The Real Estate Roundtable

October 1, 2018

The Honorable David J. Kautter
Assistant Secretary of Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William M. Paul
Chief Counsel (Acting)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Guidance Regarding Qualified Business Income Deduction (Section 199A)

Dear Assistant Secretary Kautter and Chief Counsel Paul:

On behalf of The Real Estate Roundtable, I am pleased to provide comments regarding the Qualified Business Income Deduction (Section 199A) of the *Tax Cuts and Jobs Act* ("TCJA"). The Real Estate Roundtable shares the Administration's goals of creating jobs and spurring economic growth. The positive economic effects of the recently enacted tax changes are already evident, and timely, workable regulations will only increase those effects. We very much appreciate the concerted efforts by you and your colleagues in that regard. In particular, we have no doubt that section 199A will serve as a powerful incentive for job creation and new investment once fully implemented.

Specifically, in our comments below, we respectfully recommend the following:

- The final regulations should clarify that rental income from real property held for the production of rents, within the meaning of section 62(a)(4), will be considered a trade or business for purposes of section 199A;
- The final regulations should allow taxpayers to treat all qualifying real estate rental activities, whether held directly or through a pass-through entity, as if held in a single "trade or business" for purposes of section 199A;
- When assets with associated unadjusted basis immediately after acquisition (UBIA) are transferred in a non-recognition transaction (such as a like-kind exchange or the contribution or distribution of assets involving a partnership or S corporation), the general rule should be that the UBIA of an asset (and its duration) carries over; and
- The final regulations should provide rules to help taxpayers ascertain when multiple activities (including multiple activities conducted in a single entity) constitute discrete trades or businesses.

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Introduction

Congress plainly evidenced its intent to allow conventional real estate leasing activities to qualify for the deduction when it added an asset test, as an alternative to the wage test, and also provided that REIT income passed-through as REIT dividends would qualify for the deduction.

For lessors of real estate, as well as taxpayers generally, there are several core issues presented by section 199A: whether the taxpayer's activity is a trade or business, whether it is a prohibited business activity (specified service trade or business, or SSTB) in whole or in part, and whether it satisfies the wage or asset tests. These questions are difficult to answer without knowing whether two or more activities conducted in a single entity or in multiple entities constitute a single trade or business or multiple trades or businesses. The proposed regulations only partially address these issues and questions. Accordingly, we have some suggested modifications or clarifications that we believe would work well for real estate activities, and may well make sense for all types of businesses.

The proposed regulations contain a number of rules and concepts that apply differently when different activities are considered a part of the same trade or business, or distinct businesses. This includes the *de minimis* rule and the incidental rule for SSTB and non-SSTB activities or businesses. In addition, while there is an "aggregation" rule allowing for the combining of wages or assets in certain cases from different businesses, taxpayers that fail the aggregation rule might argue that they do not have to "aggregate" if their activities are already part of a single trade or business. In addition, where an endeavor involves, say, 15% SSTB activities and 85% non-SSTB activities, it is unclear whether the taxpayer must argue that those are two distinct business to avoid a complete taint of the non-SSTB activities. An example in the real estate industry might be a partnership that receives 85% of its revenues from real estate rents and 15% of its revenues from investment management fees.

Unfortunately, the proposed regulations do not clearly indicate how one determines the boundaries of a single trade or business. For example, the illustration of the incidental rule involving a dermatologist who also sells cosmetics, with shared services and 100% common ownership, actually involves a single legal entity, a disregarded entity, that is wholly owned by the dermatologist. The example assumes that these activities are two distinct businesses, which makes the incidental rules apply (because cosmetics are not more than 5% of revenues) — but some observers might have thought that case was a single trade or business.

We see no ready way to administer these rules without either (1) making the boundaries of the tax entity the boundaries of "the business" in all cases — which would likely lead to much restructuring — or (2) essentially allowing the taxpayer to specify on an elective basis the boundaries of its distinct businesses for purposes of section 199A— whether that means treating a single entity as comprised of multiple businesses or whether it means treating activities conducted in multiple entities as constituting a single trade or business. Accordingly, we make some specific suggestions about how such an elective designation of business boundaries might occur.

Beyond that, as the proposed regulations recognize, some kind of aggregation rule is necessary to allow the wages and/or UBIA of what might otherwise be distinct businesses to be used interchangeably at the taxpayer level. In the case of rental real estate, we believe the simplest, fairest and least disruptive rule would allow all rental real estate activities to be aggregated at the level of partner, proprietor, or shareholder without regard to the percentage of ownership the taxpayer may have in any distinct entity or distinct business. It is possible that such a rule would make sense as well

for other types of businesses, but it seems to us to make sense for rental real estate for the same reasons that similar aggregation rules has long been successfully used by qualifying real estate professionals. We make some more specific comments on this concept below.

We believe that rental real estate poses special problems when it comes to determining whether a particular rental real estate activity — such as a net lease or a single beach condominium held in a rental pool — constitutes a "trade or business" if the standards of section 162 are made applicable by the final regulations. Accordingly, we suggest that a different standard may be appropriate for rental real estate activities.

We also believe that improvements can be made to the rules governing the carryover of UBIA in non-recognition exchanges, along with several other technical observations and suggestions.

From the standpoint of minimizing compliance costs and tax complexity, we believe that our suggestions would fulfill Congressional intent, conform to the strictures of the statute, and provide a practical and workable set of rules for taxpayers as well as the IRS.

Trade or Business Requirement

We recommend that the final regulations clarify that rental income from real property held for the production of rents, within the meaning of section 62(a)(4), will be considered a trade or business for purposes of section 199A. Under the current approach taken by the proposed regulations to the trade or business issue, the question of whether a real estate rental activity constitutes a "trade or business" for purposes of section 162 is likely to be a source of controversy and uncertainty in a number of cases on the margins of the somewhat sparse existing case law.[1] Problematic cases would range from a modest, single property owned by a single landlord with a single long-term lease, to sophisticated arrangements where a tenant accepts responsibility for some or all property-level obligations, such as taxes and maintenance. Similarly situated taxpayers will reach different conclusions regarding whether their real estate rental income is derived from a trade or business, leading to inconsistent and uneven application of the tax benefit.

[1] Courts have generally found a trade or business when the taxpayer or the taxpayer's agent leases properties, collects rents, pays taxes and operating expenses, and arranges for repairs. *See, e.g., Taiyo Hawaii Co. v. Comm'r*, 108 T.C. 590 (1997) (Japanese corporation that held real property for residential development and was engaged in the business activity of real property development); *Lewenhaupt v. Comm'r*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955) (nonresident alien was engaged in a trade or business through an agent who leased properties, supervised necessary repairs, and paid taxes); *Pinchot v. Comm'r,* 113 F.2d 718, 719 (2d Cir. 1940) (nonresident alien who owned an interest in eleven buildings was in a trade or business through regular and continuous activity, hiring employees, purchasing materials, and making of contracts).

In other circumstances, courts have not found a trade or business. *See, e.g., Union National Bank of Troy v. United States*, 195 F.Supp. 382 (N.D. NY 1961) (no trade or business for renting under a net lease where taxes, water rents, and ordinary assessments were all the obligations of the lessee); *E. Herbert v. Comm'r,* 30 T.C. 26 (1958) (finding that ownership of property acquired by gift with minimal activity by owner was not sufficient to treat the owner as engaged in a U.S. trade or business); *E.M.L. Neill v. Comm'r,* 46 B.T.A 197 (1942) (nonresident alien was not in a trade or business when owned a single leased property with an agent who only paid mortgage interest and other expenses).

Given the Congressional decision to adopt an alternative asset test for depreciable property where no wages at all are paid, we do not believe that Congress actually contemplated that section 199A would be unavailable to any lessor of real estate meeting the UBIA standard, even if the taxpayer was holding a net lease or was only leasing a single, modest property requiring minimal efforts by the landlord or the landlord's agent. Moreover, as you are aware, there is no "trade or business" test at all for real estate rental income passed through a REIT. Ideally, the final regulations would clarify that rental income from real property that is held for the production of rents within the meaning of section 62(a)(4) will be considered to be a trade or business for purposes of section 199A, without regard to the requirements of section 162. (Other existing definitions might also be used, such as a reference to "rents from interest in real property" within the meaning of 856(d)(1)(A) (without regard to section 856(d)(2)).

We believe that a rule like this would significantly reduce tax uncertainty and tax compliance costs (including costs for the IRS) without significantly increasing the cost to the government from reduced revenues, and thus be a prudent exercise of regulatory discretion consistent with sound, regulatory cost-benefit analysis. Additionally, by clarifying the treatment of real estate rental income along the lines recommended, Treasury regulations would create greater parity between all types of real estate investors, including small landlords, private real estate investors, and REIT shareholders.

Alternatively, the final regulations could augment the section 162 trade or business test with a safe harbor for rental income based on the number of hours dedicated to the leasing business. Because the inquiry is aimed at determining whether a trade or business exists – and not whether the individual owner is active or passive—the safe harbor should take into consideration the number of hours expended by owners, employees, and independent contractors (*e.g*., property managers, accountants, lawyers, etc.).[2] Any hours-based safe harbor should be an additional way to meet the trade or business requirement, and the option to qualify under the section 162 standard should remain otherwise available.

Aggregation of Real Estate Rental Activities

We recommend that the final regulations allow taxpayers to treat all qualifying real estate rental activities, whether held directly or through a pass-through entity, as if held in a single "trade or business" for purposes of section 199A. Under such rule, the taxpayer's allocable share of all associated wages or assets could be taken into account at the taxpayer/partner/shareholder level.

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[2] An hours-based safe harbor for determining whether a trade or business exists should consider the activity of independent contractors. The relevant case law takes into account the activities of employees and independent contractors in determining whether a trade or business exists. *See Elek v. Comm'r*, 30 T.C. 731, 733 (1958) ("The rental and management of an apartment building or residential property amounts to a trade or business of the owner, and this is true where an agent acts for the owner."); *Gilford* v. *Comm'r*, 201 F. 2d 735 (2nd Cir. 1953) ("Although it does not appear that the petitioner did anything herself in connection with the management of these eight buildings, an appreciable amount of time and work was necessarily required on the part of the managing agent. And if such management was a 'trade or business,' the petitioner was so engaged although she acted only through an agent."). Elsewhere in the tax code, independent contractors are evidence of a trade or business. *See, e.g.,* Treas. Reg. Sec. 1.355-3(b)(2)(iii) (providing that activities of independent contractors are generally not taken into account in determining whether the "active" component of an "active trade or business" is satisfied, but otherwise inferring that such activities are relevant to whether there is a "trade or business.").

This approach to aggregation of real estate rental activities is similar to the treatment of real estate rental activities that is permitted for qualified real estate professionals under section 469. Although we recognize that section 469 is not strictly relevant to section 199A, the proposed regulations already recognize that some kind of aggregation rule is necessary. We believe that this particular approach to aggregation makes more sense for real estate rental activities. We recognize that the normal rule of section 162 is that the imputation of "trade or business" status flows from the entity to the partner, and not from the partner to the entity; however, the statute itself does not mandate that section 162 principles be applied for purposes of section 199A, and actually provides in section 199A(f)(1) that in the case of a partnership or S corporation "this *section* shall be applied at the partner or shareholder level." (Emphasis supplied) Accordingly, at least in the case of real estate rental activities (where the approach of section 469 for real estate professionals has proven highly workable), we believe a similar approach should be followed for aggregating all of a taxpayer's real estate rental income, deductions, wages, and UBIA.

Trades or businesses today evolve with changing market trends. In the context of real estate, an owner may shift investment from one sector to another as market conditions dictate. The focus should fall on whether *a* trade or business is being conducted, not *which* trade or business (exclusive of specific service trades or businesses) is being conducted. There is no clear policy objective served by separating and compartmentalizing income, deductions, wages, and depreciable assets simply because the real estate activities occur in different entities or relate to different activities, particularly where it is the individual taxpayer who is deploying the capital and bearing financial risk. Full aggregation of qualified pass-through real estate activities at the partner level would more accurately capture the full extent of an individual's economic contributions and level of economic risk and exposure. It also would provide a simpler approach that lowers compliance costs, decreases the likelihood of taxpayer-government disputes, and reduces distortions that lead individuals to restructure their operations and make other business decisions based on tax considerations.[3]

Like-Kind Exchanges and Other Non-Recognition Transactions

<u>When assets with associated UBIA are transferred in a non-recognition transaction (such as a like-kind exchange or the contribution or distribution of assets involving a partnership or S corporation), we believe the general rule should be that the UBIA of an asset (and its duration) carries</u>

[3] Alternatively, we recommend that the regulations permit taxpayers to aggregate activities at the partner level, regardless of the extent of the taxpayer's ownership interest in an entity, provided the activities are substantially similar. For example, a single taxpayer may have ownership interest in multiple rental homes, each of which is held in a separate entity, such as partnership or LLC. The taxpayer's ownership interest in the various partnerships may be less than 50%, preventing the taxpayer from aggregating under the Proposed Regulations. The separate legal entities are necessary to accommodate the capital-intensive nature of the business and the need for different investors for each property. Viewed collectively, the taxpayer's partnership interests have all of the qualities of a larger, integrated trade or business. The partnerships provide a common product or service to the public, residential housing. The taxpayer's knowledge and expertise in the ownership, management, and leasing of rental homes contributes to the success of the partnerships. Here, although the taxpayer's activities are conducted across multiple entities, they should be considered a single trade or business for purposes of section 199A.

over.[4] In a like-kind exchange, the UBIA should be adjusted upwards or downwards to account for additional investment or disinvestment of the taxpayer at the time of the exchange in any unequal exchange.

The wage/capital test in section 199A seeks to measure and reward two factors—jobs and wages supported by the activity, and capital investment spurred by the activity. When a depreciable asset is purchased with cash or debt, a taxpayer is making a capital investment in the business. When one property is exchanged for another (with no cash or "boot"), there is no new net investment in the business, even if the replacement property is worth substantially more than the original cost of the relinquished property. The capital appreciation is unrealized, and it should be a nonevent for section 199A purposes (with the exception of additional cash invested at the time of the exchange). Similarly, there is no reason to penalize a taxpayer by reducing his or her basis in an asset at the time of a like-kind exchange or partnership contribution. Unless the taxpayer is receiving cash as part of the exchange, there is no net reduction in the taxpayer's level of capital investment in the business.

Upon a transfer to an S corporation, the UBIA of the transferor should be allocated among the shareholders on a pro rata basis. In the case of a partnership, the UBIA should be allocated among the partners in the same proportion as their shares of the "book" or section 704(b) depreciation with respect to that asset, and not their "tax" depreciation. Inasmuch as the purpose of the UBIA concept is not to measure a taxpayer's appropriate depreciation tax deductions, we think this simplification is appropriate, and is permitted by the statutory language.

Our statutory analysis is as follows. In the case of a sole proprietor, these issues obviously do not arise. If a sole proprietor that is the legal owner (and tax owner) of rental real estate with an existing amount of UBIA contributes that property to an S corporation or partnership, the transfer causes the statute to cease being applied at the level of the legal owner or tax owner, and is instead applied "at the partner or shareholder level." Under section 199A(f)(A)(iii), each such partner or shareholder is then treated as having a UBIA of qualified property equal to such person's allocable share of UBIA of qualified property of the partnership or S corporation for the taxable year, "(as determined under regulations prescribed by the Secretary)." (Emphasis supplied.) That delegation of regulatory

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[4] A non-recognition transaction, such as a contribution to a partnership or a like-kind exchange, involves an "acquisition" and thus the question, for purposes of section 199A, is what is the "unadjusted" basis at the time of this acquisition. Tax basis starts at cost (*i.e.*, purchase price) under the general rules of section 1012, and is then subject to "adjustments" in various provisions of the tax code. Therefore, if a taxpayer purchases depreciable property for $1,000 cash the "unadjusted" cost basis is $1,000. This basis is then "adjusted" under section 167(e)(3) for depreciation or amortization such that if the property has $600 of depreciation, the "unadjusted basis" remains at $1,000 but the "adjusted basis" is now $400. If this depreciated property is contributed to a partnership, this "adjusted basis" carries over under section 723 (which specifically says that the partnership's basis is the transferor's "adjusted basis" increased by any gain recognized under section 721(b) upon the contribution). The partnership does not have its own section 1012 unadjusted cost basis, but it instead has a carry over "adjusted basis". This leaves the question of what should be the partnership's "unadjusted" basis when it does not have its own section 1012 unadjusted cost basis. Although the concept of needing to determine "unadjusted" basis is unique to section 199A, the clearest answer is that the *unadjusted* basis carries over from the contributor just like the *adjusted* basis carried over under the statute. This result is consistent with both the carry over of the remaining tax life from the contributor[4] and is also consistent with the depreciation recapture rules under sections 1245 and 1250, which add back all of the historical depreciation from the contributor in computing the "recomputed basis" for depreciation recapture purposes. Treas. Reg. § 1.1245-1(e).

authority seems more than adequate to prescribe that the UBIA and remaining depreciable period carry over without modification in a nonrecognition transaction, such as a contribution to which section 721 or section 351 apply. Similarly, the reference to "depreciation" in the flush language following section 199A(f)(1)(A)(iii) could be interpreted as applying to depreciation as computed for purposes of section 704(b), not tax depreciation. In addition, of course, section 199A(f)(4) grants the Secretary authority to prescribe such regulations as are necessary to carry out the purposes of section 199A. We do not believe the Congressional purpose in creating the concept of UBIA would be appropriately "carried out" by insisting on an arbitrary "haircut" to UBIA in connection with routine formations, liquidations, or reorganizations of partnerships or S corporations.

a. For example, a contributing partner who contributes depreciable property with UBIA of $10 million, a basis of $4 million, and a value of $8 million, receiving a 50% share of the profits from that property (and all other properties), would be allocated 50% of the partnership's $10 million of UBIA on its original schedule. If the second partner received 50% of the profits from that property (and all other properties) contributed $8 million worth of land with no UBIA and a basis of $10 million, the second partner would be allocated 50% of the $10 million of UBIA associated with the depreciable property contributed by the first partner. UBIA could then continue to be allocated in these proportions, even if the property had been fully depreciated for book purposes.

b. Following a similar theme, if a partner purchases a partnership interest and the purchase gives rise to a section 743 adjustment reflecting a special, increased amount of basis and depreciation attributable to treating the purchase in a manner similar to a purchase of the underlying property, the section 743 adjustment should give rise to additional, new UBIA for the purchasing partner, to the extent the increased basis exceeds the original UBIA that is carrying over to the partnership.

c. Finally, when property is sold before the last day of the taxable year, the statute contemplates and may actually require regulations to provide appropriate rules for the computation of UBIA other than on a year-end basis. Such rules are proposed for the wage computation, but not for the UBIA computation. Where there are substantial asset sales or purchases, there does not appear to be any reason why the taxpayer should not be permitted to make all of his UBIA and QBI computations using two or more short taxable years or periods, taking into account the income and the UBIA for such shorter periods, using the UBIA of property held at the end of the period. In addition, more flexibility (perhaps the ability to use "any reasonable method") should be permitted to allocate wages. In particular, a special rule might address the treatment of wages for short period returns with recapture income.

Separation of Qualifying and Non-Qualifying Activities

We recommend that the final regulations provide rules to help taxpayers ascertain when multiple activities (including multiple activities conducted in a single entity) constitute discrete trades or businesses.[5] This may be important, for example, when a single entity involves an activity that would be an SSTB (not qualifying for the proposed *de minimis* test, say, because its revenues constitute

[5] Section 162 primarily serves to help determine whether a trade or business exists, but does little to distinguish between different trades and businesses. The Proposed Regulations provide almost no guidance on how to separate one qualifying trade or business from another.

more than 10% of the entity's revenues) and another activity that would not be an SSTB. As long as the books and records of the entity readily indicate the separately determinable net income of each activity (including any necessary allocations of shared items with any necessary supporting documentation), and indicate the taxpayer's intention to treat them as distinct businesses for purposes of section 199A, that should be sufficient to ensure that the QBI of the non-SSTB business qualifies for section 199A but the income of the SSTB business does not so qualify.

This result is implied by the example given of the application of the "incidental" SSTB test, where a dermatology business and a cosmetics sale business with shared expenses are *not* treated as distinct businesses *because* the cosmetics business does not constitute more than 5% of the combined business, by revenues. The implication is that if the cosmetics business was responsible for more than 5% of the total revenues, it could be considered to be a separate trade or business. In such a case, we are suggesting that it be clarified that if the books and records readily show the separately determined tax items and qualified business income of the two businesses, with allocations of shared items and any necessary supporting documentation in the files therefor, and the taxpayer's intention to treat them as distinct businesses for purposes of section 199A, they should be so treated. In effect, this would satisfy the purposes of the traditional requirement of separate books and records even if they happen to be in a single physical "book." In our industry the issue might arise with a partnership conducting both investment management services and construction or development activities.

We note that Treas. Prop. Reg. § 1.199A-3(b)(5) provides that where a taxpayer conducts multiple trades or businesses, the taxpayer must allocate any items that are attributable to more than one trade or business in a reasonable manner that is consistent with the purposes of Section 199A. In response to Treasury's request for comments on reasonable methods, the regulations under Section 199 are instructive and provide guidance for taxpayers to allocate both receipts and expenses among qualifying and non-qualifying activities using reasonable methods (without requiring distinct books and records for the activities).

Additional Issues

In the event that some or all of these proposed simplifications are not adopted, we have outlined below some technical issues, under the existing proposed regulations, that would warrant further review and possible revision. In the case of the aggregation rules, these include: examples to demonstrate when real estate activities constitute the same product or service; specific attribution rules that treat owners of entities as owning a pro rata share of any business owned by that entity; and clarification that a parent partnership can aggregate its activities with lower-tier partnerships and joint ventures; as well the application of specific attribution rules to trusts and their beneficiaries.

Aggregation Clarifications. If the final regulations do not permit general aggregation of activities at the partner level, or aggregation of similar activities conducted in multiple entities, then we respectfully request that Treasury provide additional clarity with respect to the proposed aggregation regime.

The Proposed Regulations provide a series of requirements that must be satisfied in order to aggregate separate trades or businesses. The Proposed Regulations also contain a number of examples illustrating the application of these requirements. The application of the "two of three" factors (which

reference "products and services")[6] are not easily applied in the context of many real estate scenarios, and none of the examples are informative as to the application of the factors with regard to real estate trades or businesses.

Among the common scenarios producing uncertain results in the Proposed Regulations are the following:

1. Real estate fund holds rental office building investments in California and New York. California property is designed for open work-space technology oriented environment while New York property is designed in a more traditional manner to cater to the financial services industry. Back office services and policy decision-making is common to the two properties, but direct operational management has no overlap.

2. Real estate fund holds a residential apartment building in Texas and residential condominium building in Georgia. Back office services and policy decision-making is common to the two properties, but direct operational management has no overlap.

3. Real estate fund holds a residential condominium building in Colorado and rental office building in Massachusetts. Back office services and policy decision-making is common to the two properties, but direct operational management has no overlap.

In the scenarios described above, the determination as to whether the different types of real estate projects represent the same "product or service" is unclear. Is the building type (e.g., office, industrial, residential, etc.) determinative, or is it necessary to go deeper and analyze market that the property is targeted towards? For properties that are of the same building type, is it necessary to go further and analyze whether the properties are held for rental or sale? Finally, for properties that are different building types, is it relevant that these properties are held for rental or sale?

In the interest of simplicity, administrability, and avoiding unnecessary disputes, if the current aggregation regime is retained, we recommend that all real estate activities be treated as the same product and service for purposes of the Treas. Reg. § 1.199A-4(b)((1)(v)(A) .

Alternatively, in order to accommodate analysis of these and other scenarios, it would be helpful provide examples illustrating how real estate may be analyzed as a "product or service," taking the questions posed above into account. In developing the analysis to be illustrated in the examples, it will be important to consider the fluid nature of real estate investment decision-making and the benefits of encouraging such behavior. For example, during the economic downturn in the 2008-2009 period, it was common for properties that were developed as residential condominiums to be operated for a substantial period as rental apartments until the market for condominiums recovered. Markets recovered at different times across the country, so an investment group that intended to develop and sell condominiums, in order to maximize the return for investors (and reduce risk of foreclosure), may have held projects across the country that were operated either as condominiums or apartments. Similarly, many real estate groups have investment expertise across a broad variety of property types, and investors place their money with these parties because they are nimble and able to react to market changes that make certain property types more attractive at a given time. It

[6] Prop. Treas. Reg. § 1.199A-4(b)(5)(v).

would be counterproductive for tax rules to narrowly define product types within the real estate industry, thereby discouraging such efficient behavior.

Entity Attribution Rules. Apart from the subjective standards set forth in the "two of three" test, one of the requirements under the aggregation rules in the Proposed Regulations is that "[t]he same group of persons, directly or indirectly, owns 50% or more of each trade or business to be aggregated . . . ."[7] The Proposed Regulations further provide for certain family attribution.[8] Treasury should modify the Proposed Regulations to clarify that owners who hold an interest in a business through another entity will be treated as owners for purposes of the aggregation rules.

For example, assume that two real estate businesses are owned by Individual A and Corporation B. Individual A directly owns 40%. Corporation B owns 60% indirectly with each business held through corporations C and D. Therefore, one real estate business is held by A (40%) and C (60%) and the other is held by A (40%) and D (60%). This would not appear to be sufficient to conclude that the same group of persons own 50% of each real estate business as the only common owner is A, and A does not own 50% of either real estate business.

The two real estate businesses would only be treated as having 50% common ownership if the interests held by C and D were both treated as held by B.

While the Proposed Regulations do provide that persons may hold the business "indirectly" for purposes of determining ownership, this phrase, without explicit rules allowing attribution to owners of an entity, may refer to people that may have beneficial ownership, but not legal ownership.[9] It does necessarily refer to people that own interests through other entities.

For example, section 318(a)(2) provides that stock held "directly or indirectly" by a partnership shall be considered as owned proportionately by its partners. However, it seems that the term "indirectly" in that context was not intended to provide that all stock held through tiers of subsidiary entities would be attributed to partners unless another provision in section 318 first attributed the stock to the partnership.

To illustrate the concern, assume that Individual A owns 50% of Partnership P and Partnership P owns 10% of Corporation C. The assets of Corporation C are not attributed up to Partnership P under section 318 as section 318(a)(2)(C) provides that assets of a corporation are attributed to its shareholders when the shareholder owns 50% or more in the value of the REIT stock. Section 318 does not apply in a manner in which Individual A is treated as owning an interest in the assets of Corporation C merely because Individual A owns an interest in Partnership P when Partnership P owns a less than 50% interest in Corporation C.

In light of this, we recommend providing specific attribution rules that treat owners of entities as owning a pro rata share of any business owned by that entity. Although this could be accomplished in a variety of ways, one possibility would be to incorporate the attribution rules in section 267(c)(1)

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[7] Prop. Treas. Reg. § 1.199A-4(b)(1).

[8] Prop. Treas. Reg. § 1.199A-4(b)(3).

[9] Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 9.02(1) (WG&L).

and (c)(5) for purposes of determining which persons own a business for purposes of the aggregation rules.

Apart from the standards for determining permissible aggregation, the Proposed Regulations appear to provide that only "individuals" can aggregate trades or businesses conducted in different entities. Treasury should modify the Proposed Regulations to clarify that a partnership can aggregate the activities of a parent partnership with sub-tier partnerships and joint ventures as part of its overall rental real estate trade or business. This change would greatly simplify taxpayer reporting requirements and provide taxpayers with more flexibility in the structuring of their business activities. While individual partners can elect to aggregate activities from multiple entities, it would be much simpler and less confusing for partners of commonly controlled partnerships if the partnership could aggregate its single trade or business activities and provide one disclosure to partners, rather than numerous disclosures.

Aggregation Rules and Trusts. A significant gap in the rules applicable to nongrantor trusts exists in the application of the aggregation provisions of the Proposed Regulations. There are no entity attribution rules in the Proposed Regulations; ownership flows through "relevant passthrough entities" (RPEs).[10] The last sentence of Proposed Treas. Reg. § 1.199A-6(d)(1) provides: "For purposes of this section and §§ 1.199A-1 through 1.199A-5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items." In turn, in the context of nongrantor trusts, Proposed Treas. Reg. § 1.199A-6(d)(3)(ii) provides that the relevant section 199A items of a trust are allocated to each beneficiary and to the trust based on the relative proportion of the trust's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust.

Presumably, the aggregation rules are meant to be applied by the beneficiaries of a nongrantor trust being treated as owning the portion of the entity interests owned (directly or indirectly) by the trust measured by the proportion of the trust's DNI distributed to its beneficiaries. Thus, if a trust owns a 50% partnership interest and has a father and son as its sole beneficiaries, and 60% of the trust's DNI is distributed to the father and 40% to the son, the father would be treated as owning 30% of the partnership interest and the son would be treated as owning 20% of the partnership interest for purposes of applying the aggregation rules. If this is the intended result, the appropriate explicit provisions should be added to the Proposed Regulations.

A related issue is that without an aggregation rule that attributes entity interests held (directly or indirectly) by a trust to its beneficiaries even if no DNI is distributed in a given taxable year, the beneficiaries of a trust might satisfy the 50%-or-more threshold test for aggregation in one year because the trust distributed its DNI, but not in the next year because the trust did not distribute its DNI. This is an unfair result, particularly in situations in which all or substantially all of the interests in the trust may be owned by family members who would be covered by the family attribution rule contained in Proposed Treas. Reg. § 1.199A-4(b)(3). In other words, most of the difficulties associated with determining to which beneficiaries the ownership interests held by a trust should be attributed will be made moot because of the family attribution rules. Thus, concern over difficulties applying the attribution rules should not prevent the regulations from including an explicit rule attributing

[10] *See* Proposed Treas. Reg. § 1.199A-4(b)(2).

ownership of entity interests from a trust to its beneficiaries for purposes of the aggregation rules without regard to the distribution of DNI by the trust, at least in situations in which the family attribution rules (or the terms of the trust) substantially eliminate these difficulties.

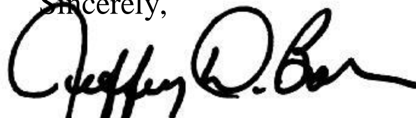
Qualified REIT Dividends. Finally, we request that the final regulations, or other guidance, confirm that the section 199A deduction applies to shareholders invested in REITs through a mutual fund. Section 199A(f)(4) provides the Secretary with the authority to "prescribe such regulations as are necessary to carry out the purposes of this section . . . ., including regulations ... for the application of this section in the case of 'tiered entities.'" The term "tiered entities" is not defined in the statute. In previously issued regulatory guidance, the Treasury Department has used the term to describe tiers of entities including RICs, REITs, and partnerships.[11]

There is no policy rationale for treating investors—particularly the low- and moderate-income investors who hold REIT shares through mutual funds—differently than investors who hold REIT stocks directly. The Roundtable requests that Department of the Treasury exercise its authority under sections 199A(f)(4) and 7805 to provide guidance confirming that shareholders of REITs through mutual funds are eligible for section 199A's 20% deduction. We strongly believe that the general authority provided to the Secretary under section 199A(f)(4) "to carry out the purposes of this section" permits regulations to allow all REIT shareholders (direct and indirect) to obtain the 20% deduction attributable to REIT shareholders as Congress intended.

* * *

The Real Estate Roundtable looks forward to working with you as you consider the many issues arising in the implementation of section 199A. Please do not hesitate to contact me or Ryan McCormick, Real Estate Roundtable Senior Vice President and Counsel, at (202) 639-8400 with any questions or requests for additional information.

Sincerely,



Jeffrey D. DeBoer
President and Chief Executive Officer

[11] Treas. Reg. § 1.362-3(d)(5)(C); see also Treas. Reg. § 1.7704-1(a)(2)(iii).