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David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Initial Comments Concerning the Aggregation and Disaggregation of Trade or Business Activities for Purposes of Section 199A

Dear Acting Commissioner Kautter:

Enclosed please find the first installment (the "Comments") of a larger project by the American Bar Association Section of Taxation (the "Section") to provide comments under section 199A, which was added by the 2017 tax legislation. These Comments are submitted on behalf of the Section and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical),
Internal Revenue Service
Thomas West, Tax Legislative Counsel, Department of the Treasury
Scott W. Dinwiddie, Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
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**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

**Initial Comments Concerning the Aggregation and Disaggregation of
Trade or Business Activities for Purposes of Section 199A**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Comments are part of a larger project undertaken by the Section of Taxation to provide feedback on the changes made by last year’s tax reform legislation (the “Act”).¹ Because of the need for guidance, the Service’s expedited regulation process, and the fact that these Comments deal with a fundamental issue in interpreting new section 199A, they are being submitted in advance of the Section’s comprehensive comments relating to section 199A, and in response to requests by the Department of the Treasury and the Service for comments on needed guidance under the Act.

Principal responsibility for preparing these Comments was exercised by Laura Howell-Smith, Thomas J. Nichols, Mark Wilensky, and Allie Petrova. The Comments have been reviewed by Beverly Katz, Vice Chair of the Partnerships and LLCs Committee, Adam M. Cohen, Council Director for the Partnerships and LLCs and Real Estate Committees, Ronald A. Levitt, Council Director for the S Corporations and Closely Held Business Committees, and Jeanne Sullivan of the Section’s Committee on Government Submissions.

Although members of the Section of Taxation who participated in preparing these comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member of the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 31, 2018

¹ An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (sometimes referred to as the “Tax Cuts and Jobs Act” or “TCJA”).

Background and Executive Summary

The Act made substantial changes in the tax rules applicable to the business activities of taxpayers, effective for the current tax year. We commend the Department of the Treasury (“Treasury”) and the Service for their commitment to provide expedited guidance and we ask that Treasury and the Service consider the following suggestions in the upcoming guidance relating to section 199A.²

Section 199A provides for a deduction in the calculation of a taxpayer’s taxable income for tax years beginning after December 31, 2017. There are several components to computing a taxpayer’s section 199A deduction for any taxable year. Among these are the “combined qualified business income amount” (“CQBI” and “QBI” for qualified business income) of the taxpayer under section 199A(b)(1), “W-2 wages” under sections 199A(b)(2)(B)(i)&(ii) and 199A(b)(4), and unadjusted basis of “qualified property” under sections 199A(b)(2)(B)(ii) and 199A(b)(6). Section 199A(b)(1)(A) requires the QBI, W-2 wages and unadjusted basis of qualified property to be determined for *each* “qualified trade or business” (“QTB”) carried on by the taxpayer. Guidance is needed on whether and how QTBs operated together in a single entity, or through multiple entities, should be treated as one or more trade or business for purposes of section 199A.

In many instances involving QTBs, it may be appropriate to allow taxpayers to aggregate activities for purposes of calculating the components of a section 199A deduction. Conversely, in situations involving both QTBs and “specified services trades or businesses” as defined in section 199A(d)(2) (each an “SSTB”), it may be appropriate to prevent the disaggregation of activities appropriately treated as part of a single economic unit.

In providing guidance as to the aggregation and disaggregation of activities for purposes of section 199A, we make the following suggestions:

- (a) Allow taxpayers to group QTBs for purposes of section 199A consistent with the principles under Treasury Regulation section 1.469-4(c).
- (b) Only prohibit aggregation of QTBs and SSTBs where the SSTB is appropriately treated as a separate, significant economic activity.
- (c) Prohibit the disaggregation of an incidental activity with respect to an SSTB from the SSTB (or with respect to a QTB, from the QTB) when the incidental activity either: (i) does not generate any revenue from independent outside third party customers; or (ii) represents no more than the lesser of (A) five percent (or if five percent is deemed too restrictive, ten percent) of gross revenues, W-2 wages, number of employees, unadjusted basis and/or one or more other objective bases or (B) \$1 million in gross revenue.³

² References to a “section” are to a section of the Internal Revenue code of 1986, as amended (the “Code”), unless otherwise indicated.

³ Cf. Reg. § 1.448-1T(e)(4)(i):

- (d) Specify that employees who have an employer-employee relationship with a taxpayer under the usual common-law rules are treated as employees of the taxpayer for purposes of section 199A, despite the fact that the employees may receive W-2's from other entities, such as common paymasters, professional employer organizations ("PEOs") and the like, for administrative, payroll tax and other reasons.

The attached chart has a depiction of these recommendations.

Discussion

Statutory authority exists to aggregate trades or businesses, especially where they are essential components of a business carried on in different entities. Section 199A(f)(4) authorizes Treasury and the Service to promulgate regulations which "are necessary to carry out the purposes of this section." For purposes of section 199A, the concepts for grouping activities under Treasury Regulation section 1.469-4 may be relevant.

Guidance should allow taxpayers to aggregate multiple trades and businesses and treat them as a single trade or business for purposes of section 199A, if they constitute an appropriate economic unit based upon criteria used under Treasury Regulation section 1.469-4(c). Section 469(c)(1)(A) partially defines a passive activity as any activity which involves the conduct of any "trade or business." Further, Treasury Regulation section 1.469-4(c)(1) provides that "[o]ne or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit" for purposes of section 469. While the grouping rules under section 469 refer to the grouping of "activities," it is clear from section 469(c)(1)(A) and Treasury Regulation section § 1.469-4(b) that "trade or business activities" under those provisions appear to be synonymous with what under section 199A is referred to as "trades or businesses," as illustrated in the examples under Treasury Regulation section 1.469-4(c)(3).⁴

[T]he performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field. Activities incident to the performance of services in a qualifying field include the supervision of employees engaged in directly providing services to clients, and the performance of administrative and support services incident to such activities.

⁴ Reg. § 1.469-4(c)(3), Exs. (1) and (2):

Example (1). Taxpayer C has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. In this case, after taking into account all the relevant facts and circumstances, there may be more than one reasonable method for grouping C's activities. For instance, depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity; a movie theater activity and a bakery activity; a Baltimore activity and a Philadelphia activity; or four separate activities. Moreover, once C groups these activities into appropriate economic units, paragraph (e) of this section requires C to continue using that grouping in subsequent taxable years unless a material change in the facts and circumstances makes it clearly inappropriate.

Example (2). Taxpayer B, an individual, is a partner in a business that sells non-food items to grocery stores (partnership L). B also is a partner in a partnership that owns and operates a trucking business (partnership Q). The two partnerships are under common control. The predominant portion of Q's business is transporting goods for L, and Q is the only trucking

Accordingly, taxpayers should be able to group one or more trades or businesses, including rental trades or businesses that constitute an appropriate economic unit, based upon the facts and circumstances test provided under Treasury Regulation section 1.469-4(c)(2), including the exceptions provided for grouping rental activities with other trades or businesses as provided under Treasury Regulation section 1.469-4(d)(1). The factors to determine whether QTBs constitute an appropriate economic unit include: (1) similarities and differences in types of trades or businesses; (2) extent of common control; (3) extent of common ownership; (4) geographical location; and (5) interdependence between and among the activities.⁵

We recommend the use of section 469's appropriate economic unit criteria for section 199A aggregation purposes because the Service and taxpayers are familiar with the grouping rules under section 469. Treasury and the Service often have employed concepts and approaches with which the government and taxpayers already are familiar when defining new rules.⁶ The grouping rules under section 469 are a balanced approach to determining the boundaries of a taxpayer's economic activities.

While we believe the concepts and approach of section 469 are appropriate for purposes of section 199A, we do not believe that a taxpayer's existing groupings under section 469 should be determinative of what constitutes a trade or business for purposes of section 199A. The purpose of section 469 is to distinguish: (1) trade or business activities in which the taxpayer is involved in operations on a regular, continuous and substantial basis from (2) trade or business activities in which the taxpayer is not so involved. In contrast, a central purpose of section 199A is to distinguish QTBs from SSTBs. Grouping under section 469 may involve grouping QTBs and SSTBs, but neither the Service nor taxpayers should be required to use a grouping under section 469 for purposes of section 199A. Nevertheless, the principles of the section 469 grouping rules, as modified by the principles discussed below, should guide the aggregation of QTBs for purposes of section 199A. Moreover, some existing section 469 groupings may be appropriate under section 199A and adoption of an existing grouping could simplify application of section 199A for both the government and taxpayers.

To facilitate the administration of section 199A, certain rules could be adopted to avoid abuse of section 199A. In particular, guidance might provide that all QTBs that are aggregated must have common ownership.⁷ In addition, we recommend that an aggregation or

business in which B is involved. Under this section, B appropriately treats L's wholesale activity and Q's trucking activity as a single activity.

⁵ See Reg. §1.469-4(d)(1)(ii), Exs. (1) and (2). See also *Kucera v. Commissioner*, T.C. Summary Opinion 2001-18, 2001 WL 1922059 (February 27, 2001); *Gregg v. United States*, 186 F. Supp. 2d 1123 (D. Or. 2000); *Lapid v. Commissioner*, T.C. Memo. 2004-222, 2004 WL 2244500, T.C.M. 2004-22 (October 4, 2004).

⁶ Cf. Reg. § 1.1250-1(f) (providing that the amount of gain recognized under I.R.C. § 1250(a) by a partnership and a partner is to be determined in a manner consistent with the principles provided in Reg. § 1.1245-1(e), a provision that deals with the allocation to partners of gain recognized by a partnership under I.R.C. § 1245(a); Notice 2018-29, 2018-16 I.R.B. 495 (announcing intention to issue regulations under new I.R.C. § 1446(f), regarding the disposition of a partnership interest that is not publicly traded, that will incorporate certain rules under I.R.C. § 1445 and the Treasury Regulations thereunder).

⁷ For example, the guidance could allow aggregation only where the common ownership tests under section 1563 and/or sections 414(b), (c) and (m) are satisfied.

disaggregation once made should be irrevocable unless the Service consents.

Further, we recommend the aggregation of only QTBs and QTBs with incidental SSTBs, and a prohibition on the aggregation of QTBs with non-incidental SSTBs. In certain situations, taxpayers could undermine the exception under section 199A for SSTBs by splitting up activities, rather than by aggregating activities and treating them as one economic unit. On the other hand, a QTB may involve some level of SSTB that should not taint the QTB. Treasury Regulation section 1.469-4(d) generally disallows the grouping of a rental activity and a non-rental trade or business activity for passive activity purposes. However, it contains an exception for when the two activities constitute an “appropriate economic unit” and one of the two activities is “insubstantial” in relation to the other, or there is the same proportionate ownership. A similar general principle and exception will be useful in the context of section 199A as illustrated in the attached chart, which supports reasonable results as follows:

- (a) Treatment of an in-house legal department of a manufacturing firm as part of the QTB of manufacturing; or
- (b) Treatment of an in-house minor function (*e.g.*, clerical) of a specified trade or business as part of single SSTB.

To prevent taxpayers from disaggregating an SSTB to obtain a deduction under section 199A, we recommend prohibiting the disaggregation of an incidental activity with respect to an SSTB from the SSTB (or with respect to a QTB, from the QTB) when the incidental activity either: (1) does not generate any revenue from independent outside third party customers; or (2) represents no more than the lesser of (A) five percent (or if five percent is deemed too restrictive, ten percent) of gross revenues, W-2 wages, number of employees, unadjusted basis and/or one or more other objective bases or (B) \$1 million in gross revenue.⁸

Any guidance should recognize overlap in taxpayer identity represented by common ownership and allow individual owners or groups of owners to group all of their operations together and aggregate the underlying QTBs, whether they conduct those operations through a group of brother-sister entities or parent-subsidiary groups. For example, an individual owner who owns more than 50% of ten brother-sister entities should be able to treat the entire group as one economic unit for section 199A purposes with himself or herself as the “parent,” just the same as tax rules treat a publicly held parent and subsidiary structure as one unit. This could include a “serial entrepreneur” – *i.e.*, an individual who has already been successful in establishing one or more business enterprises and is willing to utilize the same skills, and perhaps the resources generated thereby, to create multiple new startup enterprises.⁹

Another principle that is implicit in the section 469 passive activity rules – that an individual’s section 469 activities may not be grouped with an investor-type activity such as a

⁸ *Cf.* Reg. § 1.448-1T(e)(4)(i).

⁹ A serial entrepreneur should be able to use the section 199A deduction for multiple businesses to the extent they constitute an appropriate economic unit as provided under Treasury Reg. §1.469-4(c). This is precisely the type of economic activity that section 199A was designed to incentivize. Requiring such an entrepreneur to operate all of these new enterprises through a single legal entity would only tend to discourage such behavior.

publicly traded partnership¹⁰– may appropriately be considered in the section 199A context. Here again, the application of a common ownership rule might prevent aggregation of disparately owned and operated enterprises where little rational basis exists to view dissimilar enterprises as a single economic unit. Such a rule could prevent the development of aggressive tax transactions specifically designed to pass through W-2 wages and/or unadjusted basis that might increase an individual taxpayer’s eligibility for the section 199A deduction.

Lastly, as under prior section 199, we believe it is appropriate that a QTBE be treated as having the W-2 wages of those employees who have an employer-employee relationship with the QTBE under the usual common-law rules.¹¹ The wages of such employees should be treated as those of the taxpayer for purposes of section 199A, despite the fact that the employees may receive W-2’s from other entities, such as common paymasters, professional employer organizations (“PEOs”) and the like, for administrative, payroll tax and other reasons.

¹⁰ See I.R.C. § 469(k) (providing that I.R.C. § 469 is applied separately to publicly traded partnerships); *see also* Reg. § 1.469-2T(c)(3)(i) (providing that items of portfolio are income specifically excluded from I.R.C. § 469).

¹¹ Reg. § 1.199-2(a)(2).

Business Configurations: Four Disaggregation Scenarios

	Large QTB with small SSTB	Large SSTB with small QTB
Does NOT generate revenues from outside sources	Example: Manufacturing company (QTB) with small legal department (SSTB)	Example: Law firm (SSTB) with small advertising department (QTB)
	Outcome: Allow full 199A deduction because SSTB serves only support function	Outcome: Disallow any 199A deduction because QTB serves only support function
Generates revenues from outside sources	Example: Software company (QTB) with small consulting practice (SSTB)	Example: Veterinary practice (SSTB) with small dog walking service offering (QTB)
	Outcome: Allow full 199A deduction if SSTB is <i>de minimis</i> (i.e., disregard taint; presume SSTB is part of main business)	Outcome: Allow disaggregation of QTB if QTB is large enough to be treated as separate T/B (i.e., allow carve-out, presume QTB is not part of main business)
	<i>De minimis</i> : SSTB represents lesser of [5%] [10%] of [gross revenues] [W-2 wages] [number of employees] [unadjusted cost basis] [one or more other objective bases] - or - \$[1,000,000]	Significant: QTB represents greater of [5%] [10%] of [gross revenues] [W-2 wages] [number of employees] [unadjusted cost basis] [one or more other objective bases] - or - \$[1,000,000]