2)(iii) generally follows the rules of §1.168(i)-6 to provide that qualified property that is acquired in a like-kind exchange, as defined in §1.168(i)-6(b)(11), or in an involuntary conversion, as defined in §1.168(i)-6(b)(12), is treated as replacement Modified Accelerated Cost Recovery System (MACRS) property as defined in §1.168(i)-6(b)(1) whose depreciable period generally is determined as of the date the relinquished property was first placed in service. Accordingly, subject to one exception, proposed §1.199A-2(c)(2)(iii) provides that, for purposes of determining the depreciable period, the date the exchanged basis in the replacement qualified property is first placed in service by the trade or business is the date on which the relinquished property was first placed in service by the individual or RPE and the date the excess basis in the replacement qualified property is first placed in service by the individual or RPE is the date on which the replacement qualified property was first placed in service by the individual or RPE. As a result, the depreciable period under section 199A for the exchanged basis of the replacement qualified property will end before the depreciable period for the excess basis of the replacement qualified property ends.

The exception is that proposed §1.199A-2(c)(2)(iii)(C) provides that, for purposes of determining the depreciable period, if the individual or RPE makes an election under §1.168(i)-6(i)(1) (the election not to apply §1.168 (i)-6)), the date the exchanged basis and excess basis in the replacement qualified property are first placed in service by the trade or business is the date on which the replacement qualified property is first placed in service by the individual or RPE, with UBIA determined as of that date. In this case, the depreciable periods under section 199A for the exchanged basis and the excess basis of the replacement qualified property will end on the same date.

Thus, unless the exception applies, qualified property acquired in a like-kind exchange or involuntary conversion will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is actually placed in service; for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the relinquished property was first placed in service. The proposed regulations contain an example illustrating these rules.

5. Other Nonrecognition Transactions

The Treasury Department and the IRS have received comments requesting guidance on the application of the qualified property rules to nonrecognition transfers involving transferred basis property within the meaning of section 7701(a)(43) (transferred basis transactions). For example, taxpayers and practitioners requested guidance on how to determine the depreciable period of the property if a partnership conducts a trade or business and qualified property is contributed to that trade or business in a nonrecognition transfer under section 721(a). Also of relevance in the context of non-recognition transfers, section 199A(h)(1) grants the Secretary anti-abuse authority to apply rules similar to the rules under section 179(d)(2) (which can restrict the expensing of certain assets in transferred basis transactions) to prevent the manipulation of the depreciable period of qualified property using transactions between related parties.

The Treasury Department and the IRS believe that existing general principles used for transferred basis transactions under §168(i)(7) provide a useful analogy for administrable rules that are appropriate for the purposes of section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. Accordingly, proposed §1.199A-2(c)(2)(iv) provides that, for purposes of determining the depreciable period, if an individual or RPE (the transferee) acquires qualified property in a transaction described in section 168(i) (7)(B), the transferee determines the date on which the qualified property was first placed in service using a two-step approach. First, for the portion of the transferee's UBIA of the qualified property that does not exceed the transferor's UBIA of such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service. Second, for the portion of the transferee's UBIA of the qualified property that exceeds the transferor's UBIA of such property, if any, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer. Thus, qualified property acquired in these non-recognition transactions will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is placed in service by the transferee (for instance, the date the partnership places in service property received in a section 721 transaction); for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the transferor first placed the property in service (for instance, the date the partner placed the property in service in his or her sole proprietorship). The proposed regulations contain an example illustrating these rules.

The Treasury Department and the IRS request comments concerning appropriate methods for accounting for non-recognition transactions, including rules to prevent the manipulation of the depreciable period of qualified property using transactions between related parties.

6. Redetermination of UBIA and Subsequent Improvements to Qualified Property

The Treasury Department and the IRS have received comments requesting guidance on the treatment of subsequent improvements to qualified property. Subsequent improvements to qualified property are generally treated as a separate item of property under section 168(i)(6). The Treasury Department and the IRS do not believe a different approach is necessary for purposes of section 199A. Accordingly, proposed §1.199A-2(c)(1)(ii) provides 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 the taxpayer first placed in service on the date such addition or improvement is placed in service by the taxpayer for purposes of determining the depreciable period of the qualified property. For example, if a taxpayer acquired and placed in service a machine on March 26, 2018, and then incurs additional capital expenditures to improve the machine in May 2020, and places such improvements in service on May 27, 2020, the taxpayer has two qualified properties: the machine acquired and placed in service on March 26, 2018, and the improvements to the machine incurred in May 2020 and placed in service on May 27, 2020.

7. Allocation of UBIA of Qualified Property by RPEs

In the case of a trade or business conducted by an RPE, section 199A(f) provides that a partner's or shareholder's allocable share of the UBIA of qualified property is determined in the same manner as the partner's allocable share or shareholder's pro rata share of depreciation. Proposed §1.199A-2(a)(3) provides that, in the case of qualified property held by an RPE, each partner's or shareholder's share of the UBIA of qualified property is an amount that bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the entity's total tax depreciation attributable to the property for the year. In the case of qualified property of a partnership that does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. In the case of qualified property of an S corporation that does not produce tax depreciation during the year, each shareholder's share of the UBIA of the qualified property is a share of the UBIA proportionate to the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation.

III. Proposed §1.199A-3: QBI, Qualified REIT Dividends, Qualified PTP Income

Proposed §1.199A-3 restates the definitions in section 199A(c) and provides additional guidance on the determination of QBI, qualified REIT dividends, and qualified PTP income.

A. QBI

Section 199A(c)(1) provides that the term "QBI" means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss attributable to any qualified trade or business of the taxpayer. QBI does not include any qualified REIT dividends or qualified PTP income. Section 199A (c)(3)(A) provides that the term "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction, and loss to the extent such items are (i) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and (ii) included or allowed in determining taxable income for the taxable year. Section 199A(c) (3)(B) provides a list of items that are not taken into account as qualified items of income, gain, deduction, and loss, including capital gain or loss, dividends, interest income other than interest income properly allocable to a trade or business, amounts received from an annuity other than in connection with a trade or business, certain items described in section 954, and items of deduction or loss properly allocable to these items. Section 199A(c)(4) provides that QBI does not include reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business, any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and 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.

i. Treatment of Section 751 Gain

The Treasury Department and the IRS have received comments stating that it is unclear whether gain or loss that is treated as ordinary income under section 751 should be QBI if the section 751 income meets all of the other requirements to be QBI. This uncertainty is caused because section

199A(e)(5) lists: (i) the taxpayer's allocable share of the QBI from a publicly traded partnership and (ii) income described in section 751(a) as separate categories of qualified publicly traded partnership income, which could be read to imply that income described in section 751 is not QBI. Section 1.199-5(f), issued under former section 199, specifically included section 751(a) or (b) gains as domestic production gross receipts.

The Treasury Department and the IRS do not view the statutory reference to section 751(a) gain as qualified PTP income to exclude section 751 gain from being QBI, but rather view such reference as clarifying the rules for PTPs. Accordingly, proposed §1.199A-3(b)(1)(i) clarifies that any gain attributable to assets of a partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and therefore, may constitute QBI if the other requirements of section 199A and proposed §1.199A-3 are satisfied.

ii. Guaranteed Payments for the Use of Capital

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

iii. Section 481 Adjustments

Section 1.199-8(g), issued under former section 199, provides rules on how section 481(a) adjustments are taken into account for purposes of former section 199. Similarly, proposed §1.199A-3(b)(1)(iii) provides that section 481 adjustments attributable to a trade or business, whether positive or negative, and arising in a taxable year ending after December 31, 2017, are treated as attributable to that trade or business. Accordingly, such section 481 adjustments will constitute QBI to the extent the requirements of section 199A, including proposed §1.199A-3, are satisfied. Section 481 adjustments arising in a taxable year ending before January 1, 2018, do not constitute QBI.

iv. Previously Suspended Losses

Several sections of the Code, including sections 465, 469, 704(d), and 1366(d), provide for disallowance of losses and deductions in certain cases. Generally, the disallowed amounts are suspended and carried forward to the following year, at which point they are re-tested and may become allowable. Proposed §1.199A-3(b)(1)(iv) provides that, to the extent that any previously disallowed losses or deductions are allowed in the taxable year, they are treated as items attributable to the trade or business. However, losses or deductions that were disallowed for taxable years beginning before January 1, 2018, are not taken into account for purposes of computing QBI in a later taxable year.

v. Net Operating Losses

Generally, items giving rise to a net operating loss are allowed in computing taxable income in the year incurred. Because those items would have been taken into account in computing QBI in the year incurred, the net operating loss should not be treated as QBI in subsequent years. Otherwise, the same loss could be taken into account in multiple tax years. However, losses disallowed by section 461(l) give rise to a net operating loss without ever having been allowable in computing taxable income. Thus, if deductions are disallowed by reason of 461(l), those disallowed deductions will not be included in the QBI computation in the year incurred (because they are not includable in taxable income), and, if the resulting net operating loss also is not included in the QBI computation, the deduction would permanently escape the QBI rules. This result would be inappropriate. Accordingly, proposed §1.199A-3(b) (1)(v) provides that generally, a deduction under section 172 for a net operating loss is not considered attributable to a trade or business and therefore, is not taken into account in computing QBI. However, to the extent the net operating loss is comprised of amounts attributable to a trade or business that were disallowed under section 461(l), the net operating loss is considered attributable to that trade or business, and will constitute QBI to the extent the requirements of section 199A, including proposed §1.199A-3, are satisfied.

The Treasury Department and the IRS request comments regarding the interaction of section 199A and 461(l) generally.

vi. Requirement That an Item Be Effectively Connected With a U.S. Trade or Business

Section 199A applies to all noncorporate taxpayers, whether such taxpayers are domestic or foreign. Accordingly, section 199A applies to both U.S. citizens and resident aliens as well as nonresident aliens that have QBI. As noted previously in this Explanation of Provisions, QBI includes items of income, gain, deduction, and loss to the extent such items are (i) included or allowed in determining taxable income for the taxable year and (ii) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears).

a. Summary of Rules for Generally Determining Whether Income Is Effectively Connected With a United States Trade or Business

Section 864(c) provides rules that nonresident alien individuals and foreign corporations use to determine which items of income, gain, or loss are effectively connected with a United States trade or business. Section 873(a) permits nonresident aliens to deduct expenses only if and to the extent that they are connected with, or properly allocable and apportioned to, income effectively connected with a United States trade or business.

Thus, for example, a U.S. partner of a partnership that operates a trade or business in both the United States and in a foreign country would only include the items of income, gain, deductions, and loss that would be effectively connected with a United States trade or business. Similarly, a shareholder of an S corporation that is engaged in a trade or business in both the United States and in a foreign country would only take into account the items of income, gain, deduction, and loss that would be effectively connected to the portion of the business conducted by the S corporation in the United States, determined by applying the principles of section 864(c).

In general, whether a nonresident alien is engaged in a trade or business within the United States, as opposed to a trade or business conducted solely outside the United States, is based upon the all the facts and circumstances, as developed through case law and other published guidance. Pursuant to section 875 (1), a nonresident alien is considered engaged in a trade or business within the United States if the partnership of which such individual is a member is so engaged.

Section 864(b) provides that the term "trade or business within the United States" includes (but is not limited to) the performance of personal services within the United States at any time during the taxable year, but excludes the performance of services described in section 864(b)(1) and (2). Section 864(b) (1) covers a limited set of nonresident aliens who perform services in the United

States on behalf of foreign persons not otherwise engaged in a U.S. trade or business, or on behalf of U.S. persons through a foreign office, if the nonresident aliens are present in the United States less than 90 days during the taxable year and their compensation does not exceed $3,000. Section 864(b)(2) generally treats foreign persons, including partnerships, who are trading in stocks, securities, and in commodities for their own account or through a broker or other independent agent as not engaged in a United States trade or business.

b. Application to Section 199A

Although the cross reference in section 199A(c)(3)(A)(i) to section 864 is limited to paragraph (c) of that section, no income derived from excluded services under section 864(b)(1) or (2) could ever be effectively connected income in the hands of a nonresident alien. Accordingly, section 199A incorporates the specific rules regarding the scope of the term "trade or business in the United States" in determining QBI. As such, if a trade or business is not engaged in a U.S. trade or business by reason of section 864(b), items of income, gain, deduction, or loss from that trade or business will not be included in QBI because such items would not be effectively connected with the conduct of a U.S. trade or business.

If a trade or business is determined to be conducted in the United States, section 864(c)(3) generally treats all income of a nonresident alien from sources within the United States as effectively connected with the conduct of a U.S. trade or business. However, any income from sources within the United States described in section 871(a)(1) or (h) and any gain or loss from the sale of capital assets are only effectively connected if the income meets requirements of section 864(c)(2) and the regulations thereunder. Under section 864(c)(4), income from sources without the United States is generally not treated as effectively connected with the conduct of a U.S. trade or business unless an exception under section 864(c)(4)(B) applies. Thus, a trade or business's foreign source income, gain, or loss, (and any deductions effectively connected with such foreign source income, gain, or loss) would generally not be included in QBI, unless the income meets an exception in section 864(c)(4) (B). Whether income is U.S. or foreign sourced is determined under sections 861, 862, 863, and 865, and the regulations thereunder.

This rule does not mean that any item that is effectively connected with the conduct of a trade or business with the United States is therefore QBI. As discussed previously, the item must also be "with respect to" a trade or business. Certain provisions of the Code allow items to be treated as effectively connected, even though they are not with respect to a trade or business. For example, section 871(d) allows a nonresident alien individual to elect to treat income from real property in the United States that would not otherwise be treated as effectively connected with the conduct of a trade or business within the United Sates as effectively connected. However, for purposes of section 199A, if items are not attributable to a trade or business under 162, such items do not constitute QBI.

Similarly, the fact that a deduction is allowed for purposes of computing effectively connected taxable income does not necessarily mean that it is taken into account for purposes of section 199A. For example, for purposes of computing effectively connected taxable income, section 873(b) allows certain deductions, including for theft losses of property located within the United States and charitable contributions allowed under section 170, to be taken into account regardless of whether they are connected with income that is effectively connected with the conduct of a trade or business within the United States. However, for purposes of section 199A, these items would not be taken into account because section 199A only permits a deduction for income that is both attributable to a trade or business and that is also effectively connected income.

vii. Exclusion From QBI for Certain Items

a. Treatment of Section 1231 Gains and Losses

Section 199A(c)(3)(B)(i) provides that QBI does not include any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss. The Treasury Department and the IRS have received comments requesting guidance on the extent to which gains and losses subject to section 1231 may be taken into account in calculating QBI. Section 1231 provides rules under which gains and losses from certain involuntary conversions and the sale of certain property used in a trade or business are either treated as long-term capital gains or long-term capital losses, or not treated as gains and losses from sales or exchanges of capital assets.

Section 199A(c)(3)(B)(i) excludes capital gains or losses, regardless of whether those items arise from the sale or exchange of a capital asset. The legislative history of section 199A provides that QBI does not include any item taken into account in determining net long-term capital gain or net long-term capital loss. Conference Report page 30. Accordingly, proposed §1.199A-3(b)(2)(ii)(A) clarifies that, to the extent gain or loss is treated as capital gain or loss, it is not included in QBI. Specifically, if gain or loss is treated as capital gain or loss under section 1231, it is not QBI. Conversely, if section 1231 provides that gains or losses are not treated as gains and losses from sales or exchanges of capital assets, section 199A (c)(3)(B)(i) does not apply and thus, the gains or losses must be included in QBI (provided all other requirements are met).

b. Interest Income

Section 199A(c)(4)(C) provides that QBI does not include any interest income other than interest income that is properly allocable to a trade or business. The Treasury Department and the IRS believe that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business, and therefore should not be included in QBI, because such interest income, although held by a trade or business, is simply income from assets held for investment. Accordingly, proposed §1.199A-3(b)(2)(ii)(C) provides that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business. In contrast, interest income received on accounts or notes receivable for services or goods provided by the trade or business is not income from assets held for investment, but income received on assets acquired in the ordinary course of trade or business.

c. Reasonable Compensation

Section 199A(c)(4)(A) provides that QBI does not include "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business." Similarly, guaranteed payments for services under section 707(c) are excluded from QBI. The phrase "reasonable compensation" is a well-known standard in the context of S corporations. Under Rev. Rul. 74-44, 1974-1 C.B. 287, S corporations must pay shareholder-employees "reasonable compensation for services performed" prior to making "dividend" distributions with respect to shareholder-employees' stock in the S corporation under section 1368. See also David E. Watson, P.C. v. United States, 668 F.3d 1008, 1017 (8th Cir. 2012). The legislative history of section 199A confirms that the reasonable compensation rule was intended to apply to S corporations.

The Treasury Department and the IRS have received requests for guidance on whether the phrase "reasonable compensation" within the meaning of section 199A extends beyond the context of S corporations for purposes of section 199A. The Treasury Department and the IRS believe "reasonable compensation" is best read as limited to the context from which it derives: Compensation of S corporation shareholders-employees. If reasonable compensation were to apply outside of the context of S corporations, a partnership could be required to apply the concept of reasonable compensation to its partners, regardless of whether amounts paid to partners were guaranteed. Such a result would violate the principle set forth in Rev. Rul. 69-184, 1969-1 CB 256, that a partner of a partnership cannot be an employee of that partnership. There is no indication that Congress intended to change this long-standing Federal income tax principle. Accordingly, proposed §1.199A-3(b)(2)(ii)(H) provides that QBI does not include reasonable compensation paid by an S corporation but does not extend this rule to partnerships. Because the trade or business of performing services as an employee is not a qualified trade or business under section 199A(d)(1)(B), wage income received by an employee is never QBI. The rule for reasonable compensation is merely a clarification that, even if an S corporation fails to pay a reasonable wage to its shareholder-employees, the shareholder-employees are nonetheless prevented from including an amount equal to reasonable compensation in QBI.

d. Guaranteed Payments

Section 199A(c)(4)(B) provides that QBI does not include any guaranteed payment described in section 707(c) paid by a partnership to a partner for services rendered with respect to the trade or business. Proposed §1.199A-3(b)(2)(ii)(I) restates this statutory rule and clarifies that the partnership's deduction for such guaranteed payment is an item of QBI if it is properly allocable to the partnership's trade or business and is otherwise deductible for Federal income tax purposes. It may be unclear whether a guaranteed payment to an upper-tier partnership for services performed for a lower-tier partnership is QBI for the individual partners of the upper-tier partnership if the upper-tier partnership does not itself make a guaranteed payment to its partners. Section 199A(c)(4)(B) does not limit the term "partner" to an individual. Consequently, for purposes of the guaranteed payment rule, a partner may be an RPE. Accordingly, proposed §1.199A-3(b)(2)(ii)(I) clarifies that QBI does not include any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. Therefore, for the purposes of this rule, a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient.

e. Section 707(a) Payments

Section 199A(c)(4)(C) provides that QBI does not include, to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business. Section 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. Within the context of section 199A, payments under section 707(a) for services are similar to, and therefore, should be treated similarly as, guaranteed payments, reasonable compensation, and wages, none of which is includable in QBI. In addition, consistent with the tiered partnership rule for guaranteed payments described previously, to the extent an upper-tier RPE receives a section 707(a) payment, that income should not constitute QBI to the partners of the upper-tier entity. Accordingly, proposed §1.199A-3(b)(2)(ii)(J) provides that QBI does not include any payment described in section 707(a) to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. The Treasury Department and the IRS request comments on whether there are situations in which it is appropriate to include section 707(a) payments in QBI.

viii. Allocation of Items Not Clearly Attributable to a Single Trade or Business.

Proposed §1.199A-3(b)(5) provides that, if an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the taxpayer or entity must allocate those items among the several trades or businesses to which they are attributable using a reasonable method that is consistent with the purposes of section 199A. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income of each trade or business. There are several different ways to allocate expenses, such as direct tracing or allocating based on gross income, but whether these are reasonable depends on the facts and circumstances of each trade or business. The Treasury Department and the IRS are considering whether "reasonable method" should be defined to include the direct tracing method, allocations based on gross income, or other methods, within appropriate parameters. The Treasury Department and the IRS request comments on reasonable methods for the allocation of items not clearly attributable to a single trade or business and whether any safe harbors may be appropriate.

B. Qualified REIT Dividends and Qualified PTP Income

Proposed §1.199A-3(c)(1) restates the statutory provisions regarding qualified REIT dividends and provides additional guidance relating to such dividends. Pursuant to the regulatory authority conferred under section 199A(f)(4), proposed §1.199A-3(c) provides an anti-abuse rule to prevent dividend stripping and similar transactions aimed at capturing qualified REIT dividends without having economic exposure to the REIT stock for a meaningful period of time. The proposed anti-abuse rule incorporates the principles of section 246(c).

Proposed §1.199A-3(c)(2) restates the statutory provisions regarding qualified PTP income and provides additional guidance regarding such income. One commenter questioned whether section 751 income recognized upon the sale of an interest in a PTP must meet the standards for QBI (such as the requirement that the income be effectively connected with a U.S. trade or business) to qualify as qualified PTP income. Section 199A includes special rules exempting qualified PTP income from the W-2 wage and UBIA of qualified property limitations. However, these statutory rules do not exempt qualified PTP income from the other QBI requirements. Accordingly, proposed §1.199A-3(c) (3)(ii) clarifies that the other rules applicable to the determination of QBI apply to the determination of qualified PTP income.

IV. Proposed §1.199A-4: Aggregation Rules

A. Overview

The proposed regulations incorporate the rules under section 162 for determining whether a trade or business exists for purposes of section 199A. A taxpayer can have more than one trade or business for purposes of section 162. See §1.446-1(d)(1). However, in most cases, a trade or business cannot be conducted through more than one entity.

The Treasury Department and the IRS have received comments requesting that the regulations provide that taxpayers be permitted to group or "aggregate" trades or businesses under section 199A using the grouping rules described in §1.469-4 (grouping rules). Section 1.469-4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. Section 469 uses the term "activities" in determining the application of the limitation rules under section 469. In contrast, section 199A applies to trades or businesses. By focusing on activity, the grouping rules may be both under and over inclusive in determining what activities give rise to a trade or business for section 199A purposes.

Additionally, section 469 is a loss limitation rule used to prevent taxpayers from sheltering passive losses with nonpassive income. The section 199A deduction is not based on the level of a taxpayer's involvement in the trade or business (that is, both active and passive owners of a trade or business may be entitled to a section 199A deduction if they otherwise satisfy the requirements of section 199A and these proposed regulations). Complicating matters further, a taxpayer's section 469 groupings may include specified service trades or businesses, requiring separate rules to segregate the two categories of trades or businesses to calculate the section 199A deduction.

Therefore, the grouping rules under section 469 are not appropriate for determining a trade or business for section 199A purposes. Accordingly, the Treasury Department and the IRS are not adopting the section 469 grouping rules as the means by which taxpayers can aggregate trades or businesses for purposes of applying section 199A.

Although it is not appropriate to apply the grouping rules under section 469 to section 199A, the Treasury Department and the IRS agree with practitioners that some amount of aggregation should be permitted. It is not uncommon for what are commonly thought of as single trades or businesses to be operated across multiple entities. Trades or businesses may be structured this way for various legal, economic, or other non-tax reasons. The fact that businesses are operated across entities raises the question of whether, in defining trade or business for purposes of section 199A, section 162 trades or businesses should be permitted or required to be aggregated or disaggregated, and if so, whether such aggregation or disaggregation should occur at the entity level or the individual level. Allowing taxpayers to aggregate trades or businesses offers taxpayers a means of combining their trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations and potentially maximizing the deduction under section 199A. If such aggregation is not permitted, taxpayers could be forced to incur costs to restructure solely for tax purposes. In addition, business and non-tax law requirements may not permit many taxpayers to restructure their operations. Therefore, proposed §1.199A-4 permits the aggregation of separate trades or businesses, provided certain requirements are satisfied.

The Treasury Department and the IRS are aware that many commenters were concerned with having multiple regimes for grouping (that is, under sections 199A, 1411, and 469). Accordingly, comments are requested on the aggregation method described in proposed §1.199A-4, including whether this would be an appropriate grouping method for purposes of sections 469 and 1411, in addition to section 199A.

B. Aggregation Rules

Under proposed §1.199A-4, aggregation is permitted but is not required. However, an individual may aggregate trades or businesses only if the individual can demonstrate that the requirements in proposed §1.199A-4(b)(1) are satisfied. First, consistent with other provisions in the proposed regulations, each trade or business must itself be a trade or business as defined in §1.199A-1(b)(13).

Second, the same person, or group of persons, must directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. All of the items attributable to the trades or businesses must be reported on returns with the same taxable year (not including short years). Proposed §1.199A-4(b)(3) provides rules allowing for family attribution. Because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate. The Treasury Department and the IRS considered certain reporting requirements in which the majority owner or group of owners would be required to provide information about all of the other pass-through entities in which they held a majority interest. Due to the complexity and potential burden on taxpayers of such an approach, proposed §1.199A-4 does not provide such a reporting requirement. The Treasury Department and the IRS request comments on whether a reporting or other information sharing requirement should be required.

Third, none of the aggregated trades or businesses can be an SSTB. Proposed §1.199A-5 addresses SSTBs and trades or businesses with SSTB income.

Fourth, individuals and trusts must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors include: (1) the businesses provide products and services that are the same (for example, a restaurant and a food truck) or they provide products and services that are customarily provided together (for example, a gas station and a car wash); (2) the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (3) the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies).

C. Individuals

An individual is permitted to aggregate trades or businesses operated directly and trades or businesses operated through RPEs. Individual owners of the same RPEs are not required to aggregate in the same manner.

An individual directly engaged in a trade or business must compute QBI, W-2 wages, and UBIA of qualified property for each trade or business before applying the aggregation rules. If an individual has aggregated two or more trades or businesses, then the combined QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses is used for purposes of applying the W-2 wage and UBIA of qualified property limitations described in proposed §1.199A-1(d)(2)(iv).

D. RPEs

RPEs must compute QBI, W-2 wages, and UBIA of qualified property for each trade or business. An RPE must provide its owners with information regarding QBI, W-2 wages, and UBIA of qualified property attributable to its trades or businesses.

The Treasury Department and the IRS considered permitting aggregation by an RPE in a tiered structure. The Treasury Department and the IRS considered several approaches to tiered structures, including permitting only the operating entity to aggregate the trades or businesses or permitting each tier to add to the aggregated trade or business from a lower-tier, provided that the combined aggregated trade or business otherwise satisfied the requirements of proposed §1.199A-4(b)(1) had the businesses all been owned by the lower-tier entity. The Treasury Department and the IRS are concerned that the reporting requirements needed for either of these rules would be overly complex for both taxpayers and the IRS to administer. In addition, because the section 199A deduction is in all cases taken at the individual level, it should not be detrimental, and in fact may provide flexibility to taxpayers, to provide for aggregation at only one level. The Treasury Department and the IRS request comments on the proposed approach to tiered structures and the reporting necessary to allow an individual to demonstrate to which trades or businesses his or her QBI, W-2 wages, and UBIA of qualified property are attributable for purposes of calculating his or her section 199A deduction.

E. Reporting and Consistency

Proposed §1.199A-4(c)(1) requires that once multiple trades or businesses are aggregated into a single aggregated trade or business, individuals must consistently report the aggregated group in subsequent tax years. Proposed §1.199A-4(c)(1) provides rules for situations in which the aggregation rules are no longer met as well as rules for when a newly created or acquired trade or business can be added to an existing aggregated group.

Proposed §1.199A-4(c)(2)(i) provides reporting and disclosure requirements for individuals that choose to aggregate, including identifying information about each trade or business that constitutes a part of the aggregated trade or business. Proposed §1.199A-4(c)(2)(ii) allows the Commissioner to disaggregate trades or businesses if an individual fails to make the required aggregation disclosure. The Treasury Department and the IRS request comments as to whether it is administrable to create a standard under which trades or businesses will be disaggregated by the Commissioner and what that standard might be.

V. Proposed §1.199A-5: Specified Service Trade or Business and the Trade or Business of Performing Services as an Employee

Section 199A(c)(1) provides that only items attributable to a qualified trade or business are taken into account in determining the section 199A deduction for QBI. Section 199A(d)(1) provides that a "qualified trade or business" means any trade or business other than (A) an SSTB, or (B) the trade or business of performing services as an employee.

A. SSTB

This part V.A. explains the provisions under proposed §1.199A-5 relating to SSTBs. First, the effect of classification as an SSTB is discussed. Second, the exceptions for taxpayers below the threshold amount and a de minimis exception are described. Third, guidance is provided on the meaning of the activities listed in the definition of SSTB. Fourth, the rules for determining whether a trade or business is treated as part of an SSTB are described. Finally, rules regarding classification as an employee for purposes of section 199A are discussed.

1. Effect of being an SSTB

a. General Rule

Consistent with section 199A, proposed §1.199A-5(a)(2) provides that, unless an exception applies, if a trade or business is an SSTB, none of its items are to be taken into account for purposes of determining a taxpayer's QBI. In the case of an SSTB conducted by an entity, such as a partnership or an S corporation, if it is determined that the trade or business is an SSTB, none of the income from that trade or business flowing to an owner of the entity is QBI, regardless of whether the owner participates in the specified service activity. Therefore, a direct or indirect owner of a trade or business engaged in an SSTB is treated as engaged in the SSTB for purposes of section 199A regardless of whether the owner is passive or participated in the SSTB. Similarly, none of the W-2 wages or UBIA of qualified property will be taken into account for purposes of section 199A. For example, because the field of athletics is an SSTB, if a partnership owns a professional sports team, the partners' distributive shares of income from the partnership's athletics trade or business is not QBI, regardless of whether the partners participate in the partnership's trade or business. Proposed §1.199A-5 contains further examples illustrating the operation of this rule.

b. Exceptions to the General Rule

Under section 199A(d)(3), individuals with taxable income below the threshold amount are not subject to a restriction with respect to SSTBs. Therefore, if an individual or trust has taxable income below the threshold amount, the individual or trust is eligible to receive the deduction under section 199A notwithstanding that a trade or business is an SSTB. As described in part I.C of this Explanation of Provisions, the exclusion of QBI, W-2 wages, and UBIA of qualified property from the computation of the section 199A deduction is subject to a phase-in for individuals with taxable income within the phase-in range. The application of this phase-in is determined at the individual, trust, or estate level, which may not be where the trade or business is operated. Therefore, if a partnership or an S corporation operates an SSTB, the application of the threshold does not depend on the partnership or S corporation's taxable income but rather, the taxable income of the individual partner or shareholder claiming the section 199A deduction. For example, if the partnership's taxable income is less than the threshold amount, but each of the partnership's individual partners have income that exceeds the threshold amount plus $50,000 ($100,000 in the case of a joint return) then none of the partners may claim a section 199A deduction with respect to any income from the partnership's SSTB.

An RPE conducting an SSTB may not know whether the taxable income of any of its equity owners is below the threshold amount. However, the RPE is best positioned to make the determination as to whether its trade or business is an SSTB. Therefore, reporting rules under proposed §1.199A-6(b)(3)(B) requires each RPE to determine whether it conducts an SSTB and disclose that information to its partners, shareholders, or owners. With respect to each trade or business, once it is determined that a trade or business is an SSTB, it remains an SSTB and cannot be aggregated with other trades or business. In the case of a trade or business conducted by an individual, such as a sole proprietorship, disregarded entity, or grantor trust, the determination of whether the business is an SSTB is made by the individual.

Section 199A defines an SSTB to include any trade or business that "involves the performance of services in" a specified service activity. Although the statute, read literally, does not suggest that a certain quantum of specified service activity is necessary to find an SSTB, the Treasury Department and the IRS believe that requiring all taxpayers to evaluate and quantify any amount of specified service activity would create administrative complexity and undue burdens for both taxpayers and the IRS. Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.

Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.

Accordingly, proposed §1.199A-5(c)(1) provides that a trade or business (determined before the application of the aggregation rules in proposed §1.199A-4) is not an SSTB if the trade or business has gross receipts of $25 million or less (in a taxable year) and less than 10 percent of the gross receipts of the trade or business is attributable to the performance of services in an SSTB. For trades or business with gross receipts greater than $25 million (in a taxable year), a trade or business is not an SSTB if less than 5 percent of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.

2. Definition of Specified Service Trade or Business

The definition of an SSTB set forth in section 199A incorporates, with modifications, the text of section 1202(e)(3)(A). The text of section 1202(e)(3)(A) substantially tracks the definition of 'qualified personal service corporation' under section 448. Therefore, consistent with ordinary rules of statutory construction, the guidance in proposed §1.199A-5(b) is informed by existing interpretations and guidance under both sections 1202 and 448 when relevant. However, existing guidance under those sections is sparse and the scope and purpose of those sections and section 199A are different. The Treasury Department and the IRS also note that, unlike sections 1202(e)(3)(A) and 448, the purpose of section 199A is to provide a deduction based on the character of the taxpayer's trade or business. Distinct guidance for section 199A is warranted. Therefore, the guidance in proposed §1.199A-5(b) applies only to section 199A, not sections 1202 and 448.

a. Guidance on the Meaning of the Listed Activities

Section 199A(d)(2)(A) provides that an SSTB is any trade or business described in section 1202(e)(3)(A) (applied without regard to the words "engineering [and] architecture") or that would be so described if the term "employees or owners" were substituted for "employees" therein. Section 199A(d)(2)(B) provides that an SSTB is 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)).

Section 1202 provides an exclusion from gross income for some or all of the gain on the sale of certain qualified small business stock. Section 1202 generally requires that, for stock to be qualified small business stock, the corporation must be engaged in a qualified trade or business. Section 1202(e)(3) provides that, for purposes of section 1201(e), the term 'qualified trade or business' means any trade or business other than any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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 1 or more of its employees; any banking, insurance, financing, leasing, investing, or similar business; any farming business (including the business of raising or harvesting trees); any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and; any business of operating a hotel, motel, restaurant, or similar business.

Thus, after application of the modifications described in section 199A(d)(2)(A), the definition of an SSTB for purposes of section 199A is (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 Treasury Department and the IRS have received comments requesting guidance on the meaning and scope of the various trades or businesses described in the preceding paragraph. The Treasury Department and the IRS agree with commenters that guidance with respect to these trades or businesses is necessary for several reasons. Most importantly, section 199A is a new Code provision intended to benefit a wide range of businesses, and taxpayers need certainty in determining whether their trade or business generates income that is eligible for the section 199A deduction. As previously discussed, given the differing scope, objectives, and, in some respects, language of sections 199A, 448, and 1202, the guidance under sections 1202(e)(3)(A) and 448 (d)(2) is not an appropriate substitute for clear and distinct guidance governing what constitutes an SSTB under section 199A. In particular, some SSTBs are listed in section 1202(e)(3)(A), but not listed in section 448(d)(2), such as athletics, financial services, brokerage services, and 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. In addition, some activities are mentioned only in 199A, such as investment management, trading, and dealing. As described in the remainder of this part V.A.2., proposed §1.199A-5(b) provides guidance on the definition of an SSTB based on the plain meaning of the statute, past interpretations of substantially similar language in other Code provisions, and other indicia of legislative intent.

i. SSTBs Listed in Section 199A(d)(2)(A)

The definition of an SSTB under section 199A is substantially similar to the list of service trades or businesses provided in section 448(d)(2)(A) and §1.448-1T(e)(4)(i), as the legislative history notes. See Joint Explanatory Statement of the Committee of Conference, footnotes 44-46. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting. Under section 448, qualified personal service corporations generally are not subject to the prohibition from using the cash method. Section 448(d)(2) defines the term qualified personal service corporation to include certain employee-owned corporations, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. The regulations under section 448(d)(2), found in §1.448-1T(e)(4)(i), provide additional guidance on several of the terms, including health, performing arts, and consulting. In addition, there have been several court opinions, technical advice memoranda, and private letter rulings interpreting the various fields listed in section 448(d)(2) and §1.448-1T(e)(4)(i).

In general, the guidance under section 448(d)(2) emphasizes the direct provision of services by the employees of a trade or business, rather than the application of capital. Commenters have suggested that the regulations under section 448 serve as a reasonable starting point for defining an SSTB for purposes of section 199A. However, commenters also noted that the objectives and included categories of trades or businesses within section 448 and section 199A are different. Consistent with ordinary rules of statutory construction and the legislative history of section 199A, proposed §1.199A-5(b) draws upon the existing guidance under section 448(d)(2) when appropriate for purposes of section 199A. Proposed §1.199A-5(b) generally follows the guidance issued under section 448(d) (2) with some modifications. In certain instances, the principles of section 448(d)(2) provide useful analogies in defining the particular fields listed in section 1202(e)(3)(A) (as modified by section 199A(d)(2)(A)) for purposes of section 199A.

In addition, section 1202(e)(3)(A) also includes 'any trade or business where the principal asset of such trade or business is the reputation of skill of 1 or more of its employees.' Section 199A(d)(2)(A) modifies this clause by adding the words 'or owners' to the end, to read as follows: 'any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners.' The meaning of this clause is best determined by examining the language of section 1202(e)(3) (A) in light of the purpose of section 199A.

Case law under section 448 provides that whether a service is performed in a qualifying field under section 448(d)(2) is to be decided by examining all relevant indicia and is not controlled by state licensing laws. See Rainbow Tax Serv., Inc. v. Commissioner, 128 T.C. 42 (2007);

Kraatz & Craig Surveying Inc., v. Commissioner, 134 T.C. 167 (2010). This approach also is appropriate for section 199A purposes.

Additionally, states can widely vary in what they require in terms of licensure or certification. The Treasury Department and the IRS believe that the Federal tax law should not treat similarly situated taxpayers differently based on a particular state's decision that for consumer protection purposes or otherwise a particular business type requires a license or certification. Thus, proposed §1.199A-5(b) does not adopt a bright-line licensing rule for purposes of determining whether a trade or business is within a certain field for purposes of section 199A.

a. Health

Proposed §1.199A-5(b)(2)(ii) is informed by the definition of 'health' under section 448 and provides that the term '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. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

b. Law

Proposed §1.199A-5(b)(2)(iii) is based on the ordinary meaning of 'services in the field of law' and provides that the term '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, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

c. Accounting

Proposed §1.199A-5(b)(2)(iv) is based on the ordinary meaning of 'accounting' and provides that the term '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. Provision of services in the field of accounting is not limited to services requiring state licensure as a certified public accountant (CPA). The aim of proposed §1.199A-5(b)(2)(iv) is to capture 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 CPA. The field of accounting does not include payment processing and billing analysis.

d. Actuarial Science

Proposed §1.199A-5(b)(2)(v) is based on the ordinary meaning 'actuarial science' and 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. Accordingly, 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.

e. Performing Arts

Proposed §1.199A-5(b)(2)(vi) is informed by the definition of 'performing arts' under section 448 and provides 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. 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.

f. Consulting

Proposed §1.199A-5(b)(2)(vii) is informed by the definition of 'consulting' under section 448 and provides 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. This determination is made based on all the facts and circumstances of a person's business.

Additionally, the Treasury Department and the IRS are aware of the concern noted by commenters that in certain kinds of sales transactions it is common for businesses to provide consulting services in connection with the purchase of goods by customers. For example, a company that sells computers may provide customers with consulting services relating to the setup, operation, and repair of the computers, or a contractor who remodels homes may provide consulting prior to remodeling a kitchen. As described previously in this Explanation of Provisions, proposed §1.199A-5(c) provides a de minimis rule, under which a trade or business is not an SSTB if less than 10 percent of the gross receipts (5 percent if the gross receipts are greater than $25 million) of the trade or business are attributable to the performance of services in a specified service activity. However, this de minimis rule may not provide sufficient relief for certain trades or business that provide ancillary consulting services. The Treasury Department and the IRS believe that if a trade or business involves the selling or manufacturing of goods, and such trade or business provides ancillary consulting services that are not separately purchased or billed, then such trades or businesses are not in a trade or business in the field of consulting. Accordingly, proposed §1.199A-5(b)(2)(vii) provides that the field of consulting does not include consulting that is embedded in, or ancillary to, the sale of goods if there is no separate payment for the consulting services.

g. Athletics

The field of athletics is not listed in section 448(d)(2), and there is little guidance on its meaning as used in section 1202 (e)(3)(A). However, commenters noted, and the Treasury Department and the IRS agree, that among the services specified in section 199A(d)(2)(A) the field of athletics is most similar to the field of performing arts. Accordingly, proposed §1.199A-5(b)(2)(viii) provides that the term 'performance of services in the field of athletics' means the performances of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field , billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

h. Financial Services

Commenters requested guidance as to whether financial services includes banking. These commenters noted that section 1202(e)(3) (A) includes the term financial services, but that banking in separately listed in section 1202(e)(3)(B) which suggests that banking is not included as part of financial services in section 1202(e)(3)(A). The Treasury Department and the IRS agree with such commenters that this suggests that financial services should be more narrowly interpreted here. Therefore, proposed §1.199A-5(b)(2)(ix) limits the definition of financial services to 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 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.

i. Brokerage Services

Proposed §1.199A-5(b)(2)(x) uses the ordinary meaning of 'brokerage services' and provides 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.

j. Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of 1 or More of Its Employees or Owners

Guidance on the meaning of the 'reputation or skill' clause in section 1202(e)(3)(A) is limited to dicta in one case. In John P. Owen v. Commissioner, T.C. Memo 2012-21, the Tax Court examined whether Mr. Owen, whose business was insurance, was entitled to benefits under section 1202 with respect to the sale of his interest in a corporation conducting such business. Under the facts described in the case, the corporation had extensive training programs and sales structures, but primarily relied on the services of independent contractors (including Mr. Owen) in conducting its business. Although the Tax Court acknowledged that the business' success was due to Mr. Owen's efforts, it found that the principal asset of the company in question was the training program and sales structure of the business rather than Mr. Owen's services.

The Treasury Department and the IRS received several comments regarding the meaning of the 'reputation or skill' clause. Commenters described potential methods to give maximum effect to the literal language of the reputation or skill clause by describing ways to (1) determine the extent to which the reputation or skill of employees or owners constitutes an asset of the business under Federal tax accounting principles, and (2) measure whether such an asset is in fact the principal asset of the business.

One commenter suggested using an activity-based standard under which no service-based businesses would qualify for the section 199A deduction. An SSTB definition this broad would not comport with the statute and would deny a section 199A deduction to businesses that the statute does not appear to exclude. If the 'reputation or skill' clause was intended to exclude all service businesses from section 199A, there would have been no reason to enumerate specific types of businesses in section 199A(d)(2); that language would be pure surplusage. A broad service-based test would also fail to provide a clear classification of businesses that combine services with sales of products, such as plumbing and HVAC services, if those businesses sell goods or equipment in the course of providing services. Therefore, the Treasury Department and the IRS do not believe it is consistent with the text, structure, or purpose of section 199A to exclude all service businesses above the threshold amount from qualifying for the section 199A deduction.

Another commenter described a balance sheet test that would compare the value of assets other than goodwill and workforce in place to the value of such goodwill and workforce in place. The commenter acknowledged that such a test could also be broader than Congress intended. In addition, the commenter noted that such a test could easily lead to strange and unintuitive results, and may be difficult to apply in the case of small businesses that do not maintain audited financial statements and would both be ripe for abuse, and could potentially result in many legal disputes between taxpayers and the IRS.

Finally, one commenter described a standard based on whether the trade or business involves the provision of highly-skilled services. The commenter argued that the primary benefit of a standard like this is that it would harmonize the meaning of the reputation or skill phrase with the trades or businesses listed in section 1202(e)(3)(A), each of which involve the provision of services by professionals who either received a substantial amount of training (for example, doctors, nurses, lawyers, and accountants), or who have otherwise achieved a high degree of skill in a given field (for example, professional athletes or performing artists).

Congress enacted section 199A to provide a deduction from taxable income to trades or businesses conducted by sole proprietorships and passthrough entities that do not benefit from the income tax rate reduction afforded to C corporations under the TCJA. The Treasury Department and the IRS are concerned that a broad definition of the 'reputation or skill' phrase that relied on a balance sheet test or numerical ratios would have several consequences inconsistent with the intent of section 199A. Testing businesses based on metrics, some of them subjective, that change over time could result in inappropriate year-over-year tax consequences and lead to distorted decision-making. As the commenters noted, such mechanical tests pose administrative difficulties and fail to provide taxpayers with needed certainty regarding the tax law necessary for conducting their business affairs. Most significantly, such mechanical rules might prevent trades or businesses that Congress intended to be eligible for the section 199A deduction from claiming the section 199A deduction.

In sum, the Treasury Department and the IRS believe that the 'reputation or skill' clause as used in section 199A was intended to describe a narrow set of trades or businesses, not otherwise covered by the enumerated specified services, in which income is received based directly on the skill and/or reputation of employees or owners. Additionally, the Treasury Department and the IRS believe that 'reputation or skill' must be interpreted in a manner that is both objective and administrable. Thus, proposed §1.199A-5(b)(2) (xiv) limits the meaning of the 'reputation or skill' clause to fact patterns in which the individual or RPE is engaged in the trade or business of: (1) receiving income for endorsing products or services, including an individual's distributive share of income or distributions from an RPE 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 an RPE 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). Proposed §1.199A-5(b)(4) contains two examples illustrating the application of this definition. The Treasury Department and the IRS request comments on this rule, the clarity of definitions for the statutorily enumerated trades or businesses that are SSTBs under section 199A(d)(2)(A), and the accompanying examples.

ii. SSTBs Described in 199A(d)(2)(B)

As mentioned previously, section 199A(d)(2)(B) provides that an SSTB also includes 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)). This rule does not appear in section 1202(e)(3)(A) or section 448(d)(2).

Section 475(c)(2) provides a detailed list of interests treated as securities, including stock in a corporation; ownership interests in widely held or publicly traded partnerships or trusts; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in any of the foregoing securities or any currency, including any option, forward contract, short position, or any similar financial instruments; and certain hedges with respect to any such securities. Section 475(e)(2) provides a similarly detailed list of property treated as a commodity, including any commodity which is actively traded (within the meaning of section 1092(d)(1)) or any notional principal contract with respect to any such commodity, evidences of an interest in, or derivative financial instruments in any of the foregoing commodities, and certain hedges with respect to any such commodities.

a. Investing and Investment Management

Proposed §1.199A-5(b)(2)(xi) uses the ordinary meaning of 'investing and investment management' and provides 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. The performance of services of investing and investment management does not include directly managing real property.

b. Trading

Proposed §1.199A-5(b)(2)(xii) provides 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. Factors that have been considered relevant to determining whether a person is a trader 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. See Endicott v. Commissioner, T.C. Memo 2013-199; Nelson v. Commissioner, T.C. Memo 2013-259, King v. Commissioner, 89 T.C. 445 (1987). A person that is a trader under these principles will be treated as performing the services of trading for purposes of section 199A (d)(2)(B).

c. Dealing in Securities, Partnership Interests, and Commodities

For purposes of proposed §1.199A-5(b)(2)(xiii), 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. For purposes of the preceding sentence, 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 purposes of section 199A(d)(2). See §1.475(c)-1(c)(2) and (4) for the definition of negligible sales.

For purposes of proposed §1.199A-5(b)(2)(xiii), 'the performance of services that consist of dealing in partnership interests' means regularly purchasing partnership interests from and selling partnership interests 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 partnership interests with customers in the ordinary course of a trade or business.

For purposes of proposed §1.199A-5(b)(2)(xiii), 'the performance of services that consist of dealing in commodities (as defined in section 475(e)(2))' means regularly purchasing commodities from and selling commodities 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 commodities with customers in the ordinary course of a trade or business.

3. Defining What is Included in an SSTB

The Treasury Department and the IRS are aware that some taxpayers have contemplated a strategy to separate out parts of what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the section 199A deduction. Such a strategy is inconsistent with the purpose of section 199A. Therefore, in accordance with section 199A(f)(4), in order to carry out the purposes of section 199A, proposed §1.199A-5(c)(2) provides 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. Additionally, 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 (meaning the income will be treated as income from an SSTB). For example, A, a dentist, owns a dental practice and also owns an office building. A rents half the building to the dental practice and half the building to unrelated persons. Under proposed §1.199A-5(c)(2), the renting of half of the building to the dental practice will be treated as an SSTB.

Additionally, proposed §1.199A-5 provides a rule 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 as incidental to an SSTB and, therefore, as an SSTB, if the trade or business represents no more than five percent of gross receipts of the combined business.

B. Trade or Business of Performing Services as an Employee

Under section 199(d)(1)(B), the trade or business of performing services as an employee is not a qualified trade or business. Unlike an SSTB, there is no threshold amount that applies to the trade or business of performing services as an employee. Thus, wage or compensation income earned by any employee is not eligible for the section 199A deduction no matter the amount.

1. Definition

An individual is an employee for Federal employment tax purposes if he or she has the status of an employee under the usual common law and statutory rules applicable in determining the employer-employee relationship. Guides for determining employment status are found in §§31.3121(d)-1, 31.3306 (i)-1, and 31.3401(c)-1. As stated in the regulations, generally, the common law relationship of employer and employee exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the direction and control of the employer not only as to what shall be done but how it shall be done. In this connection it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so.

In addition, the regulations and section 3401(c) state, generally, that an officer of a corporation (including an S Corporation) is an employee of the corporation. However, an officer of a corporation who does not perform any services or performs only minor services in his or her capacity as officer and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered to be an employee of the corporation. Whether an officer's services are minor is a question of fact that depends on the nature of the services, the frequency and duration of their performance, and the actual and potential importance or necessity of the services in relation to the conduct of the corporation's business. See Rev. Rul. 74-390.

To provide clarity, proposed §1.199A-5(d) provides a general rule that income from the trade or business of performing services as an employee refers to all wages (within the meaning of section 3401(a)) and other income earned in a capacity as an employee, including payments described in §1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)) and §1.6041-2(b)(1). If an individual derives income in the course of a trade or business that is not described in section 3401(a), §1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)), or §1.6041-2 (b)(1), that individual is not considered to be in the trade or business of performing services as an employee with regard to such income.

2. Presumption for Former Employees

Section 199A provides that the trade or business of providing services as an employee is not eligible for the section 199A deduction. Therefore, taxpayers and practitioners noted that it may be beneficial for employees to treat themselves as independent contractors or as having an equity interest in a partnership or S corporation in order to benefit from the deduction under section 199A.

Section 530(b) of the Revenue Act of 1978 (Pub. L. 95-600), as amended by section 9(d)(2) of Public Law 96-167, section 1(a) of Public Law 96-541, and section 269(c) of Public Law 97-248, provides a prohibition against regulations and rulings on employment status for purposes of employment taxes. Specifically, section 530(b) provides that no regulation or revenue ruling shall be published before the effective date of any law clarifying the employment status of individuals for purposes of the employment taxes by the Treasury Department (including the IRS) with respect to the employment status of any individual for purposes of the employment taxes. Section 530(c) of the Revenue Act of 1978 provides that, for purposes of section 530, the term 'employment tax' means any tax imposed by subtitle C of the Internal Revenue Code of 1954, and the term 'employment status' means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship as an employee or as an independent contractor (or other individual who is not an employee). These longstanding rules of section 530 of the Revenue Act of 1978 limit the ability of the IRS to impose employment tax liability on employers for misclassifying employees as independent contractors but do not preclude challenging a worker's status for purposes of section 199A, an income tax provision under subtitle A of the Code.

Therefore, proposed §1.199A-5(d)(3) provides that for purposes of section 199A, 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. 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. However, it would not be appropriate to provide that someone who formerly was an employee of an employer is now 'less likely' to be respected as an independent contractor. Such a rule would not treat similarly-situated taxpayers similarly: two individuals who have a similar relationship with a company and each claim to be treated as independent contractors would be treated differently depending on any prior employment history with the company. Therefore, proposed §1.199A-5(d)(3) does not provide any new or different standards to be properly classified as an independent contractor or owner of a business. Instead, proposed §1.199A-5(d)(3) contains a presumption that applies in certain situations to ensure that individuals properly substantiate their status.

Specifically, proposed §1.199A-5(d)(3) provides that, solely for purposes of section 199A(d)(1)(B) and the regulations thereunder, 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. This presumption is solely for purposes of section 199A and does not otherwise change the employment tax classification of the individual. Section 199A is in subtitle A of the Code, and this rule does not apply for purposes of any other subtitle, including subtitle C. Accordingly, this rule does not implicate section 530(b) of the Revenue Act of 1978. Proposed §1.199A-5(d)(3)(ii) contains three examples illustrating this rule.

VI. Proposed §1.199A-6: Special Rules for RPEs, PTPs, Trusts, and Estates

Proposed §1.199A-6 provides guidance that certain specified entities (for example, RPEs, PTPs, trusts, and estates) may need to follow for purposes of computing the entities' or their owners' section 199A deductions.

A. Computational Steps for RPEs and PTPs

Although RPEs cannot take the section 199A deduction at the RPE level, each RPE must determine and report the information necessary for its direct and indirect owners to determine their own section 199A deduction. Proposed §1.199A-6(b) follows the rules applicable to individuals with taxable income above the threshold amount set forth in §1.199A-1(d) in directing RPEs to determine what amounts and information to report to their owners and the IRS, including QBI, W-2 wages, the UBIA of qualified property for each trade or business directly engaged in, and whether any of its trades or businesses are SSTBs. RPEs must also determine and report qualified REIT dividends and qualified PTP income received directly by the RPE. Proposed §1.199A-6(b)(3) then requires each RPE to report this information on or with the Schedules K-1 issued to the owners. RPEs must report this information regardless of whether a taxpayer is below the threshold. The Treasury Department and the IRS request comments whether it is administrable to provide a special rule that if none of the owners of the RPE have taxable income above the threshold amount, the RPE does not need to determine and report W-2 wages, UBIA of qualified property, or whether the trade or business is an SSTB. Although such a rule would relieve an RPE of an unnecessary burden, the RPE would need to have knowledge of the ultimate owner's taxable income.

The definition of an RPE does not include a PTP. However, PTPs must still determine and report QBI under the rules of proposed §1.199A-3 for each trade or business in which the PTP is engaged and whether those trades or businesses are SSTBs. A PTP must also determine whether it has received any qualified REIT dividends or qualified PTP income or loss from another PTP. These items must be reported on or with the Schedule K-1. A PTP is not required to determine or report W-2 wages or the UBIA of qualified property.

B. Application to Trusts, Estates, and Beneficiaries

Proposed §1.199A-6(d) contains special rules for applying section 199A to trusts and decedents' estates. To the extent that a grantor or another person is treated as owning all or part of a trust under sections 671 through 679 (grantor trust), including qualified subchapter S trusts (QSSTs) with respect to which the beneficiary has made an election under section 1361(d), the owner will compute its QBI with respect to the owned portion of the trust as if that QBI had been received directly by the owner.

In the case of a section 199A deduction claimed by a non-grantor trust or estate, section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W-2 wages and the apportionment of UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, proposed §1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's W-2 wages is determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.

In addition, proposed §1.199A-6(d)(3)(ii) provides that, to the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportion as DNI of the trust or estate is allocated. This is the case regardless of how any depreciation or depletion deductions resulting from the same property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than section 199A.

Under section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Commenters have noted that taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of section 199A. Therefore, proposed §1.199A-6(d)(3)(v) provides that trusts formed or funded with a significant purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A.

The Treasury Department and the IRS request comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. Such comments should include explanations of how amounts that may give rise to the section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.

VII. Proposed §1.643(f)-1: Anti-Avoidance Rules for Multiple Trusts

As described in section VI B of the Explanation of Provisions, under section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Therefore, taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of section 199A and general trust principles.

To address this and other concerns regarding the abusive use of multiple trusts, proposed §1.643(f)-1 confirms the applicability of section 643(f). As noted in part II of the Background, section 643(f) permits the Secretary to prescribe regulations 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. Proposed §1.643(f)-1 provides that, in the case in which two or more trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of Federal income tax, then such trusts will be treated as a single trust for Federal income tax purposes. For purposes of applying this rule, spouses are treated as only one person and, accordingly, multiple trusts established for a principal purpose of avoiding Federal income tax may be treated as a single trust even in cases where separate trusts are established or funded independently by each spouse. Proposed §1.643(f)-1 further provides examples to illustrate specific situations in which multiple trusts will or will not be treated as a single trust under this rule, including a situation where multiple trusts are created with a principal purpose of avoiding the limitations of section 199A. The application of proposed §1.643(f)-1, however, is not limited to avoidance of the limitations under section 199A and proposed §§1.199A-1 through 1.199A-6.

The rule in proposed §1.643(f)-1 would apply to any arrangement involving multiple trusts entered into or modified on or after August 16, 2018. In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the rule in proposed §1.643(f)-1 generally reflects the intent of Congress regarding the arrangements involving multiple trusts that are appropriately subject to treatment under section 643(f).

VIII. Specified Agricultural or Horticultural Cooperatives

In the TCJA and the 2018 Act, Congress provided special rules for applying section 199A in the case of specified agricultural and horticultural cooperatives. The Treasury Department and the IRS continue to study this area and intend to issue separate proposed regulations describing rules for applying section 199A to specified agricultural and horticultural cooperatives and their patrons later this year. As provided in section 199A(g)(6), such regulations will generally be based on the regulations applicable to cooperatives and their patrons under former section 199 (as in effect before its repeal). The Treasury Department and the IRS anticipate that the regulations will provide that section 199A(g) applies only to the patronage business of a relevant cooperative. The proposed regulations will also provide more information for taxpayers that must apply the reduction under section 199A(b)(7), which is a special rule with respect to income received from cooperatives.

Availability of IRS Documents

IRS notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Proposed Effective/Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the Federal Register, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the Federal Register. However, section 7805(b)(2) provides that regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which they relate are not prohibited from applying to taxable periods prior to those described in section 7805(b)(1). Furthermore, section 7805(b)(3) provides that the Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.

Accordingly, proposed §§1.199A-1 through 1.199A-6 generally are proposed to apply to taxable years ending after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. However, taxpayers may rely on the rules set forth in proposed §§1.199A-1 through 1.199A-6, in their entirety, until the date a Treasury decision adopting these regulations as final regulations is published in the Federal Register. In addition, to prevent abuse of section 199A and the regulations thereunder, the anti-abuse rules of proposed §§1.199A-2(c)(1)(iv), 1.199A-3(c)(2)(B), 1.199A-5(c)(2), 1.199A-5(c)(3), 1.199A-5(d)(3), and 1.199A-6(d)(3)(v) are proposed to apply to taxable years ending after December 22, 2017, the date of enactment of the TCJA. Finally, the provisions of proposed §1.643-1, which prevent abuse of the Code generally through the use of trusts, are proposed to apply to taxable years ending after August 16, 2018.

Section 199A(f)(1) provides that section 199A applies at the partner or S corporation shareholder level, and that each partner or shareholder takes into account such person's allocable share of each qualified item. Section 199A(c)(3) provides that the term 'qualified item' means items that are effectively connected with a U.S. trade or business, and 'included or allowed in determining taxable income from the taxable year.' Section 199A applies to taxable years beginning after December 31, 2017. However, there is no statutory requirement under section 199A that a qualified item arise after December 31, 2017.

Section 1366(a) generally provides that, in determining the income tax of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, the shareholder's pro rata share of the corporation's items is taken into account. Similarly, section 706(a) generally provides that, in computing the taxable income of a partner for a taxable year, the partner includes items of the partnership for any taxable year of the partnership ending within or with the partner's taxable year. Therefore, income flowing to an individual from a partnership or S corporation is subject to the tax rates and rules in effect in the year of the individual in which the entity's year closes, not the year in which the item actually arose.

Accordingly, for purposes of determining QBI, W-2 wages, and UBIA of qualified property, the effective dates provisions provide that if an individual receives QBI, W-2 wages, or UBIA of qualified property from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's tax year during which such RPE taxable year ends

Special Analyses

I. Regulatory Planning and Review-Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

These proposed regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Treasury Department has determined that the proposed rulemaking is subject to review as economically significant under section 1(c) of the Memorandum of Agreement, and OMB concurs with this designation. Accordingly, these proposed regulations have been reviewed by the Office of Management and Budget. For more detail on the economic analysis, please refer to the following analysis.

A. Overview

Congress enacted section 199A to provide individuals, estates, and trusts a deduction of up to 20 percent of QBI from domestic businesses, which includes trades or businesses operated as a sole proprietorship or through a partnership, S corporation, trust, or estate. As stated in the Explanation of Provisions, these proposed regulations are necessary to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 199A. The proposed regulations provide guidance to taxpayers for purposes of calculating the section 199A deduction. They provide clarity for taxpayers in determining their eligibility for the deduction and the amount of the allowed deduction. Among other benefits, this clarity helps ensure that taxpayers all calculate the deduction in a similar manner, which encourages decision-making that is economically efficient contingent on the provisions of the overall Code.

The proposed regulations contain seven sections, six proposed under section 199A (proposed §§1.199A-1 through 1.199A-6) and one proposed under section 643(f) (proposed §1.643(f)-1). Each of proposed §§1.199A-1 through 1.199A-6 provides rules relevant to the section 199A deduction and proposed §1.643(f)-1 would establish anti-abuse rules 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, including abuse of section 199A. This economic analysis describes the economic benefits and costs of each of the seven sections of the proposed regulations.

B. Baseline

The analysis in this section compares the proposed regulation to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

C. Economic Analysis of Proposed §1.199A-1

1. Background

Because the section 199A deduction has not previously been available, a large number of the relevant terms and necessary calculations taxpayers are currently required to apply under the statute can benefit from greater specificity. For example, the statute uses the term trade or business to refer to the enterprise whose income would be potentially eligible for the deduction but does not define what constitutes a trade or business for purposes of section 199A; the proposed regulations provide that taxpayers should generally apply the definition of a trade or business provided by section 162(a). The definition of trade or business in proposed §1.199A-1 is extended beyond the section 162 definition if a taxpayer chooses to aggregate businesses under the rules of proposed §1.199A-4. In addition, solely for purposes of section 199A, the rental or licensing of 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 under proposed §1.199A-4(b)(1)(i). The proposed regulations also make clear that the section 199A deduction is allowed when calculating alternative minimum taxable income of individuals.

Because the section 199A deduction has multiple components that may interact in determining the deduction, it is also valuable to lay out rules for calculating the deduction since the statute does not provide each of those particulars.

Alternative approaches the Treasury Department and the IRS could have proposed would be to remain silent on additional definitional specificities and to allow post-limitation netting in calculating the section 199A deduction. The Treasury Department and the IRS concluded these approaches would likely give rise to less economically efficient tax-related decisions than would relying on statutory language alone and requiring or leaving open the possibility of post-limitation netting.

2. Anticipated Benefits of Proposed §1.199A-1

The Treasury Department and the IRS expect that the definitions and guidance provided in §1.199A-1 will implement the 199A deduction in an economically efficient manner. An economically efficient tax system generally aims to treat income derived from similar economic decisions similarly in order to reduce incentives to make choices based on tax rather than market incentives. In this context, the principal benefit of proposed §1.199A-1 is to reduce taxpayer uncertainty regarding the calculation of the section 199A deduction relative to an alternative scenario in which no such regulations were issued. In the absence of the clarifications in proposed §1.199A-1 regarding, for example, the definition of an eligible trade or business, similarly situated taxpayers might interpret the statutory rules of section 199A differently, given the statute's limited prescription of the implementation details. In addition, without these regulations it is likely that many taxpayers impacted by section 199A would take on more (or less) than the optimal level of risk in allocating resources within or across their businesses. Both of these actions would give rise to economic inefficiencies. The proposed regulations would provide a uniform signal to businesses and thus lead taxpayers to make decisions that are more economically efficient contingent on the overall Code. As an example, proposed §1.199A-1 prescribes the steps taxpayers must take to calculate the QBI deduction in a manner that avoids perverse incentives for shifting wages and capital assets across businesses. The statute does not address the ordering for how the W-2 wages and UBIA of qualified property limitations should be applied when taxpayers have both positive and negative QBI from different businesses. The proposed regulations clarify that in such cases the negative QBI should offset positive QBI prior to applying the wage and capital limitations. For taxpayers who would have assumed in the alternate that negative QBI offsets positive QBI after applying the wage and capital limitations, the proposed approach weakens the incentive to shift W-2 wage labor or capital (in the form of qualified property) from one business to another to maximize the section 199A deduction.

To illustrate this, consider a taxpayer who is above the statutory threshold and owns two non-service sector businesses, A and B. A has net qualified income of $10,000, while B has net qualified income of -$5,000. Suppose that A paid $3,000 in W-2 wages, B paid $1,000 in W-2 wages, and neither business has tangible capital. If negative QBI offsets positive QBI after applying the wage and capital limitations, then A generates a tentative deduction of $1,500, while B generates a tentative deduction of -$1,000, for a total deduction of $500. After moving B's W-2 wages to A, A's tentative deduction rises to $2,000, while B's remains -$1,000, increasing the total deduction to $1,000. If, on the other hand, negative QBI offsets positive QBI prior to applying the wage and capital limitations (as in the proposed regulations), then A and B have combined income of $5,000, and the total deduction is $1,000 because the wage and capital limitations are non-binding. After moving B's wages to A, the total deduction remains $1,000. Thus, an incentive to shift wages arises if negative QBI offsets positive QBI after applying the wage and capital limitations. By taking the opposite approach, proposed §1.199A-1 reduces incentives for such tax-motivated, economically inefficient reallocations of labor (or capital) relative to a scenario in which offsets were taken after wage and capital limitations were applied.

3. Anticipated Costs of Proposed §1.199A-1

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by proposed §1.199A-1 and request comment regarding this anticipated impact. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

D. Economic Analysis of Proposed §1.199A-2

1. Background

Section 199A provides a deduction of up to 20 percent of the taxpayer's income from qualifying trades or businesses. Taxpayers with incomes above a threshold amount cannot enjoy the full 20 percent deduction unless they determine that their businesses pay a sufficient amount of wages and/or maintain a sufficient stock of tangible capital, among other requirements.

Because this deduction has not previously been available, proposed §199A-2 provides greater specificity than is available from the statute regarding the definitions of W-2 wages and UBIA of qualified property (that is, depreciable capital stock) relevant to this aspect of the deduction. For example, the proposed regulations make clear that property that is transferred or acquired within a specific timeframe with a principal purpose of increasing the section 199A deduction is not considered qualified property for purposes of the section 199A deduction. In addition, proposed §1.199A-2 generally follows prior guidance for the former section 199 deduction in determining which W-2 wages are relevant for section 199A purposes, with additional rules for allocating wages amongst multiple trades or businesses. In these and other cases, the proposed regulations generally aim, within the context of the legislative language and other tax considerations, to ensure that only genuine business income is eligible for the section 199A deduction, and to reduce business compliance costs and government administrative costs.

Alternative approaches would be to remain silent or to choose different definitions of W-2 wages or qualified property for the purposes of claiming the deduction. The Treasury Department and the IRS rejected these alternatives as being inconsistent with other definitions or requirements under the Code and therefore unnecessarily costly for taxpayers to comply with and the IRS to administer.

2. Anticipated Benefits of Proposed §1.199A-2

The Treasury Department and IRS expect that proposed §1.199A-2 will implement the 199A deduction in an economically efficient manner. For example, proposed §1.199A-2 will discourage some inefficient transfers of capital given the statute's silence regarding the circumstances in which certain property transfers would or would not be considered under section 199A. Specifically, the proposed rules make clear that property transferred or acquired within a specific timeframe with a principal purpose of increasing the section 199A deduction is not considered qualified for purposes of the 199A deduction.

The proposed regulations will also reduce taxpayer uncertainty regarding the implementation of the section 199A deduction relative to a scenario in which no regulations were issued. In the absence of such clarification, similarly situated taxpayers would likely interpret the section 199A deduction differently to the extent that the statute does not adequately specify the particular implementation issues addressed by 199A-2; and as a result, taxpayers might take on more (or less) than the optimal level of risk in their interpretations. The proposed regulations would lead taxpayers to make decisions that were more economically efficient, conditional on the overall Code.

3. Anticipated Costs of Proposed §1.199A-2

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by proposed §1.199A-2, and request comment regarding this anticipated impact. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

E. Economic Analysis of Proposed § 1.199A-3

1. Background

Section 199A provides a deduction of up to 20 percent of the taxpayer's income from qualifying trades or businesses. In the absence of legislative and regulatory constraints, taxpayers would have an incentive to count as income some income that, from an economic standpoint, did not accrue specifically from qualifying economic activity. The proposed regulations clarify what does and does not constitute QBI for purposes of the 199A deduction, providing greater implementation specificity than provided by the statute. Because guaranteed payments for capital, for example, are not at risk in the same way as other forms of income, they might reasonably be excluded from QBI. Similarly, Treasury proposes that income that is a guaranteed payment, but which is filtered through a tiered partnership in order to avoid being labeled as such, should be treated similarly to guaranteed payments in general and therefore excluded from QBI. This principle applies to other forms of income that similarly represent income that either is not at risk or does not flow from the specific economic value provided by a qualifying trade or business, such as returns on investments of working capital. The proposed regulations define and clarify the types of income that might reasonably be considered QBI, within the constraints of the legislation.

2. Anticipated Benefits of Proposed §1.199A-3

The Treasury Department and IRS expect that proposed §1.199A-3 regulations will implement the 199A deduction in an economically efficient manner. For example, 199A-3 will discourage the creation of tiered partnerships purely for the purposes of increasing the section 199A deduction. In the absence of regulation, some taxpayers would likely create tiered partnerships under which a lower-tier partnership would make a guaranteed payment to an upper-tier partnership, and the upper-tier partnership would pay out this income to its partners without guaranteeing it. Such an organizational structure would likely be economically inefficient because it was, apparently, created solely for tax minimization purposes and not for reasons related to efficient economic decision-making.

The Treasury Department and the IRS further expect that the proposed regulations will reduce uncertainty over whether particular forms of income do or do not constitute QBI relative to a scenario in which no regulations were issued. In the absence of regulations, taxpayers would still need to determine what income is considered QBI and similarly situated taxpayers might interpret the statutory rules differently and pursue income-generating activities based on different assumptions about whether that income would qualify for QBI. Proposed §1.199A-3 provides clearer guidance for how to determine QBI, helping to ensure that taxpayers face uniform incentives when making economic decisions, a tenet of economic efficiency.

3. Anticipated Costs of Proposed §1.199A-3 Relative to the Baseline

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by proposed §1.199A-3, and request comment regarding this anticipated impact. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

F. Economic Analysis of Proposed §1.199A-4

1. Background

Businesses may organize either as C corporations, which are owned by stockholders, or in a form generally called a passthrough, which may take one of several legal forms including sole proprietorships, under which there does not exist a clear separation between the owners and the business's decision-makers. Each organizational structure, in some circumstance, may be economically efficient, depending on the risk profile, information asymmetries, and decision-making challenges pertaining to the specific business and on the risk preferences and economic situations of the individual owners. An economically efficient tax system would keep the choice among organizational structures neutral contingent on the provisions of the corporate income tax.

This principle of neutral tax treatment further applies to the various organizational structures that qualify as passthroughs. Many passthrough business entities are connected through ownership, management, or shared decision-making. The proposed aggregation rule allows individuals to aggregate their trades or businesses for the purposes of calculating the section 199A deduction. It thus helps ensure that significant choices over ownership and management relationships within businesses are not chosen solely to increase the section 199A deduction.

An alternative approach would be not to allow aggregation for purposes of claiming the deduction. The Treasury Department and the IRS decided to allow aggregation in the specified circumstances to minimize or avoid distortions in organizational form that could arise if aggregation were not allowed.

2. Anticipated Benefits of Proposed §1.199A-4

The Treasury Department and the IRS expect that the aggregation guidance provided in proposed §1.199A-4 will implement the 199A deduction in an economically efficient manner. Economic tax principles are called into play here because a large number of businesses that could commonly be thought of as a single trade or business actually may be divided across multiple entities for legal or economic reasons. Allowing taxpayers to aggregate trades or businesses offers taxpayers a means of putting together what they think of as their trade or business for the purposes of claiming the deduction under section 199A without otherwise changing ownership and management structures. If such aggregation were not permitted, certain taxpayers would restructure solely for tax purposes, with the resulting structures leading to less efficient economic decision-making.

3. Anticipated Costs of Proposed §1.199A-4

The proposed regulations require common majority ownership to apply the aggregation rule. If no aggregation were allowed, taxpayers would have to combine businesses to calculate the deduction based on the combined income, wages, and capital. The majority ownership threshold may thus encourage owners to concentrate their ownership in order to benefit from the aggregation rule. The additional costs of the proposed regulations would be limited to those owners who would find merging entities too costly based on other market conditions, but under these regulations may find it beneficial to increase their ownership share in order to aggregate their businesses and maximize their QBI deduction.

Changes to the collective paperwork burden arising from proposed §1.199A-4 and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis. The Treasury Department and the IRS request comments regarding these and other potential costs arising from the regulations.

G. Economic Analysis of Proposed §1.199A-5

1. Background

Section 199A provides a deduction of up to 20 percent of the taxpayer's income from qualifying trades or businesses. In the absence of legislative and regulatory constraints, taxpayers have an incentive to receive labor income as income earned as a an independent contractor or through ownership of an RPE, even though this income may not derive from the risk-bearing or decision-making efficiencies that are unique to being an independent contractor or to owning an equity interest in an RPE. The Act provided several provisions that bear on this distinction.

Proposed §1.199A-5 provides guidance on what trades or businesses would be characterized as an SSTB under each type of services trade or business listed in the legislative text. In addition, proposed §1.199A-5 provides an exception to the SSTB exclusion if the trade or business only earns a small fraction of its gross income from specified service activities (de minimis exception). Finally, the proposed regulations state that former employees providing services as independent contractors to their former employer will be presumed to be acting as employees unless they provide evidence that they are providing services in a capacity other than an employee.

An alternative approach to the de minimis exception would be to require businesses or their owners to trigger the SSTB exclusion regardless of the share of gross income from specified service activities. The Treasury Department concluded that providing a de minimis exception is necessary to avoid very small amounts of SSTB activity within a trade or business making the entire trade or business ineligible for the deduction, an outcome that is inefficient in the context of section 199A.

2. Anticipated Benefits of Proposed §1.199A-5

The Treasury Department and the IRS expect that proposed §1.199A-5 will implement the 199A deduction in an economically efficient manner. To this end, proposed §1.199A-5 clarifies the definition of an SSTB. In the absence of such clarification, similarly situated taxpayers might interpret the legislative text differently, leading some taxpayers to invest in particular businesses under the assumption income earned from that entity was eligible for the deduction while other taxpayers might forgo that investment due to the opposite assumption. These disparate investment signals generate economic inefficiencies. The proposed regulations reduce this inefficiency relative to a scenario in which no regulation providing a de minimus exception was issued.

Furthermore, in the absence of the proposed regulations, some owners of businesses may find it advantageous to separate their business activity into SSTB and non-SSTB businesses in order to receive the section 199A deduction on their non-SSTB activity. The proposed regulations would disallow this behavior by stating that a taxpayer that provides property or services to an SSTB that is commonly-owned will have the portion of property or services provided to the SSTB treated as attributable to an SSTB. Additionally without these regulations, some businesses may have an incentive to pay a portion of their employees as independent contractors. Either of these actions would entail some loss of economic efficiency due to changes in businesses' decision-making structures based on tax incentives. They may also inefficiently provide incentives to change employment relationships in favor of independent contractors. The proposed regulations help to avoid these sources of inefficiency.

3. Anticipated Costs of Proposed §1.199A-5 Relative to the Baseline

In addition to the statutory threshold amount, below which SSTB status is not relevant, proposed §1.199A-5 provides a de minimis rule with tiered-thresholds of gross revenues arising from specified service activity in determining whether a trade or business with a smaller amount of specified service activity is classified as an SSTB. This threshold may cause businesses near the cutoff to decrease their specified service activities or increase their non-specified service activities to avoid being classified as an SSTB. Additionally, the de minimis rule may encourage smaller entities engaged in SSTBs to merge with larger entities not engaged in an SSTB. The economic costs of these mergers are difficult to quantify.

Changes to the collective paperwork burden arising from §1.199A-5 and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis. The Treasury Department and IRS request comment regarding these and other potential costs arising from the regulations.

H. Economic Analysis of Proposed §1.199A-6

1. Background

The 199A deduction is reduced below 20 percent for some businesses and taxpayers. The attributes that determine any such reduction must be determined by taxpayers claiming the section 199A deduction. Proposed §1.199A-6 provides rules for RPEs, PTPs, trusts, and estates relevant to making these determinations. In particular, RPEs are required to calculate and report their owners' QBI, SSTB status, W-2 wages, UBIA of qualified property, REIT dividends, and PTP income. Similarly, PTPs must calculate and report their owners' QBI, SSTB status, REIT dividends, and other PTP income.

2. Anticipated Benefits of Proposed §1.199A-6

The Treasury Department and IRS expect that proposed §1.199A-6 will implement the 199A deduction in an economically efficient manner. As with other proposed regulations discussed in this Analyses, a principal benefit of proposed §1.199A-6 is to increase the likelihood that all taxpayers interpret the statutory rules of section 199A similarly. Additionally, we expect that requiring RPEs to determine and report the information necessary to compute the section 199A deduction will result in a more accurate and uniform application of the regulations and statute relative to an alternative approach under which individual owners would most likely determine these items.

3. Anticipated Costs of Proposed §1.199A-6 Relative to the Baseline

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by proposed §1.199A-6, and request comment on these estimated impacts. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

I. Economic Analysis of Proposed §1.643(f)-1

1. Background

Proposed §1.643(f)-1 provides that taxpayers cannot set up multiple trusts in certain cases with a principal purpose of tax avoidance, which would include the avoidance of the statutory threshold amounts under section 199A.

2. Anticipated Benefits of Proposed §1.643(f)-1 Relative to the Baseline

The Treasury Department and IRS expect that the proposed §1.643(f)-1 will implement the 199A deduction in an economically efficient manner. Because proposed §1.643(f)-1 defines the manner in which trusts are subject to the threshold amount where the statute is silent, the Treasury Department and the IRS anticipate that the proposed regulations will lead to fewer resources being devoted to setting up trusts in attempts to avoid the threshold amount rules under section 199A. If multiple trusts have substantially the same grantors and beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of Federal income tax, then the various trusts would be generally considered one trust, including for section 199A purposes.

3. Anticipated Costs of Proposed §1.643(f)-1 Relative to the Baseline

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by proposed §1.643(f)-1, and request comment on these estimated impacts. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

J. Anticipated Impacts on Administrative and Compliance Costs

1. Discussion

The proposed regulations have a number of effects on taxpayers' compliance costs. Proposed §1.199A-2 provides guidance in determining a taxpayer's share of W-2 wages and UBIA of qualified property. The Treasury Department and the IRS expect that this guidance reduces the tax compliance costs of making this determination and reduces uncertainty. In the absence of the proposed regulations, taxpayers would still need to determine how to allocate W-2 wages and UBIA of qualified property, among other calculations. These regulations provide clear instructions for how to do this, simplifying the process of complying with the law.

Proposed §1.199A-4 requires that owners who decide to aggregate their trades or businesses report the aggregation annually. This reporting requirement adds to the tax compliance burden of these owners. For owners who consider aggregating, these regulations increase compliance costs because the owners must calculate their deduction for both disaggregated and aggregated trades or businesses to make the aggregation decision. These additional compliance costs would be voluntary and accrue only to owners who find it beneficial to aggregate for the purposes of calculating their section 199A deduction.

Proposed §1.199A-5 includes a requirement for former employees working as independent contractors for their former employer to show that their employment relationship has changed in order to be eligible for the section 199A deduction. The burden to substantiate employment status exists without these proposed regulations; however, the proposed regulation may increase these individuals' compliance costs slightly.

Proposed §1.199A-6 specifies that RPEs must report relevant section 199A information to owners. Due to these entity reporting requirements, the proposed regulations will increase compliance costs for RPEs. These entities will need to keep records of new information relevant to the calculation of their owners' section 199A deduction, such as QBI, W-2 wages, SSTB status, and UBIA of qualified property. This recordkeeping is costly. Without these regulations, it is likely that only some RPEs would engage in this record keeping.

Proposed §1.199A-6 reduces the compliance burden on many individuals that own RPEs relative a scenario in which no regulations were issued or regulatory alternatives that assigned each owner of an RPE the responsibility to acquire the required information were issued without any requirement for the RPE to provide such information. Under the proposed regulations, owners will receive information pertaining to the section 199A deduction from the RPE, such as whether a given trade or business is an SSTB, whereas in the alternate they could have been required to make such determinations themselves.

Overall, it is likely to be more efficient for RPEs, rather than individual owners, to keep records of section 199A deduction information. Therefore, the Treasury Department and the IRS expect that proposed §1.199A-6 will reduce compliance costs on net and relative to these alternative scenarios.

2. Estimated Effect on Compliance Costs

As explained above, key provisions of proposed §§1.199A-1 through 1.199A-6 will reduce compliance costs that taxpayers would likely have incurred in the absence of the proposed rule. Most notably, the de minimis rule of proposed §1.199A-5 provides that a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity. This provision is expected to reduce compliance costs associated with section 199A for millions of U.S. businesses. In addition, the aggregation rules will reduce overall costs for taxpayers because some taxpayers would restructure their business arrangements in order to receive the benefit of the deduction. These and other discretionary choices by the Treasury Department and the IRS in the proposed rule will substantially reduce taxpayers' compliance costs.

The Treasury Department and the IRS also assessed the provisions of the proposed rule that could increase compliance burdens. Estimates of the change in annual reporting burden associated with these proposed regulations are presented here and in further detail in the Paperwork Reduction Act (PRA) section. The Treasury Department and the IRS estimate a gross (not net) increase in total reporting burden of 25 million hours annually. The estimates primarily reflect two effects of the regulations. First, the Treasury Department and the IRS project that approximately 1.2 million individuals with more than one directly owned or pass-through business who voluntarily choose to aggregate will spend 0.66 hours annually complying with proposed §1.199A-4. Second, the Treasury Department and the IRS project that - in complying with the proposed §1.199A-6 requirement to report relevant section 199A information to their approximately 8.8 million owners - RPEs will spend 2.75 hours annually per owner. These estimates do not include the decrease in compliance costs to individuals who would no longer find it necessary to compute the quantities detailed in proposed §1.199A-6 because they would receive this information from each RPE. Nor do these estimates reflect the decrease in compliance costs outlined above.

Valuations of the burden hours of $39/hour in the case of individuals making aggregation decisions and $53/hour in the case of RPEs reporting section 199A information lead to a PRA-based estimate of the gross reporting annualized costs to taxpayers of approximately $1.3 billion over ten years; this estimate does not account for the provisions of the proposed regulations that will substantially reduce compliance costs. Because these estimates assume that the costs are the same each year, the annualized costs do not vary with the discount rate. It is possible that costs will be higher in the first years that the deduction is allowed and lower in future years once taxpayers have more experience with the calculations and reporting requirements associated with the deduction. Finally, the estimates reflect data for entities of a size and form expected to be impacted by section 199A. More specifically, because of the scope of the section 199A deduction, the Treasury Department and the IRS expect the majority of affected entities to be largely small, and medium in size.

The Treasury Department and the IRS solicit comments on the assumptions and the methodology used to calculate the compliance costs imposed by the proposed regulations relative to the baseline. This includes, among other things, assumptions and methodology regarding the reporting burden per respondent, the number of impacted entities, and the hourly labor cost estimate for reporting.

Annualized monetized effect on compliance costs from proposed regulations	Years 2018 to 2027 (3% discount rate, millions $2018)	Years 2018 to 2027 (7% discount rate, millions $2018)
Estimated Gross Costs	$1,317	$1,317
Estimated Savings	Not quantified	Not quantified

K. Executive Order 13771

The Treasury Department and the IRS request comment on the Executive Order 13771 designation for these proposed regulations. Details on the estimated costs of the proposed regulations can be found in this economic analysis.

II. Regulatory Flexibility Act

It is hereby certified that the collections of information in proposed §§1.199A-4 and 1.199A-6 will not have a significant economic impact on a substantial number of small entities. Although the Treasury Department and the IRS believe that the proposed regulations may affect a substantial number of small entities, the economic impact on small entities as a result of the collections of information in this notice of proposed rulemaking is not expected to be significant.

The collection in proposed §1.199A-4 may apply to individuals and certain trusts or estates that can claim the section 199A deduction and that choose to aggregate two or more trades or businesses for purposes of section 199A. If a taxpayer chooses to aggregate its trades or businesses, the taxpayer, must include an attachment to its tax return identifying and describing each trade or business aggregated, describing changes to the aggregated group, and providing other information as the Commissioner may require in forms, instructions, or other published guidance. RPEs are not subject to the collection in proposed §1.199A-4 because RPEs are not permitted to aggregate trades or businesses. Aggregation is not required by a person claiming the section 199A deduction, and therefore the collection of information in proposed §1.199A-4 is required only if the person chooses to aggregate multiple trades or businesses. It is not known how many small entities will choose to aggregate multiple trades or businesses, therefore a number of affected entities is not estimated at this time.

The small entities subject to the collection of information in proposed §1.199A-6 are business entities formed as estates, trusts, partnerships, or S corporations that conduct, directly or indirectly, one or more trades or businesses. Proposed §1.199A-6 requires such an entity to attach a statement describing the QBI, W-2 wages, and UBIA of qualified property for each separate trade or business to the Schedule K-1 required under existing law to be issued to each beneficiary, partner, or shareholder. Although data is not available to estimate the number of small entities affected by the §1.199A-6 requirements, the Treasury Department and the IRS believe that number would include a substantial number of small entities.

As discussed elsewhere in this preamble, the reporting burden is estimated at 30 minutes to 20 hours, depending on individual circumstances, with an estimated average of 2.5 hours for all affected entities, regardless of size. The burden on small entities is expected to be at the lower end of the range (30 minutes to 2.5 hours). Using the IRS's taxpayer compliance cost estimates, taxpayers who are self-employed with multiple businesses are estimated to have a monetization rate of $39 per hour. Pass-throughs that issue K-1s have a monetization rate of $53 per hour.

For these reasons, the Treasury Department and the IRS have determined that the collection of information in this notice of proposed rulemaking will not have a significant economic impact. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Notwithstanding this certification, the Treasury Department and the IRS invite comments from interested members of the public on both the number of entities affected and the economic impact on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

The Treasury Department and the IRS request comments on all aspects of the proposed rules.

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the ADDRESSES heading. All comments will be available at www.regulations.gov or upon request.

Drafting Information

The principal authors of these regulations are Frank J. Fisher, Wendy L. Kribell, Adrienne M. Mikolashek, and Benjamin H. Weaver, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

1. INCOME TAXES

PAR. 1 The authority citation for part 1 are amended by adding sectional authorities for §§1.199A-1 through 1.199A-6 and §1.643(f) to read in part as follows:

26 U.S.C. 7805

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Section §1.199A-1 also issued under 26 U.S.C. 199A(f)(4).
Section §1.199A-2 also issued under 26 U.S.C. 199A(b)(5), (f)(1)(A), (f)(4), and (h).
Section §1.199A-3 also issued under 26 U.S.C. 199A(c)(4)(C) and (f)(4.)
Section §1.199A-4 also issued under 26 U.S.C. 199A(f)(4).
Section §1.199A-5 also issued under 26 U.S.C. 199A(f)(4).
Section §1.199A-6 also issued under 26 U.S.C. 199A(f)(1)(B) and (f)(4).
Section 1.643(f)-1 also issued under 26 U.S.C. 643(f)
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Kirsten Wielobob,
Deputy Commissioner for Services and Enforcement.

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