| asset management group

October 1, 2018

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

Re: REG-107892-18–Comments on the Proposed Regulations Concerning the Deduction for Qualified Business Income under Section 199A of the Internal Revenue Code.

Dear Sir or Madam:

The Securities Industry and Financial Markets Association Asset Management Group ("SIFMA AMG") is pleased to submit comments on the proposed regulations concerning the deduction for qualified business income under section 199A of the Internal Revenue Code (the "Proposed Regulations").[1]

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $39 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of

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[1] Unless otherwise indicated, all "section", or "subchapter" references are to the Internal Revenue Code of 1986, as amended (the "Code"). All references to the "IRS" are to the Internal Revenue Service and references to "Treasury" are to the U.S. Department of the Treasury.

individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.[2]

SIFMA AMG seeks clarification with regard to the definition in the Proposed Regulations of "investing and investment management" and the application of this definition to financial firms, the business of which involves to a significant degree the investment of capital in the research, development, and sale of investment products. These firms are readily distinguishable from investment advisory firms, the income of which is principally attributable to personal services involving the provision of investment advice.

I. Summary of Recommendations

The definition of a trade or business that involves the "performance of services that consist of investing and investment management" should be limited to investment management and investment advisory businesses the income of which is principally attributable to the performance of personal services involving the provision of investment advice or the regular and contemporaneous management of investors' assets by individual employees or owners of the business. This definition should exclude a large, diversified asset manager that invests significant capital in and derives significant income from the research, development, and sale of investment products.

II. The SSTB Limitation

In general, Section 199A permits a taxpayer other than corporation to deduct 20 percent of its combined qualified business income. Qualified business income generally is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.[3] A "qualified trade or business" of the taxpayer means any

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[2] For more information, visit http://www.sifma.org/amg.

[3] Section 199A(c)(1).

trade or business other than a specified services trade or business (an "SSTB") or the trade or business of performing services as an employee.[4]

Section 199A(d)(2) defines an SSTB as any trade or business:

> (A) which is described in section 1202(e)(3)(A) (applied without regard to the words "engineering, architecture,")[5] or which would be so described if the term "employees or owners" were substituted for "employees" therein, or
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> (B) which 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)).

Of particular relevance to SIFMA AMG members is the definition of "investing and investment management." Under the Proposed Regulations, some additional guidance is provided with regard to this definition. Prop. Reg. § 1.199A-4 provides that "the performance of services that consist of investing and investment management" refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments."

Under the Proposed Regulations, to the extent that any trade or business has more than *de minimis* gross receipts attributable to an SSTB, the entire trade or business is treated as an SSTB (referred to herein as the "SSTB *De Minimis* Rule").[6] Thus, in the case of a trade or

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[4] Section 199A(d)(1).

[5] Section 1202(e)(3)(A) provides that for purposes of section 1202 a qualified trade or business excludes "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees."

[6] *See* Prop. Reg. § 1.199A-5(c)(1).

business with gross receipts greater than $25 million, the entire business is an SSTB if more than five percent of such gross receipts are attributable to an SSTB.[7]

In addition, if a business that has 50 percent or more common ownership with an SSTB provides 80 percent or more of its property or services to such SSTB, then such business is classified as an SSTB (referred to herein as the "SSTB Related-Party Charge Rule").[8] Finally, if a business has 50 percent or more common ownership with an SSTB and has shared expenses with the SSTB, including shared wage or overhead expenses, then such trade or business is treated as incidental to and, therefore, part of the SSTB unless the gross receipts of the otherwise qualifying trade or business are more than five percent of the total combined gross receipts of the business and the SSTB (referred to herein as the "SSTB Incidental Rule").[9]

A. Policy Background to Section 199A

Section 199A is the result of a series of legislative compromises intended to ensure that passthrough entities would share in the benefits of tax reform. In 2017, prior to the enactment of the tax reform bill (referred to here as the Tax Cuts and Jobs Act or "TCJA"), many passthrough entities enjoyed a tax rate advantage over corporations taxed under Subchapter C of the Code ("C corporations"). In the case of a C corporation, income of the corporation was taxed at 35 percent and dividends generally were taxed at a top rate of 23.8 percent. Thus, in the case of an individual stockholder in the highest marginal rate bracket, income earned by a corporation and paid out in the same year as a dividend was taxed at an effective rate of 50.47 percent.[10] In the case of a passthrough entity, the top rate on an owner's share of income was

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7 See id.

8 *See* Prop. Reg. § 1.199A-5(c)(2).

9 *See* Prop. Reg. § 1.199A-5(c)(3).

10 This calculation begins with corporate taxable income and does not take into account: state or foreign tax; the benefits of deferral; the Pease limitation; or graduated rate brackets, and it assumes that the dividends paid are qualified dividends. For example, if, prior to 2018, a

equal to the top marginal rate on individual income—40.5 percent, including the Medicare payroll tax. TCJA reduced the nominal rate advantage enjoyed by passthrough entities and their equity investors when it reduced the corporate rate.

In order to ensure that owners of certain businesses organized as passthrough entities would share in the benefits of tax reform, the House tax reform bill (H.R. 1), and the so-called "United Framework" on which it was based, offered a permanent rate cut (to 25 percent) for business income of individuals attributable to capital.[11] Thus, passive investors in passthrough entities generally were entitled to the lower rate. Active owners, except to the extent they owned "capital-intensive" businesses generally did not get a benefit under the House bill. Owners of capital-intensive businesses were entitled to a partial benefit. A further limitation was imposed on active owners of "specified service activities," which included the businesses enumerated in section 1202(e)(3)(A) along with "investing, trading, or dealing" in securities, partnership interests, or commodities. This limitation is consistent with the United Framework, which "contemplates that the committees will adopt measures to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate."[12]

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corporation had $100 of taxable income $35 would be due in corporate tax, leaving $65 that could be distributed to shareholders. The individual shareholder would be required to pay $13 in capital gains tax (20%) and $2.47 Medicare tax (3.8%). The sum of these amounts is $50.47.

11 The *United Framework for Fixing our Broken Tax Code*, was a short policy document, that set out the plans of the Trump Administration, the House Committee on Ways and Means, and the Senate Finance Committee to "achieve pro-American, fiscally-responsible tax reform." *United Framework for Fixing Our Broken Tax Code*, Sept. 27, 2018, p. 3, available at https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf (hereinafter, the "United Framework").

12 *United Framework*, p.7.

The Senate, which passed its version of the legislation under the tighter revenue constraints imposed by the budget reconciliation rules, offered a proposal for a temporary deduction with a significantly lower revenue cost. In drafting its provision (new section 199A) the Senate reached back to a bill originally drafted in 2012 by then House Majority Leader Eric Cantor (H.R. 9). Cantor's bill was a targeted tax cut for small businesses that generally applied only to businesses with fewer than 500 full-time equivalent employees. Nevertheless, the basic design of the Cantor bill (a 20 percent rate cut that borrowed the W-2 wage limitation from section 199) served as the foundation for the Senate TCJA proposal.

Unlike the House provision, the Senate passthrough provision allowed all business owners (not just passive owners), to claim the full benefit of the deduction, while at the same time imposing two significant limitations intended to prevent highly compensated, skilled professionals, such as doctors, lawyers, lobbyists, and consultants, from claiming a benefit with respect to income from their own labor. First, the Senate generally only made the deduction available to businesses that had either a significant W-2 wage base or significant depreciable assets, thus limiting the ability of business owners to claim a benefit for income generated primarily by the labor of owners. Second, the Senate limited the availability of the benefit to businesses involving the provision of certain kinds of services (i.e., SSTBs).

In general, the businesses listed in section 1202(e)(3)((A) are businesses that traditionally have been conducted in flow-through form and much of whose income is attributable to the labor of their owners (e.g., medicine, law, accounting, actuarial science, consulting). Such businesses generally do not compete with C corporations and thus typically are not put at a competitive disadvantage by reductions to the corporate tax rate. Clear examples are provided by law and accounting firms—businesses for which capital typically is not a material income producing factor, that often charge for their labor by billing their clients on an hourly basis for the services they perform, and that are almost always conducted by sole proprietors or through passthrough entities.

We are aware of no explicit explanation for the provision in section 199A(d)(2)(B) denying the benefit of the passthrough deduction to a business "which involves the performance of services that consist of investing and investment management, trading, or dealing in securities . . . ,

partnership interests, or commodities." However, based on the apparent rationale for the treatment of the professional services enumerated in section 199(d)(2)(A) (by means of the cross-reference with section 1202(e)(3)(A), the most plausible explanation is that the list in (d)(2)(B) simply is intended to address additional professions that frequently share common characteristics with those enumerated in (d)(2)(A).

B. Principles for Clarifying the Definition of SSTBs

In writing regulations to clarify the definitions regarding the types of businesses that should or should not qualify for the section 199A deduction, Treasury ought to look to the underlying economic rationale for the inclusion of any business on the lists in section 199A(d)(2) rather than attempting to make *ad hoc*, business-by-business determinations based on generic labels (such as "asset management") that can be used to describe many different types of businesses. One model for such a rule is found in the regulations under section 1348, which until its repeal in 1981, provided a maximum tax rate on "earned income." Pursuant to regulations under section 1348, earned income generally included the fees received by taxpayers "engaged in a professional occupation, such as a doctor, lawyer, architect, or accountant."[13] (To be clear, in section 199A something like "earned income" of highly compensated individuals is what the drafters were trying to define and exclude from the benefit of the 20 percent deduction). Under the section 1348 regulations, earned income did not include income from a business in which "capital is a material income producing factor." For purposes of identifying these businesses, Treasury took a hybrid approach, enumerating certain professions for which capital typically is not a material income producing factor and also identifying a common thread in their economic model as the source of a rule:

> Whether capital is a material income-producing factor must be determined by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital

[13] Treas. Reg. § 1.1348-3(a)(3).

> in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment. In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual. Thus, the practice of his profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice.[14]

Revenue Ruling 78-306 addressed the application of section 1348 and the regulations thereunder to a partnership engaged in underwriting, investment counseling, investment banking, financial services and brokerage activities.[15] The IRS held that capital was a material income producing factor in the partnership's business, because the partnership employed "substantial amounts of capital to finance its brokerage, underwriting and investment activities, in addition to the amounts necessary to meet the capital requirements of the New York Stock Exchange." In contrast, capital was not a material income producing factor in the business of the investment firm described in *George E. Barnes*,[16] which "did no underwriting, carried no inventories of securities, and made no investments for its own account." Customers patronized the firm described in *Barnes* "in order to avail themselves of the firm's professional skills."[17]

An approach similar to that taken for purposes of section 1348 (to distinguish between professional services business for which capital is merely incidental and businesses for which

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14 Treas. Reg. § 1.1348-3(a)(3)(ii).

15 1978-2 C.B. 218. *See also*, GCM 37387, Jan. 19, 1978.

16 T.C. Memo 1987-544 (1987).

17 *Id.*

capital is material) is warranted with respect to understanding and interpreting the SSTB limitation under section 199A. The enumerated professions in section 199(d)(2)(A) can be understood as a list of professions that typically earn income principally from fees for personal services and for which capital is merely incidental. At the same time, there needs to be an acknowledgement of the fact that a particular label, e.g., "investing and investment management" does not mean the same thing in all cases, and that certain businesses that may relate to investing and investment management should qualify for the benefit of the 20 percent deduction. All firms referred to traditionally as "investment managers" are not created equal—some are professional services firms for which capital is merely incidental, but others are firms that invest material capital to research, develop, test, and sell products and strategies.

Clearly there are investment firms comprised of advisors, brokers, and fund managers whose income is derived principally from the provision of personal services to investors and whose capital investments are "only incidental" to the professional services they provide. However, this model does not describe the business and operations of certain large, diversified asset managers. The business models of these asset managers look very different from those of a professional services firm. Moreover, the competitors of these large, diversified asset managers are often large C corporations that benefitted from the corporate rate cut in TCJA.

III. Business and Operations of Large Diversified Asset Managers

The following factors distinguish certain large, diversified asset management firms that have material capital at risk from those firms that earn their income primarily from the performance of personal services.

- Capital at risk is a material income producing factor. Certain large, diversified asset management firms generally require "seed" or testing capital from their owners to facilitate the research, development, and testing of investment products and strategies. Such capital investments are not merely incidental to a service offering; instead, they are critical to testing, developing, and producing products (as opposed to advice) for investors.

- The employees and owners of these large, diversified asset management firms devote significant time to research, develop, and market investment products, such as investment strategies, investment allocation strategies, quantitative models, mutual funds, and private funds.
- The investments of these large, diversified asset managers in research and technology are focused on product development and not on facilitating the provision of advice to or managing the assets of retail clients or investors.
- Large, diversified asset managers that are passthroughs, typically compete against large C corporations (not small retail investment advisors). Moreover, unlike small retail investment advisors, these large, diversified asset managers serve a different customer base, and often sell their products to institutional and other large, sophisticated consumers of investment products.

In many ways, the business models of certain large, diversified asset managers more closely resemble those of manufacturers, such as auto makers, than those of professional service partnerships. An auto maker, for example, risks its owners' capital to research, develop and produce new products to market—and hopefully sell—to customers. Although significant labor, provided by the auto maker's employees, is involved in the activities undertaken to research and develop new cars, the manufacturer ultimately is selling a product and not a service. The equity owners of the auto maker only realize a profitable return on their investment if and to the extent cars are sold in sufficient quantity and at a sufficient price. In contrast, for a professional services firm, labor is the product, and capital investments (in office equipment, real estate, etc.) are made to facilitate the provision of services and are only incidental to such services. A significant portion of the cost of labor in such firms is recovered directly from clients, as time is billed to them. Certain large, diversified asset managers are more closely analogous to manufacturers. Owners' capital is put at risk to research, develop, and test new product offerings, such as a mutual fund, strategy, or algorithm. Like an auto maker, these large, diversified asset managers have employees who work to research, test, and develop products, before the products are sold—hopefully—to customers (investors). The cost of such employees' wages and other risk capital is recovered only if and when the products are sold.

IV. Proposed Changes

The final regulations under Section 199A should clarify that the definition of a trade or business that involves the "performance of services that consist of investing and investment management" is limited to investment management and investment advisory businesses the income of which is principally attributable to the performance of personal services involving the provision of investment advice or the contemporaneous management of assets by fund managers.

Such clarification could be provided in the form of a rule that narrowly and appropriately defines the "performance of services that consist of investing and investment management." Alternatively or additionally, Treasury could provide a safe harbor for firms that meet all or most of the criteria set forth in section III of this letter. Additional guidance should be provided to modify the SSTB *De Minimis* and Incidental Rules if necessary to effectuate such safe harbor.[18]

Ultimately, what is at stake for the large, diversified asset managers described in this letter is the ability to continue to operate as partnerships. Absent some relief in the form of the section 199A deduction, it may become impossible for them to remain competitive with firms organized as C corporations. As discussed in section II.A. of this letter, part of section 199A's purpose was to avoid upsetting the competitive balance that existed between certain passthroughs and C corporations prior to the passage of TCJA. In general, these large, diversified asset managers

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[18] For example, Treasury could adopt a rule for investing an investment management services that are ancillary to the sale of investment products that is similar to the rule provided for ancillary consulting services in Prop. Reg. § 1.199A-5(b)(2)(vii). Under the rule in the Proposed Regulations, consulting services ancillary to the sale of goods are not treated as the provision of consulting services if there is no separate payment for the consulting services. As explained in the preamble to the Proposed Regulations, the special rule adopted due to the fact that the *De Minimis* Rule may not provide sufficient relief in all cases.

that are partnerships would prefer to remain partnerships because the shared sense of ownership and responsibility that comes from being a partnership is critical to their business culture. This culture and incentive structure is important to the owners as well as their clients. Section 199A was passed for the purpose of helping businesses in this position due to anticipated changes to incentives caused by corporate tax reform, and its provisions should be interpreted in a manner consistent with this intent.

If you have any questions please do not hesitate to contact Lindsey Keljo (lkeljo@sifma.org) or Payson Peabody (ppeabody@sifma.org), both reached at (202) 962-7300.

Sincerely,

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