KPMG report: Analysis and observations of final section 199A regulations

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Introduction

The U.S. Treasury Department and IRS on January 18, 2019, publicly released a version of final regulations under section 199A.

Section 199A was enacted as part of the tax legislation in the United States that is often referred to as the "Tax Cuts and Jobs Act" (Pub. L. No. 115-97, enacted December 22, 2017).

The final regulations were posted on the IRS website in advance of being published in the Federal Register. This release finalizes regulations that were proposed in August 2018 and generally apply to tax years ending after the publication of the final regulations in the Federal Register (the date when these regulations will be published in the Federal Register is uncertain given the partial shutdown of the federal government). However, certain rules that the IRS and Treasury believe will address abuses of section 199A are proposed to be effective retroactive to the date of enactment of section 199A (December 22, 2017).

Read text of the **final regulations** [PDF 749 KB] (247 pages)

Because of the effective date under the final regulations, the regulations do not apply to the 2018 tax year of calendar year taxpayers. However, both the final and the 2018 proposed regulations remain relevant for individuals with interests in passthrough entities that are calendar year return filers because the final regulations specifically provide that taxpayers may rely on the final regulations (in their entirety) or on the proposed regulations (in their entirety) for tax years ending in the calendar year 2018.

In this report because of the potential applicability of the 2018 proposed regulations to returns currently being prepared, the proposed regulations are not being referred to in the past tense.

Accordingly, this report includes:

- An overview of section 199A as well as observations regarding the final regulations
- A focus on significant revisions made to proposed regulations under section 199A—**REG-1042266-18** [PDF 405 KB] issued in August 2018

The final regulations under section 199A contain significant revisions or clarifications relating to real estate and like-kind exchanges. Those revisions and clarifications will be the subject of a separate report from KPMG, one that will be specifically directed toward individuals and entities engaged in those businesses and thus are not discussed in this report.

Background

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

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

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

A QTB of the taxpayer is any trade or business other than a "specified service trade or business" or "SSTB" (the "SSTB Exclusion") or the trade or business of performing services as an employee.[1] The deductible amount with respect to each QTB carried on by a taxpayer generally is subject to the following "Limitations," which are the lesser of—

- An amount equal to 20% of the taxpayer's qualified business income with respect to the QTB, or

- The greater of—

    - 50% of the W-2 wages paid with respect to the QTB (the "Wage Limitation");[2] or

    - The sum of 25% of the W-2 wages with respect to the QTB plus 2.5% of the unadjusted basis (determined immediately after an acquisition) of all qualified property (the "Wage and Basis Limitation").[3]

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

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

- Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss

- Any dividend, income equivalent to a dividend (other than certain patronage dividends paid by a cooperative organization), or payment in lieu of dividends described in section 954(c)(1)(G)

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

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

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

- Any interest income other than interest income that is properly allocable to a trade or business

- Any item of deduction or loss properly allocable to any of the listed excluded items[4]

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

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

- Any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners, and

- Any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

As noted above, the IRS and Treasury issued proposed regulations under section 199A in August 2018 (the "Proposed Regulations"). The Proposed Regulations provide guidance useful in determining whether and to what extent an individual (including a trust or estate) is entitled to a deduction under section 199A (the " § 199A Deduction") with regard to trade or business income earned through a sole proprietorship, partnership, or S corporation. Although the Proposed Regulations generally were proposed to be effective when finalized, it is clear that taxpayers could rely on the Proposed Regulations until final regulations are issued. Notwithstanding the general effective date, certain rules that the IRS and Treasury felt addressed abuses of section 199A were proposed to be effective retroactive to the date of enactment of section 199A.

Following issuance of the Proposed Regulations, numerous commentators formally and informally submitted recommendations regarding changes to the proposed regulations. Those recommendations included suggested additions to the Proposed Regulations, as well as revisions to those issues actually addressed therein. After consideration of the comments, the IRS and Treasury publicly released on January 18, 2019, the final regulations (the "Final Regulations").

The Final Regulations provide guidance on issues addressed by the Proposed Regulations, as well as additional issues with respect to which clarification of the statutory language was requested.

The Final Regulations also include reporting requirements that must be complied with for the 2018 tax year, some of which may result in significant effort on the part of certain partnerships or S corporations. The following discussion focuses on certain noteworthy revisions made to the Proposed Regulations in the Final Regulations.

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

Definition of a trade or business

The availability of a § 199A Deduction generally is determined on the basis of an individual trade or business. The Proposed Regulations generally define "trade or business" for section 199A purposes as consistent with the meaning of that phrase under section 162(a). However, the Proposed Regulations extend that definition in one respect. Specifically, solely for purposes of section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled (within the meaning of Prop. Reg. section 1.199A-4(b)(1)(i)).[5]

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

That being said, the adoption of the section 162 definition of a trade or business did not provide the level of clarity that taxpayers would prefer. In the Proposed Regulations, the IRS and Treasury made it clear that they believed one entity (such as an S corporation or a partnership) may have more than one trade or business. Determining whether one entity has just one or more than one trade or business may be a difficult endeavor. In the preamble to the Proposed Regulations (the "Proposed Regulations Preamble"), the IRS and Treasury noted that the definition of a trade or business for purposes of section 162(a) as having been developed through a "large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries." Although it is true that a significant number of section 162(a) authorities exist, the vast majority of these authorities relate to whether an activity of a taxpayer is a trade or business at all—not whether the taxpayer's activities give rise to more than one trade or business. On the latter issue, the guidance available is much more limited and found under other Code sections.

In certain situations, treating two types of activities performed by one entity as separate trades or businesses may provide a more favorable result. For example, if one entity engages in one activity that is an SSTB and one that is not, treating the two as separate trades or businesses may result in a larger § 199A Deduction. Absent the existence of an SSTB, however, treatment of two activities as one trade or business generally is beneficial to a taxpayer because it allows QBI and the Limitations to be determined on an aggregate basis, which may allow excess wage expense or unadjusted basis in qualified property associated with one activity to offset QBI with respect to another. Although the Proposed Regulations did provide for aggregation of trades or businesses in certain situations (see the discussion below), if those rules did not apply, the determination of whether activities are one trade or business or separate trades or businesses may become important.

As an initial matter in determining whether one or multiple trades or businesses exist, the Proposed Regulations Preamble provided some insight into the government's view regarding the ability of one

[5] Under the Proposed Regulations, two businesses are commonly controlled for this purpose if the same person or group of persons, directly or indirectly, owns 50% or more of each trade or business, meaning in the case of a trade or business owned by an S corporation; 50% or more of the issued and outstanding shares of the corporation; or, in the case of a trade or businesses owned by a partnership, 50% or more of the capital or profits in the partnership. Although it is not entirely clear from the language in the Proposed Regulations, it appears that this ownership must exist for the majority of the tax year in question.

entity to be in more than one trade or business. Specifically, the Proposed Regulations Preamble clearly indicates that the IRS and Treasury believe that one entity may be engaged in more than one trade or business. Conversely, the IRS and Treasury state in the Proposed Regulations Preamble their view that one trade or business generally may *not* be operated through more than one entity. Both of these statements are consistent with authorities in existence prior to publication of the Proposed Regulations. Under those authorities, although separate legal entities may be under common ownership (e.g., subsidiaries of a common parent), the business activities of one entity generally are not attributed to others, meaning the form of the legal entity is respected. On the other hand, a single legal entity may operate multiple divisions within that entity.

However, there is some uncertainty as to what the IRS and Treasury meant by "entity" in this context. Reg. section 301.7701-2(a) indicates that the term "entity" means any entity recognized for federal tax purposes (including an entity disregarded as an entity separate from its owner). Applying this standard, a partnership and a disregarded entity owned by it would be two separate entities and thus would essentially be presumed *not* to be in the same trade or business. If that is the case, then the initial determination of whether an individual partner in the partnership is eligible for a § 199A Deduction as well as the partnership's reporting requirements will include at least two trades or businesses. However, if the Proposed Regulations Preamble reference to "entity" was intended to mean "taxpayer," a partnership and its disregarded entity would be one "entity" for this purpose. If so, the business operated by the partnership and the disregarded entity may be one trade or business—but factually may also be separate trades or businesses under the definition of a "trade or business" in the Proposed Regulations.[6]

In comments relating to the Proposed Regulations, many commentators pointed out uncertainties arising from using the section 162(a) standard in defining a trade or business for section 199A purposes and requested additional guidance for determining whether an activity rises to the level of a section 162 trade or business. Suggestions included a specific regulatory definition, a bright-line test, a factor-based test, or a safe harbor. If provided, such guidance would have been useful both for purposes of determining whether a taxpayer engaged in one activity was engaged in a trade or business at all, as well as for determining whether a taxpayer engaged in multiple activities was engaged in one trade or business or multiple trades or businesses.

Unfortunately, after considering the comments submitted, the IRS and Treasury concluded that the question of whether an activity is a section 162 trade or business at all is a factual determination with respect to which specific guidance was beyond the scope of the Final Regulations. However, the preamble to the Final Regulations (the "Final Regulations Preamble") does make certain statements that may be useful in making the determination of whether an activity rises to the level of a section 162 trade or business. Specifically, in the Final Regulations Preamble, the government specifically rejected application of the definitions or rules regarding a trade or business found in other provisions of the Code, including sections 469 and 1411. Moreover, the Final Regulations Preamble notes that:

> [C]ourts have established elements to determine the existence of a trade or business. The courts have developed two definitional requirements. One, in relation to profit motive, is said to require the taxpayer to enter into and carry on the activity with a good faith intention to make a profit or with the belief that a profit can be made from the activity. The second is in relation to the scope of the activities and is said to require considerable, regular, and continuous activity. See generally Commissioner v. Groetzinger, 480 U.S. 23 (1987).

[6] This view appears consistent with the IRS's analysis in Chief Counsel Advice 201430013 (July 25, 2014), described in more detail below.

Note that any guidance derived from these inclusions in the Final Regulations Preamble seems to be more useful in determining whether a taxpayer engaged in one activity is in a trade or business at all—rather than whether a taxpayer engaged in more than one activity is in more than one trade or business. In the latter area (which likely arises more often), significant uncertainty remains.

On the issue of whether a taxpayer is engaged in more than one trade or business, several commenters suggested that the IRS and Treasury provide a safe harbor or list of factors for purposes of delineating separate trades or businesses within an entity. The factors described included those derived from existing guidance in other areas in which existence of a separate trade or business was relevant, including separate books and records, facilities, locations, employees, and bank accounts; operation of separate types of businesses or activities; or separate legal entities. One commenter suggested adoption of the separate trade or business rules provided in regulations under sections 446 and 469. Reg. section 1.446-1(d) provides that no trade or business is considered separate and distinct unless a complete and separable set of books and records is kept for that trade or business; trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected.

The government declined to adopt the recommendations, concluding that specific guidance under section 162 is beyond the scope of the regulations and guidance under section 469 is inapplicable. Further, the government concluded that Reg. section 1.446-1(d) does not provide guidance on when trades or businesses will be considered separate and distinct, noting that the regulation:

> …provides that a taxpayer can use different methods of accounting for separate and distinct trades or businesses and specifies two circumstances in which trades or businesses will not be considered separate and distinct. Section 1.446-1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete separate set of books and records is kept for such trade or business. The Treasury Department and the IRS acknowledge that an entity can conduct more than one section 162 trade or business. This position is inherent in the reporting requirements detailed in §1.199A-6, which require an entity to separately report QBI, W-2 wages, UBIA of qualified property, and SSTB information for each trade or business engaged in by the entity. Whether a single entity has multiple trades or businesses is a factual determination.

This language raises questions about what specific facts should be examined in making the determination of whether multiple trades or businesses exist. Presumably, those facts and circumstances are those used in making the same determination under Reg. section 1.446-1(d), section 469, and other pre-section 199A authorities that the IRS seems to have specifically rejected as determinative.

The IRS and Treasury do state in the Final Regulations Preamble their belief that multiple trades or businesses generally will not exist within an entity unless different methods of accounting could be used for each trade or business under Reg. section 1.446-1(d). So, in the government's view, a taxpayer that intends to treat different activities as separate trades or businesses must, at a minimum, keep a "complete and separable set of books and records" for the trade or business. It is interesting to note that the requirement under Reg. section 1.446-1(d) is for a *separable* set of books and records. As "separable" means "capable of being separated" rather than actually separated—this standard in and of itself may raise significant questions.

The Final Regulations do provide some guidance with respect to disregarded entities and the effect of their existence in determining whether a taxpayer is in more than one trade or business. Specifically, Reg. section 1.199A-1(e)(2) provides that an entity disregarded as an entity separate from its owner under Reg. section 301.7701-3 is disregarded for purposes of section 199A and the regulations thereunder. Thus, trades or businesses conducted by an entity disregarded as an entity separate from its owner under the section 7701 regulations will be treated as conducted directly by the owner of the entity for section 199A purposes.

Although this provision undoubtedly may be helpful to partnerships that own disregarded entities, it raises two concerns. First, it is unclear whether this should be interpreted as an indication that the IRS and Treasury have changed their view expressed in the Proposed Regulations Preamble—that their view that one trade or business generally may *not* be operated through more than one entity. As noted above, a disregarded entity is an "entity" for federal tax purposes; indeed, if it was not an entity, it could not be classified under Reg. section 301.7701-3 at all. Presumably it does not, but rather indicates that "entity" was really used to mean "taxpayer" even though contrary to the treatment of a disregarded entity as an entity under section 7701.

More importantly, limiting the language in the Final Regulations to entities disregarded as separate from their owners under Reg. section 301.7701-3, raises a question as to whether the same rule should apply to qualified subchapter S subsidiaries ("QSubs") owned by S corporations. QSubs are classified as corporations (rather than disregarded entities) under Reg. section 301.7701-3; their treatment as disregarded entities derives from section 1361(b)(3). Thus, they do not appear to fit within the language of Reg. section 1.199A-1(e)(2). It is unclear whether this exclusion was intentional or merely an oversight. There does not seem to be a rational explanation for disparate treatment of a QSub (which legally may be formed as a limited liability company) and a limited liability company disregarded under Reg. section 301.7701-3. Moreover, if the IRS saw a reason for differing treatment, it presumably should have explained that in the Final Regulations Preamble. Hopefully, a correction to the Final Regulations will be forthcoming.

The Final Regulations also include certain (generally favorable) revisions or clarifications of the definition of a trade or business relating to real estate activities. As noted above, those revisions and clarifications will be addressed in a separate report from KPMG.

KPMG observation

In the end, as with the Proposed Regulations, the Final Regulations leave taxpayers to look to apply existing guidance to determine whether an activity rises to the level of a section 162 trade or business, as well as whether the taxpayer conducts more than one trade or business.

Aggregation of separate trades or businesses

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

The most common example of this situation likely is a payroll entity that employs the employees necessary for a related operating business, and then leases those employees to the related operating entity at a cost-plus margin. In that situation, the payroll entity may have a substantial amount of W-2 wages, but very little income. In contrast, the operating entity may have a significant amount of income, but no W-2 wages. In light of this and similar situations, commentators had suggested that the IRS and Treasury permit the aggregation of trades or businesses (including those operated by different entities) relying on the grouping rules of section 469 relating to passive losses.

In the Proposed Regulations Preamble, the IRS specifically rejected this approach. Instead, the Proposed Regulations provide that an individual taxpayer—not a partnership or an S corporation—may (but does not have to) aggregate trades or businesses, but only if certain requirements are met. Specifically, aggregation is allowed for two or more trades or businesses only if:

1) None of the businesses is an SSTB;

2) The same persons directly or indirectly own a majority interest in each of the businesses for the majority of the tax year in which the items to be aggregated are included in income;

3) All the items related to the trades or businesses are reported on returns with the same tax year; and

4) The businesses meet two of three factors that establish what the IRS thinks of as a symbiotic relationship between the businesses. Specifically, the trades or businesses must satisfy two of the following:

    a. The businesses provide products and services that are the same or products and services customarily provided together;

    b. The businesses share facilities or centralized elements; or

    c. The businesses are operated in coordination with, or in reliance on, other businesses in the aggregated group.

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

If aggregation is available under the Proposed Regulations, it is only available at the individual taxpayer level. Thus, a partnership or S corporation engaged in multiple trades or businesses (or owning interests in multiple entities each in a trade or business) can choose to aggregate trades or businesses. Instead, the entity—including an upper-tier holding company—must report the relevant items from each trade or business separately. It is then up to the individual to determine whether and to what extent it can aggregate (and whether it wants to aggregate). Under these rules, it is easy to foresee significant additional compliance costs for passthrough entities in certain situations, as the entities will be required to provide the information necessary for their individual partners to determine whether they can aggregate—that's in addition to the information that partnerships and S corporations were already required to provide with regard to QBI, unadjusted basis (determined immediately after an acquisition) of all qualified property ("UBIA"), and W-2 wages.

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

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

The Final Regulations clarify (or completely revise) the aggregation rules in the Proposed Regulations in many respects. First, the Final Regulations clarify that "majority of the taxable year" for purposes of determining whether aggregation is available must include the last day of the tax year and the relevant tax year is that of the individual or entity that engages in the trade or business. Further, the Final Regulations provide that the requisite ownership requirement is satisfied if the same person or group of persons, directly or by attribution through sections 267(b) or 707(b), own 50% or more of each trade or business; a C corporation may constitute part of this group. In addition, the Final Regulations describe the first factor as products, *property*, or services that are the same or customarily offered together. The Final Regulations also provide that a taxpayer's failure to aggregate trades or businesses will not be treated as an aggregation under section 199A; thus, later aggregation is not precluded. However, the Final Regulations generally do not allow for an initial aggregation to be made on an amended return (except one filed for the 2018 tax year). As was the case under the Proposed Regulations, taxpayers that choose to aggregate must continue to do so unless there is a material change in circumstances.

Finally—and most significantly—the Final Regulations allow both individuals and Relevant Passthrough Entities ("RPEs") to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of apply the Limitations.[7] The resulting aggregation must be reported by the RPE and all of its owners. Thus, an individual or upper-tier RPE may not separate the aggregated trade or business of a lower-tier RPE, but instead must maintain the lower-tier RPE's aggregation. However, an individual or upper-tier RPE may aggregate additional trades or businesses with the already aggregated businesses of a lower-tier RPE if the requirements for aggregation are otherwise satisfied.

KPMG observation

Although the ability to aggregate trades or businesses at the RPE level may reduce the extent to which a taxpayer's § 199A Deduction may be subject to the Limitations, aggregation at that level is not always available and will still result in additional reporting obligations.

Allowing aggregation at the RPE level should significantly reduce obligations caused by the need to report items on an individual trade or business basis. Further, in many cases, it may reduce the significance of determining whether a trade or business is in one trade or business or multiple trades or businesses. Thus, it provides welcome relief for many RPEs and their owners.

[7] An RPE is a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. Other passthrough entities including common trust funds and religious or apostolic organizations described in section 501(d) are also treated as RPEs if the entity files a Form 1065, *U.S. Return of Partnership Income*, and is owned, directly or indirectly, by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, or PTP income.

Unadjusted basis immediately after acquisition

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

- Held by, and available for use in, the QTB at the close of the tax year;
- Used at any point during the tax year in the production of qualified business income; and
- The depreciable period for which has not ended before the close of the tax year. For this purpose, the term "depreciable period" means the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of—(1) the date that is 10 years after such date, or (2) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to section 168(g)).

As described below, the Final Regulations significantly revise the Proposed Regulations with regard to UBIA in several ways.

UBIA after nonrecognition exchanges

The Proposed Regulations contain a somewhat controversial provision relating to the determination of a taxpayer's recovery period and UBIA with respect to assets received in certain nonrecognition exchanges, such as a contribution of property to a corporation subject to section 351 or a contribution of property to a partnership subject to section 721. In these situations, for purposes of determining *the depreciable period* of the property for the corporation or partnership, the portion of the transferee's basis in the property that equals the transferor's basis therein is treated as placed in service when the property was placed in service; any excess basis is treated as placed in service on the date of the transfer. In the case of a like-kind exchange under section 1031, similar rules apply to a taxpayer's exchanged basis and excess basis.[8]

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

Example

To illustrate the application of these rules, assume that A, an individual, acquires for $100 Asset A, an asset that is qualified property and depreciable using straight-line depreciation over a five-

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

year useful life for $100. A uses the asset in a QTB. For purposes of determining the trade or business's UBIA with respect to Asset A, the property has a $100 unadjusted basis and a depreciable period of 10 years (i.e., the greater of its five-year useful life and 10 years). A's trade or business depreciates the property for two years. Although this depreciation reduces A's actual tax basis in the property to $60, it does not affect the UBIA with respect to it. Thus, at the end of the two-year period, A's depreciable period with respect to the property has eight years remaining and the UBIA in the property is $100.

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

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

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

In response to comments regarding the determination of UBIA in nonrecognition exchanges, the Final Regulations revise the rule for determining UBIA after a section 351 or 721 exchange. Under the Final Regulations, solely for the purposes of section 199A, if qualified property is acquired in a transaction described in section 168(i)(7)(B) (which includes a section 351 or 721 transfer, as well as nonrecognition distributions of property under section 332 or 731), the transferee's UBIA in the qualified property is the same as the transferor's UBIA in the property, decreased by the amount of money received by the transferee in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction. This rule should eliminate the "disappearing UBIA" issue described above.

The Final Regulations provide a similar revisions applicable in the context of section 1031. Those revisions will be discussed in a separate report from KPMG.

Basis adjustments under sections 734 and 743

The Proposed Regulations provide that UBIA generally equals the taxpayer's basis of property determined under section 1012 or other provisions (subchapter C, subchapter K, etc.), but is determined without regard to adjustments including adjustments made to the basis of the assets of a partnership under either section 734(b) or 743(b). The Proposed Regulations Preamble describes concerns about inappropriate duplication of the UBIA of qualified property in circumstances such as when the fair market value of property has not increased and its depreciable period has not ended. While acknowledging the duplication concern, many commenters suggested that the IRS and Treasury revise the treatment of basis adjustments under sections 734(b) and 743(b), such that those adjustments are treated as qualified property to the extent the fair market value of the qualified property to which the adjustments relates exceeds the UBIA of the property immediately before the adjustment.

With regard to basis adjustments under section 734, the IRS and Treasury concluded in the Final Regulations that these types of adjustments (which arise as a result of a distribution of money or other property by a partnership) are not "acquisitions" for section 199A purposes. Thus, the Final Regulations retain the position in the Proposed Regulations that section 734(b) adjustments do not result in UBIA for the partnership. However, the IRS and Treasury did revise their position with regard to certain section 743(b) adjustments (which arise as a result of a transfer of a partnership interest from one person to another). Specifically, the Final Regulations provide that a partner with a section 743 (b) adjustment may treat the partner's "excess section 743(b) basis adjustment" as a separate item of qualified property placed in service when the transfer of a partnership interest occurs. For this purpose, an "excess section 743(b) basis adjustment" is an amount determined with respect to each item of qualified property equal to the excess of the partner's section 743(b) basis adjustment with respect to each item over an amount that would represent the partner's section 743(b) basis adjustment with respect to the property, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property.

KPMG observation

The provision in the Final Regulations allowing a partner to increase its share of UBIA by it excess section 743(b) basis adjustment may prove valuable for partners that purchase an interest in a partnership. However, it appears that the provision with respect to the determination of the "excess section 743(b) basis adjustment" does not result in the proper amount to capture the portion of the section 743(b) basis adjustment that reflects an increase in the fair market value of the underlying qualified property. KPMG tax professionals have had informal discussions with government officials to make them aware of the issue. Hopefully, the IRS and Treasury will make a correction to the Final Regulations to properly compute the amount.

Partner's share of partnership's UBIA

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

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

When read together, the general depreciation rule and the exception create a strange result as related to depreciable section 704(c) property contributed to a partnership with a built-in gain. While that property is actually being depreciated, a disproportionately large amount of tax depreciation may be allocated to the non-contributing partner; as a result, the non-contributing partner's share of UBIA for those tax years may be disproportionately high. However, when the property is fully depreciated for tax purposes, a disproportionately large amount of the gain with respect to the property will be allocated to the contributing partner. Thus, the partner's relative shares of the partnership's UBIA will "flip" in the first year during which there is not tax depreciation with respect to the property.

In the Final Regulations Preamble, the IRS acknowledged the described shift. In light of this, the Final Regulations provide that each partner's share of the UBIA of qualified property is determined in accordance with how depreciation would be allocated for *section 704(b) book* purposes under Reg. section 1.704-1(b)(2)(iv)(g) on the last day of the tax year. While this addresses the "flip" issue, it raises a new set of issues. Specifically, the Final Regulations look to how deprecation would be allocated for section 704(b) book purposes "on the last day of the taxable year" rather than on how depreciation is actually allocated for the entire year. Presumably, the intent was to ensure that only those partners that own an interest in the partnership at the close of the partnership's tax year benefit from the partnership's UBIA (see more discussion below). However, there is some uncertainty as to whether the language in the Final Regulations goes further, and requires that a partnership determine how depreciation would be allocated among its partners for section 704(b) book purposes if the partnership had a tax return that only reflected the last day of its tax year. Informal conversations with government personnel indicate that this may not be the intent of the rule, and thus some clarification may be forthcoming. Lastly, the Final Regulations Preamble requests comments on whether a new regime is necessary in the case of a partnership with qualified property that does not produce tax depreciation during the tax year. Presumably, this is intended to request comments with respect to situations when there is no section 704(b) book depreciation.

KPMG observation

The standard for determining a partner's share of a partnership's UBIA may result in a disproportionately large share of UBIA for a partner that acquires an interest in the partnership on the day before the last day of the partnership's tax year. The partner may be allocated only a small portion of the partnership's QBI for the year, but may have a large share of UBIA. This may lead to situations in which one partner has a very large share of QBI but very little UBIA, while another has a large share of UBIA but very little QBI. That result may be inconsistent with congressional intent in enacting a statute providing that each partner is treated as having UBIA for the tax year in an amount equal to such partner's allocable share of the UBIA of the partnership for the tax year.

Passthrough entities and the close of the year requirement

Section 199A(b)(6)(A)(i) and Prop. Reg. section 1.199A-2(c) provide that qualified property must be held by, and available for use in, the qualified trade or business at the close of the tax year. One commenter suggested the final regulations contain a rule for determining the UBIA of qualified property in a short year on acquisition or disposition of a trade or business, similar to the guidance provided in Reg. section

1.199A-2(b)(2)(v) for purposes of calculating W-2 wages. The commenter suggested that one approach for UBIA could be a pro rata calculation based on the number of days the qualified property is held during the year. The IRS and Treasury declined to adopt the "per day" calculation of UBIA suggestion because the statute looks to qualified property held at the close of the tax year.

KPMG observation

The government's conclusion will have particular significance in situations in which a taxpayer sells all or some portion of its assets during its tax year. In such a case, the entity may have significant QBI for the year resulting from recapture income with respect to its assets. The depreciation that gave rise to the recapture income reduced the taxpayer's QBI (and thus the amount of its § 199A Deduction) in prior years. Thus, fairness might dictate that the recapture income similarly increase the taxpayer's ability to take the deduction. However, the taxpayer's UBIA for that year will be zero ($0); that means the § 199A Deduction with respect to the QBI necessarily will be limited to 50% of W-2 wages (which may also be small—particularly if the sale occurs near the beginning of the year). This may present a significant issue for some taxpayers.

The Final Regulations also address requests for additional guidance with respect to the end of the year requirement relating to qualified property held by an RPE. Specifically, a commenter questioned whether the applicable tax year is that of the taxpayer or the RPE, which would be relevant if an individual owner of an RPE transferred its interest in the entity during the RPE's tax year. In response, the Final Regulations provide that a taxpayer that transfers an interest in an RPE prior to the close of the RPE's tax year is not entitled to a share of UBIA from the RPE. With regard to a partnership, that rule is implemented using the determination of a partner's share of UBIA with the difficulties described above. In the S corporation context, the shareholder's share of UBIA is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the tax year over the total issued and outstanding shares of the S corporation.

Qualified trade or business

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

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

The IRS and Treasury received numerous comments relating to the presumption that the income of an individual once classified as an employee continues to be treated as earned by an employee. The government declined to remove the presumption from the Final Regulations. However, the Final Regulations do provide that an individual may rebut the presumption by showing records—such as contracts or partnership agreements—that are sufficient to corroborate the individual's status as a non-employee for three years from the date a person ceases to treat the individual as an employee for federal employment taxes. Moreover, the Final Regulations added an example demonstrating the application of the presumption for the situation in which an employee has **materially modified the employee's relationship** with the employer such that the employee can successfully rebut the presumption. In the example, an employee becomes a partner in the former employer and rebuts the presumption by showing the promotion was made as a career milestone, the former employee shares in the net profits of the firm, and the employee is not otherwise an employee under federal tax principles.

Specified service trade or business

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

- Any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, and

- Any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

Items attributable to an SSTB

The Proposed Regulations provide that if a trade or business is an SSTB, none of the income from that trade or business allocable to an owner (even a passive owner) with taxable income above the Threshold Amount generally is QBI. Application of this rule is illustrated by an example. Under the Proposed Regulations, a determination as to whether a trade or business operated by a partnership or S corporation was an SSTB is made by the entity itself. The entity then discloses that information to its owners. In making this determination, the entity must consider several rules contained in the Proposed Regulations. Under the Proposed Regulations, income from an SSTB generally was "bad" income, even if it is derived from an activity that is not itself an SSTB. So, if a trade or business is an SSTB, the "taint" applied to SSTB income and other items applies to all the items of the trade or business.

The Proposed Regulations provide a de minimis rule pursuant to which a trade or business is not an SSTB if it provides only a small amount of services in a specified activity. Specifically, a trade or business is not an SSTB if less than 5% (10% in the case of a trade or business with gross receipts of $25 million or less) of its gross receipts are attributable to the performance of services in an SSTB (the "De Minimis Threshold"). This rule could prove quite useful for trades or businesses that generally are not in a SSTB, but do (as a necessary part of the trade or business) provide limited services in a prescribed field (such as limited consulting services or the like). Note, however, that in determining whether the 5% or 10% of gross receipts standard is met, the performance of any activity "incident" to the actual performance of services in the field is considered the performance of services in that field. Under these rules, if the "good" and "bad" activities were part of the same trade or business, a relatively small amount of gross receipts in a prescribed field could exclude from QBI a large amount of what would otherwise be good income.

Following publication of the Proposed Regulations, many commenters submitted requests for an increase in the De Minimis Threshold. In the Final Regulations, the IRS specifically rejected these requests, concluding that the prescribed thresholds would remain at the levels described.

KPMG observation

Although the De Minimis Threshold was intended to provide a benefit for taxpayers, it results in a "cliff effect"—if the De Minimis Threshold is exceeded, the entire trade or business is treated as an SSTB.

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

Dividing the ownership of the building and the practice between two separate entities would seem to establish that they are two separate trades or businesses under the Proposed Regulations (although it would require the entity owning the building to lease a portion of the building to the entity operating the medical practice). However, the IRS and Treasury were aware that taxpayers were considering restructuring for this purpose. In response, the IRS and Treasury included what they view as two anti-abuse rules in the Proposed Regulations.

The first rule provides that an SSTB includes any trade or business that provides 80% or more of its property or services to an SSTB with 50% or more common ownership (the "80% Rule").[9] Under this rule, if the 80% threshold is reached, 100% of the income of the trade or business providing the property and services to the SSTB would be treated as income of the SSTB. Failure to reach the 80% level under the anti-abuse rule in the Proposed Regulations did not mean a taxpayer was in the clear. Rather, if a

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

trade or business provides less than 80% of its property or services to a commonly owned SSTB, then a proportionate amount of the income is treated as part of the SSTB. Applying that rule to the example, if the building and the medical practice are split between commonly owned entities, then if 80% or more of the building is leased to the medical practice, all the rental income will be bad. On the other hand, if 30% of the building is from leasing part of the building to the medical practice, then 30% of the rental income will be treated as bad income from an SSTB. The second rule in the Proposed Regulations provides that, if a trade or business (that would not otherwise be treated as an SSTB) has both 50% or more common ownership with an SSTB and shared expenses with an SSTB, then the trade or business is treated as incidental to and, therefore, part of the SSTB, if the gross receipts of the trade or business represent no more than 5% of the total combined gross receipts of the trade or business and the SSTB in a tax year (the "Incidental Rule"). Both rules were proposed to be effective on the date of enactment of section 199A,

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

The IRS and Treasury received numerous comments relating to the Mandatory Aggregation Rules. In response to comments, the final regulations clarify that: (1) sections 267(b) and 707(b) apply in determining common ownership for purposes of the Mandatory Aggregation rules; and (2) the Mandatory Aggregation rules apply only to those who make up the common ownership test. Further (and more importantly), the Final Regulations remove both the Incidental Rule and the 80% Rule. Thus, under the Final Regulations, if a trade or business provides 90% of its property or services to a related entity, then 90% (rather than 100% as under the Proposed Regulations) will be treated as an SSTB.

KPMG observation

The rules under the Final Regulations continue to limit the ability to successfully separate a good trade or business from an SSTB. Further, if separation into two or more entities would accomplish the desired result, it may be difficult for entities—particularly regulated entities—to restructure into separate entities. In these cases, the only remaining option appears to be developing an argument that the activities are two separate trades or businesses.

Clarifications regarding certain listed fields

As described above, section 199A defines an SSTB as: (1) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; and (2) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) (the "Specified Fields"). The Proposed Regulations provide clarifications with regard to the Specified Fields.

The Final Regulations provide numerous (mostly favorable) clarifications with regard to the Specified Fields. First, at the request of commenters, the IRS and Treasury clarified the treatment of a franchisor selling a franchise in a Specified Field. Under the example, a franchisor licenses the right to use the business tradename, other branding intellectual property, and a marketing plan to third-party financial planner franchisees that operate franchise locations that generally provide personal wealth management, retirement planning, and other financial advice services to customers for a fee. The franchisor does not provide financial planning services itself. In exchange for its rights under the franchise agreement, the franchisee compensates the franchisor based on a fee structure that includes a one-time fee to acquire the franchise. In the example, the government concludes that the franchisor is not engaged in the performance of services in the field of financial services for purposes of section 199A.

The Final Regulations also provide further clarifications with regard to the Specified Fields. Clarifications in the Final Regulations include:

1. Health

Treasury and the IRS received a variety of comments requesting additional guidance on the meaning of "performance of services in the field of health." Many of these comments are addressed in the Final Regulations. The Proposed Regulations provide a test for identifying services performed in the field of health—one prong of that test is that the services be performed "directly" to a patient (the service recipient). The Final Regulations eliminate this requirement. The Final Regulations Preamble explains that proximity to the patient is not a necessary component of providing services in the field of health. Thus, for example, a radiologist who consults with a physician is engaging in the same exercise of medical skills and judgement as a physician who sees patients and thus performs services in the field of health.

The IRS and Treasury received numerous comments requesting clarification on the application of section 199A to specific fields or types of operations. In response, the IRS and Treasury declined to exclude veterinary services from the definition of the field of health, citing the "long-standing treatment of veterinary services as the performance of services in the field of health" under section 448, as memorialized in Rev. Rul. 91-30.[10] However, the Final Regulations add an example confirming that an LLC that provides veterinary services performed by licensed staff and also develops and sells its own line of dog food may be in two separate trades or businesses, such that dog food line may give rise to QBI.

KPMG observation

Although the Final Regulations Preamble acknowledges that the intent behind section 199A is different from sections 1202 and 448, the IRS and Treasury have not yet illustrated any case in which the identification of services in the field of health would be narrower or otherwise differ for purposes of section 199A. Taxpayers should exercise caution, therefore, before taking inconsistent positions when identifying services in the field of health for purposes of section 199A versus another tax provision (for example, for purposes of applying the nonaccrual experience method of accounting under section 448(d)(5)).

The IRS and Treasury declined to adopt rules excluding physical therapy, operation of medical equipment, laboratory testing, and the manufacture and production of gene therapy, stem cell therapy, RNA-based therapist and other similar products; these services require a facts-and-circumstances determination in determining whether a trade or business involves the performance of services in the field of health. The

[10] 1991-1 C.B. 61.

Final Regulations contain an example illustrating a situation in which a laboratory is not treated as providing services in the field of health.[11] In the example, a specialty laboratory is the developer and provider of a patented test to detect a particular medical condition. The lab's clients are healthcare professionals. The lab does not have contact with patients, and its employees do not diagnose, treat or manage any aspect of patient care. The lab's employees are not healthcare professionals, but they are highly educated and receive specialized training for working with the lab's test, which training is of no use to any other employer. The example concludes that the lab is not providing services in the field of health within the meaning of section 199A.

Several commentators also requested clarification regarding the services performed by a pharmacist and the sale of pharmaceuticals and medical devices generally. The IRS and Treasury note in the Final Regulations Preamble that the sale of pharmaceuticals and medical devices by a retail pharmacy is not itself a trade or business of performing services in the field of health, but some services provided by a retail pharmacy through a pharmacist could be. This is illustrated by an example added in the Final Regulations. In the example, a pharmacist (acting as an independent contractor) contracts with a medical facility to provide services that include receiving, reviewing and filling orders; making recommendations to the prescribing physician regarding dose and alternatives; performing inoculations; and checking for drug interactions. The example concludes that the pharmacist is engaged in the performance of services in the field of health within the meaning of section 199A.

KPMG observation

The example does not indicate whether the activities of the pharmacist would also be imputed to the contracting facility for purposes of determining whether the facility is engaged in a trade or business of performing services in the field of health. In the example, the question is likely not relevant, as the facility: (1) likely is engaged in other activities that constitute the performance of services in the field of health; and (2) employs another pharmacist on a full-time basis. The Final Regulations do not provide guidance on whether a retail pharmacy that otherwise is not performing services in the field of health for purposes of section 199A would be treated as so engaged through the activities of an independent contractor pharmacist who performs the activities described in the example.

In addition to the above, the Final Regulations provide insight into the treatment of institutional healthcare providers and facilities, such as skilled nursing homes, assisted living facilities, hospitals, ambulatory surgery centers, home health care agencies, outpatient radiology centers, and hospice. In the Final Regulations Preamble, the IRS and Treasury note their agreement that such facilities do provide multi-faceted services, but declined to provide any bright-line rules on the treatment of these providers and facilities. Rather, the determination of whether a trade or business is performing services in the field of health requires a facts-and-circumstances inquiry. The Final Regulations contain several new examples illustrating situations in which the IRS and Treasury believe these facilities are not performing services in the field of health as follows:

- *Senior living facility.* The operator of a residential facility for senior citizens provides a variety of services, including housing management and maintenance, meals, laundry, and entertainment. The operator also contracts with local professional healthcare organizations to offer residents a range of medical and health services including skilled nursing, physical and occupational therapy, speech-language pathology services, medical social services, medications, medical supplies and equipment,

[11] This example is similar to the facts set forth in PLR 201717010 (January 23, 2017).

ambulance transportation, and dietary counseling. The health and medical services are billed directly by the healthcare providers. The example concludes that the facility operator is not performing services in the field of health within the meaning of section 199A.

- *Specialty surgery center.* A private organization owns and operates surgery centers that provide outpatient medical procedures. For each facility, the surgery center operator manages the facility, performs all administrative functions, and bills patients for facility costs related to their procedures. The surgery center does not employ physicians, nurses or medical assistants, but instead enters into agreements with professional medical organizations and medical professionals to perform procedures and provide all medical care. The healthcare professionals bill patients directly for the costs of the procedure conducted by the physician and medical support team. The example concludes that the surgery center operator does not perform services in the field of health within the meaning of section 199A.

KPMG observation

Although not explicitly stated, one important fact in determining whether a facility or institutional provider is providing services in the field of health appears to be whether the taxpayer is the employer of healthcare professionals (physicians, nurses, etc.). Taxpayers, when structuring their operations, should keep in mind that if healthcare professionals are employed through a separate but related entity, the Mandatory Aggregation Rules may apply. Also, taxpayers should not assume that the IRS and Treasury intended to create a bright-line rule based on employment status; classifying a worker as an independent contractor likely would not be determinative, but rather a factor in the overall facts-and-circumstances inquiry that might also look at billing arrangements, supervision of the healthcare professionals, and other factors.

2. Actuarial science

The Final Regulations clarify that the mere employment of actuaries (by an insurance company, for example) does not itself cause a trade or business to be treated as the performance of services in the field of actuarial science. Rather, that determination is made by examining all the facts and circumstances.

3. Performing arts

To the extent that a writer is paid for written material (such as a song or a screenplay) that is integral to the creation of the performing arts, the writer is performing services in the field of performing arts.

4. Consulting

A business that assists other businesses in meeting their personnel needs by referring job applicants to them does not engage in the performance of services in the field of consulting when the compensation for the business referring job applicants is based on whether the applicants accept employment positions with the businesses searching for employees. Further, services within the fields of architecture and engineering are not treated as consulting services for purposes of section 199A. Finally, consulting services that are separately billed are generally not considered to be provided in the context of the provisions of goods or services.

5. **Athletics**

A professional sports club may operate more than one trade or business. For example, a team may operate its concession services as a separate trade or business; if so, the concession services generally would not be a trade or business of performing services in the field of athletics.

Nonetheless, a professional sports club's operation of an athletic team is a trade or business of performing services in the field of athletics. Income from that trade or business—including income from ticket sales and broadcast rights—is income from a trade or business of performing services in the field of athletics. However, 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.

KPMG observation

The treatment of professional sports clubs in the Proposed Regulations and Final Regulations remains curious. It seems that the government has concluded that sports teams are in the field of performing services in the field of athletics solely because they employ athletes that engage in the relevant sport. It is difficult to reconcile that treatment with the government's conclusion with regard to actuarial science described above (i.e., that a trade or business is not treated as performing services in the field of actuarial science solely because it employs actuaries).

6. **Financial services**

The Final Regulations clarify that the provision of financial services does not include taking deposits or making loans; however, it does include arranging lending transactions between a lender and borrower. Further, insurance is not considered a financial service for purposes of section 199A.

However, services provided by insurance agents are not categorically excluded from financial services, as financial services such as managing wealth, advising clients with respect to finances, and the provision of advisory and other similar services can be provided by insurance agents. However, the provision of these services to the extent that they are ancillary to the commission-based sale of an insurance policy will generally not be considered the provision of financial services for purposes of section 199A.

KPMG observation

There is no discussion of what is meant by "ancillary to" in the final regulations. However, this provision likely will be helpful to insurance agents that may provide advisory services.

7. **Investing and investment management**

Commission-based sales of insurance policies generally will not be considered the performance of services in the field of investing and investing management for purposes of section 199A. Further, the Final Regulations Preamble provides that the SSTB Exclusion applies to direct and indirect owners of a trade or business that is an SSTB; thus, the direct and indirect management of real property (which under the Proposed Regulations and Final Regulations is not investing or investment management) includes management through agents, employees, and independent contractors. It may be worth noting, however, that the regulation itself continues to provide that the performance of services of investing and investment management does not include directly managing real property. In addition, the Final Regulations clarify that there is no broad exemption from the Specified Fields for all services that may legally be permitted to be performed by a bank.

KPMG observation

Thus, to the extent a bank operates a single trade or business that involves the performance of services listed as SSTBs outside of the De Minimis Threshold (such as investing and investment management), the bank's single trade or business will be treated as an SSTB. However, an RPE (including an S corporation bank), may operate more than one trade or business. Thus, an S corporation bank could segregate specified service activities from an existing trade or business and operate such specified service activities as an SSTB separate from its remaining trade or business, either within the same legal entity or in a separate entity.

8. Dealing

The performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is performing services consisting of dealing in securities. Further, the definition of dealing in commodities for purposes of section 199A is limited to a trade or business that is dealing in financial instruments or otherwise does not engage in substantial activities with respect to physical commodities. To distinguish a trade or business that performs substantial activities with physical commodities from a trade or business that engages in a commodities trade or business by dealing or trading in financial instruments that are commodities (within the meaning of section 475(e)(2)), or a trade or business that otherwise does not perform substantial activities with commodities, the Final Regulations adopt rules similar to the rules that apply to qualified active sales of commodities in Reg. section 1.954-2(f)(2)(iii).

9. Skill or reputation

The final category of business included in the definition of an SSTB is a trade or business the principal asset of which is the skill or reputation of one or more of its owners or employees. Prior to publication of the Proposed Regulations, many practitioners worried that a broad interpretation of this rule could result in treatment as an SSTB of virtually any business operated in the name of an owner or employee, or any business that was successful as a result of the personal reputation or skill of an owner. This could result in the denial of a section 199A deduction to businesses such as a "Joe the Plumber" or "Mom and Pop's Corner Store" that Congress likely intended to be eligible for the deduction.

In the Preamble, the government expressed its view that this rule was intended to describe a narrow set of trades or businesses not otherwise enumerated. In light of this view, the IRS and Treasury limit the meaning of the "reputation or skill" clause to fact patterns in which an individual or RPE is engaged in the trade or business of: (1) receiving income for endorsing products or services (including an individual's share of income or distributions from 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).

KPMG observation

The interpretation of the reputation or skill provision in the Proposed Regulations significantly limits the number of businesses that should be concerned about being ineligible for the section 199A deduction under this provision. However, it is arguably contrary to: (1) the determination and treatment of an SSTB in other situations; and (2) congressional intent as described by the Joint Committee on Taxation in the "Bluebook" describing the intent of section 199A. Notwithstanding this concern, the IRS and Treasury maintained the rule in the Final Regulations.

Effective dates

The Proposed Regulations generally were proposed to be effective for tax years ending after the date final regulations were published in the Federal Register; however, it was clear from the Proposed Regulations Preamble that taxpayers could rely on the Proposed Regulations until final regulations are issued. However, certain rules that the IRS and Treasury felt addressed abuses of section 199A were proposed to be effective retroactive to the date of enactment of section 199A.

The Final Regulations are effective for tax years ending after the date they are published in the Federal Register. As that date will be after December 31, 2018, the Final Regulations by their terms do not apply to returns filed for tax years ending in or with the 2018 calendar year. Thus, the only true guidance of those tax returns is the statute itself and the legislative history accompanying its enactment. However, the Final Regulations specifically provide that taxpayers may rely on the Final Regulations (in their entirety) or on the Proposed Regulations (in their entirety) for tax years ending in calendar year 2018.

KPMG observation

Although valuable for many taxpayers, the "all or nothing" approach to applying either the Proposed Regulations or the Final Regulations may prove difficult for some taxpayers. For example, consider a partnership that owns both a women's basketball team and a men's basketball team. Relying on an interpretation of only the statutory language of section 199A and the definition of the performance of services in the field of athletics in the Proposed Regulations, the partnership may want to take the position that it is not engaged in an SSTB. However, the partnership or its owners may also want to aggregate the two teams at the partnership level under the Final Regulations. As aggregation at the entity level is only provided in the Final Regulations, the taxpayer may be forced to forego aggregation at the partnership level in order to take its position relating to whether it is an SSTB. This may leave certain taxpayers in a tough spot during the 2018 filing season.

Summary

The discussion above looks at some of the more significant differences between the Proposed Regulations and the Final Regulations under section 199A. However, there are many other differences that may need to be considered. For these purposes or for help in determining whether to apply for the

2018 tax year all of the Proposed Regulations, all of the Final Regulations, or neither by relying on an interpretation of the statutory language itself, contact a KPMG tax professional.

Contact us

Questions about the regulations under section 199A? Contact a tax professional in KPMG's Washington National Tax office:

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