October 1, 2018

CC:PA:LPD:PR (REG-107892-18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Attention: Regina Johnson

RE: Comment on IRS Notice of Proposed Rulemaking titled "Qualified Business Income Deduction," REG-107892-18 (August 16, 2018)

Dear Ms. Johnson:

Pursuant to REG-107892-18, the S Corporation Association ("S-Corp") appreciates the opportunity to comment on proposed rules governing the application of the new Section 199A deduction for pass-through businesses.

Section 199A provides a deduction of up to 20 percent of a pass-through owner's income from qualifying trades or businesses. Ensuring broad access to this deduction, as intended by Congress, is essential to balancing the tax treatment of millions of pass-through businesses with the new, lower 21 percent tax rate applied to C corporations.

As our recent EY study made clear, pass-through businesses receiving the full deduction still will pay an effective tax rate that is 1.3 percent higher than the rate paid by the average C corporation. Pass-through businesses not receiving the full deduction, or those precluded from receiving any deduction, will pay rates *significantly* higher.

Average C Corporation	30.6%
S Corporation with Full 199A Deduction	31.9%
S-Corp Manufacturer with Brother-Sister	34.0%
S-Corp with 100% Passive Shareholders	35.5%
S-Corp Retailer with Common Paymaster	36.2%
S-Corp Taxed as a C Corporation	36.8%
S Corporation with no 199A Deduction	40.0%

Broad access to the Section 199A deduction is also pivotal in order for Tax Reform to achieve its fundamental goals of job creation and economic growth. Pass-through businesses represent 95 percent of all business entities, employ over half of private sector workers in the United States, and contribute a majority of business income to our gross domestic product. Much of the economic potential of Tax Reform will be lost if the Main Street community is not a full partner in the reforms.

With this in mind, the S Corporation Association applauds the Department of the Treasury and the Internal Revenue Service ("Treasury") for taking a broad approach to the proposed rules. Section 199A is a new concept which requires Treasury and business owners to navigate through many difficult issues. The proposed rules will require taxpayers to learn new definitions, engage in multistep computations, and comply with complicated anti-abuse rules. These complexities are inherent in the statutory provision itself, however, and the rules go a long way toward establishing a workable program.

That said, the comments below include a number of recommendations we believe will improve the rules significantly and help ensure that the statute is applied as broadly and fairly as possible to qualified business income. These are important recommendations and we appreciate their consideration by Treasury.

Aggregation

Earlier this year, S-Corp joined 43 other trade groups in sending a letter to Treasury formally request that it allow business owners to aggregate (or group) multiple business entities when calculating the Section 199A deduction. As the letter argued:

> *Allowing taxpayers to aggregate or "group" legal business entities together for purposes of calculating the pass-through deduction is vital to making the deduction fair and workable. Main Street businesses often utilize multiple legal entities for non-tax business reasons.*

S-Corp believes that the aggregation regime in the proposed rules is generally consistent with the general sentiments expressed in that letter, with significant exceptions. Those exceptions are articulated below, together with recommendations on how the proposed rules could be improved.

<u>QBI vs. Aggregation</u>: Section 199A-1(d)(2)(iii)(A) of the proposed rules requires that loss-generating trades or businesses to be aggregated with unrelated profit-making trades or businesses for purposes of netting losses against income in determining "qualified business income" (QBI). However, Section 199A-1(d)(2)(iii)(A) states that W-2 wages and/or qualified property from the loss-generating trades or businesses may be taken into account *only* if the businesses satisfy the five requirements discussed in more detail below. The W-2 wages and qualified property of these unprofitable trades or businesses that are blocked from aggregation are effectively "wasted."

In other words, the losses from unprofitable businesses are automatically taken into account when calculating a taxpayer's QBI to *reduce* the taxpayer's potential Section 199A deduction, whereas the W-2 wages and qualified property of those same unprofitable businesses might not be taken into account when they could increase the taxpayer's potential Section 199A deduction.

This uneven treatment of loss-generating businesses appears to be a solution in search of the problem. There is little incentive for a taxpayer to run up W-2 wages and property in order to take advantage of the Section 199A deduction. A taxpayer is not going to incur $100,000 of W-2 wage costs in order to save $18,500 on their taxes ($100,000 in wages divided by 50 percent times the 37 percent tax rate). The math is even worse when you take into account the income tax and the employer and employee FICA taxes paid on all such wages, especially below the FICA wage base. The net costs to the taxpayer of using the combined W-2 wages/qualified property test are even more unfavorable.

Section 199A(b)(2) provides that the operative amount for each qualified business is to be equal to the lesser of (A) "20 percent of the qualified business income with respect to the qualified trade or business" and (B) the W-2 wage/qualified property limitation for that trade or business. While this language could be interpreted to mean that qualified business "losses" should simply be ordered in the year in which they are realized, the Conference Report (page 221) to H.R. 1 takes the opposite position.

To be consistent, then, S-Corp requests that if the proposed rule mandates aggregation of unprofitable trades or businesses for purposes of calculating QBI, it should also allow for aggregation, at least on an elective basis, of those unprofitable trades or businesses, including their W-2 wages and qualified property, when calculating the 199A deduction.

50 Percent Ownership**:** Owners must satisfy five separate requirements in order to aggregate businesses operated by multiple entities when calculating the Section 199A deduction, including a requirement that the same group of owners hold a 50 percent or higher stake in all the businesses included in the group:

> *The same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business to be aggregated. Prop Treas. Reg. §1.199A-4(b)(1)(i).*

S-Corp disagrees that 50 percent ownership is a necessary or helpful condition for aggregation under Section 199A. There are many instances where an owner, or group of owners, operates a trade or business organized in multiple entities where their ownership stake is consistently below 50 percent. For example, a franchising S corporation may retain minority partnership interests in each of its franchisees as part of its business model. Under the proposed rules, the franchising S corporation would not be eligible to aggregate because its partnership interests would fail the 50% common ownership test. This result is inconsistent with the goals of Section 199A – the franchisor's business obviously constitutes a single enterprise and it should be allowed to compute its Section 199A deduction as an aggregated whole.

This concern is particularly compelling when the owner is not a passive investor, but rather manages the businesses to be included within the group. It is not uncommon for a minority stakeholder to be the manager of multiple properties or businesses, and there are a number of industries where the managers of a business with multiple locations (restaurants, hotels, utilities, etc.) hold a minority stake in each of the locations they manage, each with a different set of partners.

S-Corp requests that Treasury delete the 50 percent ownership test. At a minimum, the unitary business of such minority owners who actively manage multiple properties or businesses should be treated as a single business.

Multi-Tiered Ownership Structures**:** Regarding tiered structures, the Preamble to the proposed rules states:

> *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 [would have] 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.(Page 48)*

Many partnerships and S corporations actively engage in more than one trade or business and these trades or businesses are often operated through multiple RPEs. As explained above, such entities have little incentive to incur W-2 or qualified property expenditures solely in order to generate additional section 199A deduction potential. As a consequence, allowing RPEs to aggregate qualifying trades or businesses at the RPE level is unlikely to give rise to any significant tax abuse. Moreover, since aggregation will generally be taxpayer favorable, upper-tier owners are unlikely to want or need to disaggregate trades or businesses that have been aggregated at the RPE level. This approach would dramatically decrease the otherwise substantial compliance burden imposed on, for example, large RPEs engaged in multiple trades or businesses conducted in numerous lower-tier entities. Allowing RPEs to irrevocably aggregate activities at the RPE level, has worked well in the passive activity area without any significant issues.

S-Corp agrees with Treasury that permitting aggregation at the individual taxpayer level can provide more flexibility to taxpayers, assuming the individual is provided appropriate information to aggregate the trades or businesses without introducing unwarranted complexity. One simplification, which would greatly reduce the burden and recordkeeping requirements with no revenue cost, would be to allow an upper-tier RPE to aggregate, for both computation and reporting purposes, trades or businesses conducted directly by the upper-tier RPE, lower-tier RPEs, or a combination of both, if the requirements of proposed Section 199A-4(b)(1)(v) are otherwise met. Allowing the upper-tier RPE to aggregate or "group" trades or businesses without the necessity to separately account for the activities of each lower-tier RPE will substantially reduce the complexity that would otherwise follow if the upper-tier RPE is required to make a separate accounting of QBI, W-2 wages, UBIA of qualified property for each lower-tier entity. S-Corp also believes it would be helpful to clarify that a disregarded entity is not treated as conducting a trade or business for computational or reporting purposes.

To ensure taxpayers have the necessary information, S-Corp believes that if an RPE has interests in two or more trades or businesses, including trades or businesses operated, in whole or in part, in one or more lower-tier RPEs, that would satisfy two or more of the factors set forth in proposed Section 199A-4(b)(1)(v), but that are not aggregated by the RPE itself, then the RPE should be required to report additional information on an attachment to the Schedule K-1 issued to its owners. If applicable, the RPE should be allowed to report information with respect to a qualifying trade or business conducted by multiple commonly controlled RPEs on an aggregate basis, without regard to legal entities.

This information should include (i) a description of each trade or business, (ii) the name and EIN of each entity in which a trade or business is operated, and (iii) which factors set forth in proposed §1.199A-4(b)(1)(v) are satisfied by two or more trades or businesses.

Each RPE should be required to report on an attachment to the Schedule K-1 the information described in proposed Section 199A-4(b)(1)(i)-(iii) reported to it by any RPE in which the RPE owns a direct or indirect interest except in circumstances where the RPE is allowed to "group" trades or businesses as suggested above, this type of reporting would not be unduly burdensome or complex and would greatly improve the ability of individual shareholders and partners to appropriately aggregate trades or business operated in lower-tier pass-throughs.

If the proposed Section 199A-4(b)(1)(i) 50 percent common ownership test is retained, S-Corp also requests that for purposes of aggregation, such requirement may be satisfied at lower tiers without regard to whether the requirement is met at the upper tiers. Once the 50 percent common ownership requirement is met, it should not be affected by the lack of 50 percent common ownership in an upper-tier pass-through. As long as, at some level, a single person or group of persons is both incurring the W-2/UBIA expenditure and procuring the section 199A deduction benefit, the economics described above should prevent availability of the deduction in circumstances where it is unwarranted.

S-Corp requests that Treasury clarify the proposed rules to state clearly that items of Qualified Business Income, W-2 wages, and other items necessary for determination of the Section §199A deduction retain their character as the distributive or allocable share of such items progress through the upper-tiers to the individual shareholders and partners that can claim the deduction.

Factor Test: Section 1.199A-4(b)(1)(v) of the proposed regulations requires that, in addition to satisfying 50% common ownership and other requirements, two or more trades or businesses may be aggregated only if they satisfy at least two of the following three factors: (A) products and services that are either the same or customarily offered together, (B) shared facilities or significant centralized business elements and (C) operations in coordination with and/or reliance upon each other.

As explained above, there is no economic incentive for a taxpayer to incur W-2 wages or UBIA solely to qualify for a section 199A deduction unless there are other bona fide business reasons to incur such expenditures. In short, if the taxpayer is spending his or her own money, there's no need to worry about artificial inflation of the W-2/UBIA limitation.

Since the proposed rules allow a business to "get the benefit of" W-2 wages or UBIA of another business if they are in the same industry, manufacturing for example, there does not seem to be any principled reason why there can be no such crossover benefits if the second business happens to be in a different industry. The benefits to the American economy are the same in both instances.

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Taxable Year Requirements: Sections 199A-4(b)(1)(ii) and (iii) of the proposed regulations contain specific taxable year requirements. The first Section appears to provide that the 50 percent common ownership test must be applied on a taxable-year-by-taxable-year basis, based on ownership during the majority of each taxable year. The second Section requires all items relating to aggregated businesses to be reported in the same taxable year.

With respect to subparagraph (ii), although some type of "all in or all out" rule may be appropriate for trades or businesses conducted by large RPEs with regular and ongoing ownership changes, the large majority of these aggregation determinations will be made by taxpayers owning closely held businesses, where ownership changes, especially those involving a change in control, are significant events and not undertaken lightly. As a consequence, simply applying the 50 percent common ownership test throughout the year is likely to be much less counterintuitive for most taxpayers, and avoid imposing unexpected additional compliance burdens. If the proposed 50 percent common ownership test is retained, then S-Corp recommends that the specific taxable year requirements be removed.

With respect to subparagraph (iii), the majority of individuals, S corporations and partnerships eligible for the Section 199A deduction are calendar year taxpayers. However, some S corporations and partnerships do elect September, October or November taxable years under Section 444 of the Code, but they are required to make a deposit to offset the revenue effects of any income deferral that may occur as a consequence. For example, an S corporation retailing concern may elect a September 30 taxable year in order to avoid having to close its books in the middle of its busiest season, while the commonly controlled partnership from it which it rents its real estate facilities might continue to report on a calendar taxable year basis. There is no reason why such entities should be precluded from aggregating their respective businesses.

S-Corp requests that Treasury drop the specific taxable year requirements under Sections 199A-4(b)(1)(ii) and (iii).

Unified Aggregation**:** In creating a new aggregation regime, Treasury explicitly rejected the use of existing Section 469 aggregation rules. Treasury requested comments as to whether the aggregation method described in proposed Section 199A-4 would be an appropriate grouping method for purposes of Section 469 and Section 1411.

S-Corp believes it would be inappropriate to attempt to apply the Section 199A aggregation regime for these purposes. As explained in our comments above, however, we do believe the new Section 199A aggregation approach could be improved through the adoption of some of the principles embraced in Section 469.

The Section 469 grouping rules permit Section 162 trade or business *activities* to be treated as a single activity for purposes of Section 469 if they constitute an appropriate economic unit. Whether activities constitute an appropriate economic unit is based on a five factor "facts and circumstances" test:

1. Similarities and differences in types of trades or businesses;
2. The extent of common control;
3. The extent of common ownership;
4. Geographical location; and
5. Interdependencies between or among the activities

Interdependencies include the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records. *Not all of the above are necessary for a taxpayer to treat more than one activity as a single activity.*

Compare those rules with the proposed Section 199A aggregation rules. For Section 199A, you also have five tests, *all* of which must be met in order to aggregate under Section 199A, and one of which includes three additional conditions, of which two must be met. It's a much more rigorous threshold:

1. The same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business to be aggregated;
2. The ownership exists for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income;
3. All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;
4. None of the trades or businesses to be aggregated is a specified service trade or business (SSTB); and
5. The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):
    a. The trades or businesses provide products and services that are the same or customarily offered together;
    b. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or
    c. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

The Section 469 grouping rules are clearly more permissive and flexible. This is critical because under Section 469, an "activity" is the unit of measurement for the passive activity loss and credit limitations. An activity is utilized not just to compute gain or loss, but to determine whether or not the taxpayer materially or significantly participates in the activity.

For many taxpayers, grouping of multiple Section 162 trade or business activities into a single activity is what allows them to meet the 500 hour material participation test or the 100 hour significant participation test. A taxpayer would desire the most permissive and flexible grouping rules for

purposes of Section 469 because ungrouped loss activities may receive unfavorable passive loss treatment. Application of the more restrictive Section 199A aggregation rules for Section 469 grouping would not be helpful.

The most significant difference between the two approaches is the 50 percent common ownership *requirement* for Section 199A, whereas in Section 469 the *extent* of common ownership is just one of the five factors to be considered. Under Section 469, minority interests in activities that are clearly in the same trade or business may be combined.

Moreover, the Section 199A majority of the year ownership test would be a problem under Section 469. A taxpayer must report income or loss from an activity for his or her period of ownership no matter how long or short his or her ownership is in that year. It seems unfair to exclude a short year startup or short year terminating activity from an otherwise qualified single activity.

It also would make little sense to apply the Section 199A exclusion of SSTBs to Section 469 grouping. A doctor may be a member of several S corporations or partnerships that practice the same medical activities. Why should the doctor be precluded from grouping them for Section 469 purposes?

Specified Services Businesses

Section 199A excludes certain industries and occupations from receiving the Section 199A deduction. These “specified services trade or businesses” (SSTBs) are defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, partnership interests, or commodities, *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.

Using the tax code to define, and then treat differently, taxpayers based on their industry or occupation is highly problematic and will inevitably result in arbitrary results. This difficulty is the result of the underlying statute, however, and not the proposed rules. Congress should revisit this misguided policy at the earliest possible moment. In the meantime, S-Corp requests two specific changes to the proposed rules.

<u>De Minimis Thresholds</u>: The proposed rules include thresholds establishing the level of specified services revenue a non-SSTB trade or business may have and still qualify for the Section 199A deduction. As the preamble notes, “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.” The proposed rules set the threshold at 10 percent for a non-SSTB trade or business with gross revenues of $25 million or less, and just 5 percent for a trade or businesses with gross revenues over $25 million.

The proposed rules explain why a de minimis threshold is necessary, but they do not explain why there should be two different thresholds or why Treasury set the thresholds so low. Why is a non-SSTB trade or business with gross revenues of $24 million allowed specified services gross revenues of $2.4 million, but the same business with $26 million in gross revenues is limited to just $1.3 million? Does the additional $2 million in gross revenues make a material difference to the nature of the businesses?

The de minimis rule is not contained in the statute. Rather, it is a product of the rulemaking process. As such, the proposed rules should be crafted to take the taxpayer's interest into account. Establishing multiple percentages needlessly complicates the proposed rules; establishing very low thresholds needlessly increases the number of taxpayers affected.

S-Corp recommends that the percentage should be 25 percent and the 25 percent threshold should apply to all non-SSTB trades or businesses, regardless of their size.

Trading and Dealing:

Even if Treasury adopts our recommended higher threshold, there remains a challenge for businesses that are obviously not SSTBs but that traditionally employ a significant level of specified service activities as part of their overall operations. Energy companies and farmers trade in commodities as a hedge against fluctuating prices. Banks and mortgage lenders originate loans and then sell those loans on the secondary markets.

Several non-SSTB industries have submitted comments requesting specific relief from the SSTB rules. S-Corp supports these requests. In addition, S-Corp requests that Treasury consider a more general approach for non-SSTB trades or businesses that traditionally offer specified services activities are not penalized.

Section 199A-4(b)(v)(A) allows a taxpayer to aggregate together trades or businesses if, among other conditions, the "trades or businesses provide products and services that are the same or customarily offered together." This same approach could be taken with regard to non-SSTB trades or businesses that provide, as part of their traditional operations, a significant amount of specified services.

Electing Small Business Trusts

One area of potential confusion clarified by the proposed rules was whether Electing Small Business Trusts would qualify for the Section 199A deduction. Concerns had been raised that the definition of income for ESBTs did not include Section 199, in its former or current form. This concern ran headlong into the obvious intent of Congress that estates and trusts qualify for the Section 199A deduction.

The proposed rules address this issue and make clear that ESBT's with qualified Section 199A income are eligible for the deduction. As the proposed rule notes:

> *(iv) Electing small business trusts. An electing small business trust (ESBT) is entitled to the deduction under section §199A. The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. See §1.641(c)-1.*

S-Corp supports this position and appreciates the effort by Treasury to clarify this important policy.

Conclusion

Thank you for the opportunity to comment on the proposed rules. We welcome the opportunity to meet with Treasury or the Commissioner to discuss these comments in detail or to answer any questions about these comments. We also look forward to the opportunity to comment on any revised version of the proposed rules that address these and other comments you have received.

Sincerely,

Brian Reardon
President
S Corporation Association