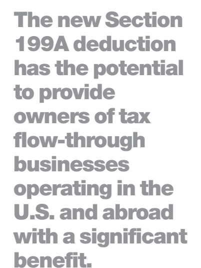
APPLICATION OF SECTION 199A TO DOMESTIC TAXPAYERS ENGAGED IN U.S. AND FOREIGN BUSINESS OPERATIONS



The new Section 199A deduction has the potential to provide owners of tax flow-through businesses operating in the U.S. and abroad with a significant benefit.

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Among the litany of new provisions included in the recent tax reform legislation, generally known as the Tax Cuts and Jobs Act (the "TCJA"),[1] Congress enacted the Section 199A "pass-through" deduction for businesses, benefitting individual sole proprietors and owners of tax flow-through entities.[2] At a high level, Section 199A provides eligible owners with a 20% deduction attributable to certain income generated by the business, termed "qualified business income." To be "qualified business income," potentially eligible income must be considered, among other things, "effectively connected with the conduct of a trade or business within the United States." Eligible businesses and owners engaged in an active business located wholly inside the U.S. should be able to satisfy this standard without much thought.

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For many individual-owned U.S. businesses structured as sole proprietorships or tax flow-through entities that are eligible for the new qualified business income ("QBI") deduction, however, U.S. business earnings potentially subject to QBI benefits may only comprise part of their business operations. As even small businesses' ability to deploy capital and operate outside of the U.S. has exponentially expanded over the past decades, privately held tax flow-through businesses have increasingly conducted foreign operations, whether directly or through a foreign branch or affiliate treated as fiscally transparent for U.S. tax purposes. For these entities and their owners potentially eligible for the Section 199A deduction with respect to their U.S. operations, the existing income and deduction sourcing rules previously only relevant for foreign tax credit computation and limitation purposes take on added significance. These rules will now also determine what income and deductions will be treated as

"effectively connected with the conduct of a trade or business within the United States" to be taken into account as QBI.

This article reviews the Section 199A deduction rules set forth in the statute[3] and considers how they interact with the current rules for domestic businesses that also conduct international operations.

The Section 199A Deduction

Section 199A provides a taxpayer other than a corporation with a deduction for 20% of its QBI from partnerships, S corporations, and sole proprietorships, as well as 20% of its aggregate qualified real estate investment trust ("REIT") dividends, qualified cooperative dividends, and qualified publicly traded partnership income, subject to certain limitations.[4] The deduction is available for tax years beginning after December 31, 2017, and terminates for tax years beginning after December 31, 2025.[5] A taxpayer may claim the QBI deduction regardless of whether he or she itemizes deductions or takes the standard deduction for the tax year.[6] The deduction reduces a taxpayer's taxable income, but it does not reduce adjusted gross income and is not taken into account in applying the limitation on itemized deductions.[7]

Taxpayers claiming the Section 199A deduction are subject to a lower threshold to be subject to the Section 6662 substantial understatement of income tax penalty.[8] Specifically, the Section 6662 substantial understatement of income tax penalty, which can be 20% of the unpaid tax, may generally be imposed if the taxes are understated by the greater of 5% of the tax required to be shown on the return or $5,000 if the taxpayer makes a Section 199A deduction. Otherwise, the Section 6662 penalty applies only where taxes are understated by the greater of 10% or $5,000. Due to this lower understatement threshold for the Section 6662 penalty, there may be greater reliance on return preparers by clients taking the Section 199A deduction, as the penalty does not apply if there is reasonable cause and the taxpayer acted in good faith.[9]

For partnership or S corporation businesses, the Section 199A deduction applies at the individual partner or shareholder level.[10] Individuals with ownership interests in one or more partnerships, S corporations, or other tax flow-through businesses may, in any tax year, have income from activities that qualify as QBI, as well as income from other activities that are non-QBI.

[1] P.L. 115-97. The purported policy goal underpinning this new Section 199A deduction is to level the playing field for U.S. businesses operated in a tax flow-through structure as compared to a C corporation structure after the reduction in corporate income tax rates from 35% to 21%.

[2] "Tax flow-through entities," "tax pass-through entities," and similar terms included in this article refer to domestic entities classified as a partnership, disregarded entity, S corporation, or qualified subchapter S subsidiary.

[3] As of the date this article was submitted for publication, it was anticipated that the government would soon issue regulations addressing the application of the Section 199A deduction.

[4] Sections 199A(a), (b)(1)(B). Since the focus of this article is on trades or businesses with QBI, a detailed discussion of the deduction for qualified cooperative dividends, qualified REIT dividends, and qualified publicly traded partnership income is beyond the scope of this article.

[5] P.L. 115-97, § 1101(e); Section 199A(i); H. Conf. Rep't No. 466, 115th Cong., 1st Sess. 214, 224 (2017) (hereinafter referred to as the "Conference Report").

[6] Section 63(d)(3); Conference Report at 224.

[7] Sections 62(a), 63(d).

[8] See Section 6662(d)(1)(C).

[9] See Section 6664(c). Additionally, for purposes of the Section 6662 substantial understatement of income penalty, an "understatement" is reduced to the extent it is attributable to an item for which there was substantial authority for the tax treatment or the relevant facts affecting the treatment are disclosed in or with the tax return and there was a reasonable basis for the treatment. Section 6662(d)(2)(B).

[10] Section 199A(f)(1)(A)(i); Conference Report at 219. Trusts and estates are also eligible for the Section 199A deduction. Section 199A(f)(1)(B).

[11] Qualified REIT dividends include any dividend received from a REIT other than a dividend that is a capital gain dividend (as defined in Section 857(b)(3)) or qualified dividend income (as defined in Section 1(h)(11)). Section 199A(e)(3).

[12] Qualified publicly traded partnership income generally means the sum of (1) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss from a publicly traded partnership (as defined in Section 7704(a)) that is not treated as a corporation, plus (2) any gain recognized by the taxpayer upon disposition of its interest in the publicly traded partnership that is treated as ordinary income. Section 199A(e)(4).

[13] Section 199A(b)(2). As discussed below, if a taxpayer's taxable income is equal to an amount below certain applicable thresholds for the tax year, the deduction is not limited by the W-2 wage limitation.

[14] Conference Report at 223.

[15] Section 199A(c)(2); Conference Report at 214.

[16] Section 199A also permits a deduction for taxpayers with qualified REIT dividends or qualified publicly traded partnership income and for a specified agricultural or horticultural cooperative with "qualified production activities income" or for a patron thereof who receives a "qualified payment" from the cooperative. See Section 199A(g).

[17] Sections 199A(c)(1), (f)(1)(C)(i).

[18] The effectively connected with the conduct of a trade or business within the U.S. standard for Section 199A purposes is determined by substituting "qualified trade or business" for "nonresident alien individual or a foreign corporation" or for a "foreign corporation" each place it appears in Section 864(c).

[19] Section 199A(c)(3)(A). Qualified REIT dividends and qualified publicly traded partnership income are not considered QBI, and, instead, such items are added to a taxpayer's deductible QBI for any tax year with the sum equaling the CQBI of the taxpayer. Sections 199A(b)(1), (c)(1); Conference Report at 224.

[20] Section 199A(c)(4).

[21] Section 199A(c)(3)(B); Conference Report at 215.

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

To determine the Section 199A deduction for QBI in any particular tax year, a taxpayer must navigate a web of interrelated definitions, limitation rules, and cross references to other Code sections. Further, as the calculation is limited by or based on taxable income for the tax year (determined without regard to Section 199A), the amount of the deduction will generally be calculated after taxable income is determined. The following describes the mechanics for determining the QBI deduction by working through the array of definitions provided in Section 199A.

CQBI: As a starting point, Section 199A(a) provides a deduction for any tax year equal to the *lesser* of (1) the taxpayer's combined QBI ("CQBI"), or (2) 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 such tax year. A taxpayer's CQBI equals the sum of the deductible amounts determined for each "qualified trade or business" ("QTB") carried on by the taxpayer, and 20% of the taxpayer's qualified REIT dividends[11] and qualified publicly traded partnership income.[12] The deductible amount for each QTB of the taxpayer is generally equal to the lesser of (1) 20% of the taxpayer's QBI with respect to the QTB, or (2) the "W-2 wage limitation."[13]

Accordingly, the QBI deduction may not exceed the taxpayer's taxable income for the tax year (reduced by net capital gain).[14] A taxpayer unable to deduct positive QBI due to this taxable income limitation is not permitted to carry forward the QBI to make a deduction to offset income in a later tax year in a manner akin to a net operating loss. Instead, the potential benefit of this "unused" QBI is forfeited, as it may never be deducted by the taxpayer. In contrast, if the net amount of QBI from all QTBs of a taxpayer for any tax year is a negative number, such amount is treated as a loss from a QTB in the succeeding tax year, thereby reducing the available deduction in that year.[15]

QBI: A taxpayer must generally have QBI in order to qualify for the Section 199A deduction.[16] For purposes of Section 199A, QBI means the net amount of qualified items of income, gain, deduction, and loss with respect to any QTB of the taxpayer for any tax year.[17] To be considered QBI, a taxable item must be effectively connected with the conduct of a trade or business within the United States or Puerto Rico,[18] as discussed in greater detail below, and included or allowed in determining the taxable income of the taxpayer for the tax year.[19] Therefore, to the extent a taxpayer generates earnings that are not effectively connected with a U.S. trade or business, such earnings will not be eligible for the Section 199A deduction.

Significantly, QBI does not include (1) reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business, (2) any Section 707(c) guaranteed payment made to a partner for services rendered with respect to the trade or business, and (3) to the extent provided in regulations, any Section 707(a) payment by a partnership to a partner acting other than in its capacity as a partner for services with respect to the trade or business.[20] Also excluded from QBI are certain investment-related items of income, gain, deduction, and loss. More specifically, QBI does not include (1) any item taken into account in determining short-term or long-term capital gain or loss; (2) dividends, income equivalent to a dividend, or payments in lieu of dividends (described in Section 954(c)(1)(G)); (3) interest income other than that which is properly allocable to a trade or business; (4) the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business; (5) the excess of foreign currency gains over foreign currency losses attributable to any Section 988 transactions, other than transactions directly related to the business needs of the QTB; (6) net income from notional principal contracts, other than any clearly identified hedging transactions that are not treated as capital assets; and (7) any amount received from an annuity that is not received in connection with a trade or business.[21]

QTB: As mentioned above, only income from a QTB is classified as QBI and potentially eligible for the Section 199A deduction. A QTB is defined as any trade or business other than a "specified service trade or business" ("SSTB"), which, as discussed below, refers to most professional service or investment businesses, or the trade or business of being an employee.[22] In other words, non-wage income from any non-SSTB trade or business constitutes income from a QTB that may potentially qualify as deductible QBI. Accordingly, the ability of a tax-

payer to obtain the benefit of the Section 199A deduction for QBI depends upon both the nature of the trade or business and the taxpayer's role and economic rights relative to the entity carrying on the trade or business.

The term "trade or business" is not defined in Section 199A. Thus, until additional guidance is issued, it is uncertain as to whether certain activities, including rental real estate activities, will rise to the level of a "trade or business" for purposes of Section 199A and the definition of a QTB. The standard for determining the existence of a "trade or business" is most developed in the context of Section 162, which allows deductions for the ordinary and necessary expenses of a trade or business. Generally, for purposes of Section 162, an activity must be conducted "with continuity and regularity" and with the primary purpose of earning profit in order to constitute a trade or business.[23] This fact intensive determination is particularly challenging, for example, in the case of a taxpayer whose only activity is the rental of a single property. The preamble to the Section 1411 regulations regarding the determination of a trade or business for purposes of the net investment income tax sets forth that, in certain situations, the rental of a single property can rise to the level of a trade or business within the meaning of Section 162, provided that the rental activity requires regular and continuous involvement.[24] Absent additional guidance, it is unclear whether a taxpayer renting a single property must satisfy the trade or business standard of Section 162 by having regular and continuous involvement in the rental activity to have a QTB. The anticipated regulations will hopefully provide meaningful guidance regarding the definition of trade or business for this purpose.

Generally, a partner or member of an LLC classified as a partnership for U.S. federal income tax purposes (referred to hereafter as a "partner" and a "partnership") is not treated as an employee of the partnership.[25] As a result, a partner's distributive share of QBI-eligible income of the partnership is potentially eligible to be classified as QBI (provided the income is not a guaranteed payment or paid to the partner other than in its capacity as a partner). In the S corporation context, a shareholder may receive distributions as a shareholder, compensation as an employee, or a combination of both from the S corporation, depending on the shareholder's role and activity with respect to the corporation's operations. Shareholders that perform services for the S corporation, including corporate officers, are generally treated as employees of the corporation. Those employee-shareholders may receive a combination of employment compensation and shareholder distributions from the S corporation.[26] In contrast, shareholders providing only capital to the S corporation and who do not serve as a corporate officer are considered only shareholders and not employees, and, accordingly, receive only shareholder distributions from the corporation.

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[23] *Groetzinger*, 480 U.S. 23 (1987).

[24] TD 9644 (Dec. 2, 2013).

[25] See Rev. Rul. 69-184, 1969-1 CB 256 (partners are not considered employees of a partnership for employment tax and income tax withholding); Temp. Reg. 301.7701-2T; TD 9766 (May 4, 2016) (partners not treated as employees of a disregarded entity owned by a partnership; instead, amounts paid to partners providing services to the disregarded entity are taxed as self-employment income). However, a general partner or partner providing services to the partnership may be treated as self-employed.

[26] See, e.g., *Joseph M. Grey Public Accountant, P.C.*, 119 TC 121 (2002).

[27] Rev. Rul. 59-221, 1959-1 CB 225.

[28] See, e.g., Rev. Rul. 74-44, 1974-1 CB 287 (ruling that the IRS may recharacterize a distribution to a shareholder as wages paid to a shareholder, and as a result, assess whatever FICA and FUTA taxes would have been due).

[29] Section 199A(c)(4)(A).

[30] In addition to the employment taxes and any applicable penalties resulting from the recharacterization of S corporation distributions as compensation, taxpayers claiming the Section 199A deduction are subject to the substantial understatement of income tax penalty if the understatement exceeds the greater of 5% of the tax required to shown on the return or $5,000, as mentioned above. See Section 6662(d)(1)(C).

[31] As another planning alternative, there may be certain circumstances in which a partnership or S corporation reclassifies its employee as an independent contractor since the remuneration paid to an independent contractor may potentially qualify as deductible QBI to the recipient service provider.

[32] For example, as a Schedule K-1 partner in a partnership, the person would now be subject to self-employment tax reporting, estimated tax payment requirements, and requirements to file tax returns in jurisdictions where the partnership files tax returns. The person additionally would no longer be eligible to participate in the partnership's employee benefit programs.

[33] Seemingly, the general prohibition on SSTB income from qualifying for the QBI deduction is intended to prevent highly compensated service providers from avoiding the top personal tax rate. See Unified Framework for Fixing Our Broken Tax Code (Sept. 27, 2017), https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf.

[34] For this purpose, a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (Sections 475(c)(2) and 475(e)(2), respectively). Conference Report at 223.

[35] Presumably, a trade or business involving the architecture and engineering fields are not considered SSTBs regardless of the reputation or skill of one or more of a firm's employees or owners. In the Senate's bill, engineering and architectural services were included in the definition of an SSTB, but the conference agreement and Section 199A as enacted by Congress removed such services from the definition. See Conference Report at 223.

Because S corporation distributions are not subject to payroll taxes,[27] S corporations and their shareholders have historically been inclined to underpay employee-shareholders wages for services they render to the corporation and effectively make up the difference through shareholder distributions. However, the IRS has a long history of challenging S corporations that fail, in the judgment of the IRS, to pay "reasonable compensation" to a shareholder for services rendered by the shareholder to the corporation.[28]

The distinction between employee reasonable compensation and shareholder distributions could have critical significance to many S corporation shareholders in light of the new Section 199A deduction. For an S corporation engaged in a QTB, S corporation income flowing through to a shareholder-employee as reported on a Schedule K-1 may constitute QBI, while Form W-2 compensation is not QBI to the recipient shareholder-employee.[29] This disparate tax treatment may further incentivize an S corporation to classify payments to employee-shareholders as distributions rather than compensation; but, any impact on the S corporation's W-2 wage base must be considered. Given the IRS's long-standing position on S corporation shareholder compensation, however, S corporations should also be cognizant of the general requirement that shareholders providing services to the corporation receive adequate, reasonable compensation commensurate with the scope of such services.[30]

In addition, since a non-owner employee of a partnership or S corporation engaged in a QTB does not enjoy the benefit of the Section 199A deduction with respect to his or her wages, there may be circumstances where the owners of the entity decide to grant an equity interest to the employee so that he or she may obtain the benefit of the deduction.[31] Prior to issuing an equity interest, however, the owners should consider whether the reduction in the W-2 wage base resulting from "converting" an employee to a shareholder or partner diminishes the Section 199A deduction currently enjoyed by the existing owners, or whether the new equity holder would accept any additional economic risk to its payments from the business posed by only receiving distributions not made as reasonable compensation or Section 707 non-partner capacity payments that could potentially constitute QBI. Other considerations, including any additional economic or administrative rights afforded to equity holders under state law and the entity's governance documents, and additional commercial and tax reporting complexities to the entity and the recipient,[32] should also be weighed in making such a determination.

SSTB: An SSTB is excluded from the definition of QTB for purposes of Section 199A.[33] Therefore, unless a taxpayer's taxable income falls below the applicable thresholds described below, income derived from an SSTB does not qualify for the Section 199A deduction.

To determine the Section 199A deduction for qualified business income in any particular tax year, a taxpayer must navigate a web of interrelated definitions, limitation rules, and cross references to other Code sections.

Section 199A(d)(2) defines an SSTB as a trade or business involving the performance of services in the fields of health, law, 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, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[34] Specifically carved out of the SSTB definition are engineering and architecture services.[35] Thus, most professional service trades or businesses are considered SSTBs, and, consequently, the highly compensated owners of such businesses are generally prohibited from taking advantage of the QBI deduction.

The determination of whether a trade or business is considered an SSTB may be challenging for many owners and their tax advisors. This assessment may be particularly difficult where the business annually derives substantial amounts of gross receipts from the reputation or skill of one or more of its employees or owners or where the business performs a variety of services.

For example, if a restaurant garners public acclaim and patronage resulting from the notoriety of its chef-owner who appears on a televised cooking competition, would such owner's reputation and skill be considered the principal asset of the business? How would the IRS value the owner's reputation and skill relative to the other business assets? What if the chef-owner attains celebrity status by author-

ing cookbooks and licensing his or her name to adorn home cooking products? Moreover, consider that a business may provide a diverse spectrum of services, including some that are listed in the definition of an SSTB and others that are not. Would any degree of involvement in an activity listed in the definition of an SSTB taint the entire business, such that it would per se be considered an SSTB? Or would the SSTB determination be based on which activities comprise the business's core operations? These questions, and many more, are left unanswered by the language of Section 199A.[36] Further, there is little in the Conference Report interpreting the definition of an SSTB or revealing Congress's intent as to the scope of the term.[37] Since the term SSTB is defined in part by a cross reference to the definition of a "qualified trade or business" in Section 1202(e)(3)(A) (with certain modifications), the legislative history and interpretations of that Code section theoretically provide additional guidance.[38] However, there are currently few interpretations of Section 1202(e)(3)(A) that aid in this analysis.[39] It is anticipated that the IRS will help fill this void by issuing regulations to address and interpret the definition of SSTBs in various contexts.[40] Until additional and comprehensive guidance is developed, there is considerable uncertainty over whether certain businesses will be considered SSTBs for Section 199A purposes.

Subject to positions taken by the IRS in the forthcoming proposed and then final regulations, certain planning strategies have emerged for owners of businesses conducting (at least in part) an SSTB to more fully benefit from Section 199A. For example, a partnership or S corporation engaged in an SSTB could consider restructuring or organizing its business operations to segregate core professional service personnel and assets from those that are ancillary to such operations, as well as any real property owned by the entity. This would involve the owners of the business transferring ancillary personnel and assets to a separate partnership or S corporation held by the owners with the new ancillary entity providing services and assets to the SSTB in return for a royalty, management, rent, or other services fee from the SSTB entity.[41] This planning strategy, often referred to as "cracking," is designed to facilitate the owners treating the income earned by the ancillary entity as deductible QBI, since such income would no longer be generated by an SSTB. In this way, the owners of an SSTB that would otherwise be prohibited from a QBI deduction could enjoy the benefit of the deduction on a portion of the business enterprise's income.

Another potential QBI planning strategy involves "packing" a non-SSTB with trade or business activities that, if conducted independently, would constitute an SSTB. The purpose of this strategy is to "pack" or combine an entity that generates QBI, such as an architecture or real estate development firm, with activities or assets that would otherwise produce non-QBI, such as legal or investment services. Provided the core trade or business of the packed entity remains the same post-packing, all the income produced by the entity could potentially be treated as QBI. As with "cracking," taxpayers implementing the packing strategy will need to consider how the IRS will treat the income under forthcoming regulations and other guidance.

The W-2 Wage Limitation: As mentioned above, the potentially deductible amount attributable to each QTB of the taxpayer is generally equal to the lesser of (1) 20% of the taxpayer's QBI with respect to the QTB, or (2) the "W-2 wage limitation." The W-2 wage limitation for each QTB is equal to the greater of (1) 50% of the "W-2 wages" with respect to the QTB, or (2) the sum of (a) 25% of the W-2

[36] As with all decisions regarding whether to claim the Section 199A deduction, taxpayers must consider the additional risk posed by the reduced understatement threshold for being subject to a Section 6662 substantial understatement penalty if they do claim the deduction.

[37] See Conference Report at 216, fns. 44, 45 (2017) (mentioning that a similar list of service trades or business is provided in Section 448(d)(2)(A) and Temp. Reg. 1.448–1T(e)(4)(i) regarding the limitation on use of the cash method of accounting). While the Conference Report mentions Section 448 in several footnotes, the text of Section 199A does not actually reference Section 448.

[38] See Section 199A(d)(2)(A). Section 1202 provides a full exclusion of all or a portion of the gain from the sale of certain qualified small business stock in a corporation conducting a qualified trade or business.

[39] The IRS has issued several private letter rulings addressing whether certain businesses operating in the healthcare industry would be considered a qualified trade or business under Section 1202(e)(3)(A). See Ltr. Rul. 201717010; Ltr. Rul. 201436001; see also Mellor, "Gauging the Height of the Specified Service Business Guardrail," Tax Notes (Feb. 5, 2018); Kehl, "The Most Important Deduction in the 2017 Tax Act: § 199A," Real Estate J. (BNA) (Mar. 7, 2018).

[40] As mentioned above, no administrative guidance has been released as of the date this article was submitted for publication.

[41] For example, a medical services practice could transfer all non-medical personnel, including receptionists, administrators, accountants, marketing department employees and billing coordinators, and office equipment, to a new LLC owned by the owners of the medical practice.

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wages with respect to the QTB, plus (b) 2.5% of the unadjusted basis (immediately after acquisition) of all "qualified property."[42] However, if the taxpayer's taxable income is below an applicable threshold amount, the W-2 wage limitation does not apply to limit the taxpayer's QBI deduction, as described below.

W-2 wages are defined as the total wages subject to wage withholding, elective deferrals and deferred compensation paid by the QTB with respect to employment of its employees during the calendar year ending during the tax year of the taxpayer.[43] W-2 wages do not include any amount that is not properly allocable to the QBI as a qualified item of deduction, and any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.[44]

For purposes of the W-2 wage limitation, "qualified property" means, with respect to a QTB, tangible property of a character subject to depreciation under Section 167 (1) that is held by, and available for use in, the QTB at the end of the tax year, (2) that is used in the production of QBI, and (3) for which the "depreciable period" has not ended before the close of the tax year.[45] The "depreciable period" of qualified property is defined as the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (1) the date ten 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)).[46]

Threshold Amounts and Phase-In: Section 199A provides an important exception that allows certain taxpayers with taxable income below stated thresholds to deduct QBI with respect to income that would otherwise be nondeductible under the above rules. In any tax year, if the taxpayer's taxable income falls below certain thresholds, the W-2 wage limitation and the SSTB exclusion do not apply in determining the QBI deduction for the taxpayer.[47] In this regard, a noncorporate owner of a tax flow-through entity whose total taxable income is below the applicable threshold may generally obtain the benefit of the QBI deduction regardless of the amount of wages paid to the business's employees, the amount of depreciable property utilized by the business, or the type of business being operated.

The taxable income threshold amounts in 2018 are $315,000 for joint filers and $157,500 for all other taxpayers (indexed for inflation for future years).[48] In addition, the W-2 wage limitation and the SSTB exclusion are phased in for a taxpayer with taxable income in excess of the applicable threshold amount and are fully phased in for a taxpayer with taxable income in excess of the applicable threshold amount plus $100,000 for joint filers and $50,000 for all other taxpayers.[49] For purposes of Section 199A, including the determination of whether the threshold amount has been exceeded, taxable income generally refers to a taxpayer's taxable income (as defined in Section 63) [50] computed without regard to any QBI deduction taken by the taxpayer. [51] Therefore, for example, a married service provider partner in an SSTB partnership whose distributive share of

[42] Section 199A(b)(2). As discussed below, if a taxpayer's taxable income is below certain applicable thresholds for the tax year, the deduction is not limited by the amount of the QTB's W-2 wages or qualified property.

[43] Section 199A(b)(4); Conference Report at 217.

[44] Sections 199A(b)(4)(B), (C).

[45] Section 199A(b)(6)(A).

[46] Section 199A(b)(6)(B).

[47] Sections 199A(b)(3), (d)(3).

[48] Section 199A(e)(2).

[49] Sections 199A(b)(3)(B), (d)(3)(A)(ii), and (d)(3)(B). Therefore, for tax years beginning in 2018, the W-2 wage limitation and the SSTB exclusion are fully phased in for joint filers with taxable income in excess of $415,000 and for all other taxpayers with taxable income in excess of $207,500.

[50] Section 63(a) defines "taxable income" as gross income minus the deductions allowed by Chapter 1 of the Code (other than the standard deduction).

[51] Section 199A(e)(1).

[52] Section 199A(f)(1)(A)(i); Conference Report at 219.

[53] Section 199A(f)(1)(A)(ii); see also Conference Report at 219-220.

[54] Section 199A(f)(1)(A)(iii).

[55] Section 199A(f)(1) (flush language).

[56] Conference Report at 219-220.

[57] Section 199A(f)(1) (flush language).

[58] Foreign jurisdictions, in determining the extent to which they will tax an activity or investment carried out within their borders, will look to the extent and nature of the activity, as does the U.S. with respect to a foreign person considered engaged in a U.S. trade or business. See Sections 862, 864. If an income tax treaty is in effect between a particular jurisdiction and the U.S., the threshold of the activity that will cause the income derived therefrom to be subject to tax in the foreign jurisdiction generally is determined under the "permanent establishment" article of the treaty. This permanent establishment standard may be different than that which would apply in the absence of a treaty.

[59] The Section 901 foreign tax credit is a dollar-for-dollar credit against U.S. tax for foreign taxes imposed on foreign earnings, while Section 164 only provides a deduction for foreign taxes. The Section 164 deduction for foreign taxes is therefore generally less valuable to taxpayers so that taxpayers typically elect to apply the foreign tax credit provisions. The remainder of this article therefore assumes that taxpayers will elect to apply the foreign tax credit rather than claim a deduction under Section 164.

income from the partnership is around the $415,000 ceiling for complete Section 199A deduction phase-out may still benefit from the deduction once the partner's other deductions used to compute taxable income are taken into account.

Special Partnership and S Corporation Rules: Section 199A contains special rules for allocating and determining QBI among partners of a partnership and shareholders of an S corporation. As previously mentioned, in the case of a partnership or S corporation, Section 199A applies at the partner or shareholder level.[52] Under these special rules, each partner or S corporation shareholder takes into account such person's allocable or pro rata share of each qualified item of income, gain, deduction, and loss in determining QBI.[53]

For purposes of the W-2 wage limitation, each partner or S corporation shareholder is treated as having W-2 wages and an unadjusted basis (immediately after acquisition) of qualified property for the tax year equal to the such person's allocable or pro rata share of the entity's W-2 wages and unadjusted basis (immediately after acquisition) of qualified property for the tax year.[54] A partner's or S corporation shareholder's allocable or pro rata share of W-2 wages is determined in the same manner as the partner's or shareholder's share of wage expenses.[55] For example, in the event a partner is allocated a deductible amount of 20% of wages paid by the partnership to its employees for the tax year, the partner must be allocated 20% of the W-2 wages of the partnership for purposes of calculating the partner's W-2 wage limitation.[56] Similarly, a partner's or shareholder's share of the unadjusted basis (immediately after acquisition) of qualified property is determined in the same manner as such person's allocable or pro rata share of depreciation.[57]

Beyond QBI—Section 199A Deduction for Cross-Border Businesses

As previously mentioned, only taxable items of income, gain, deduction or loss that are effectively connected with the conduct of a trade or business within the United States are eligible to be taken into account in the computation of a taxpayer's QBI eligible for the Section 199A deduction. For businesses organized as a tax flow-through structure operating and selling only in the U.S., this determination should be relatively straightforward, with only the "trade or business" standard and not the "effectively connected trade or business within the United States" standard being relevant. But, what about U.S. businesses organized as tax flow-through structures that operate and/or sell both in the U.S. and abroad? How do these businesses compute their QBI and non-QBI and how are their owners otherwise impacted by the new Section 199A deduction? The following discussion considers these issues.

Foreign Operations—ECI

By way of background, U.S. individuals and domestic corporations are subject to U.S. federal income tax on their worldwide income. While certain earnings of foreign corporations owned by U.S. shareholders may not be subject to immediate U.S. taxation and may even be repatriated to a U.S. corporation shareholder tax-free under the newly enacted participation exemption of Section 245A, the taxable income of a foreign branch or subsidiary that is not treated as a foreign corporation and is owned by a U.S. individual or corporation is subject to immediate tax in the U.S. This means that the income of a foreign branch, a foreign partnership, or a foreign entity treated as a partnership or disregarded entity for U.S. tax purposes but that is subject to tax as a separate entity for foreign tax purposes (a "hybrid" branch[58] or entity) will be immediately includable in its U.S. owners' taxable income. This same immediate taxation result applies for individuals holding their interests in the foreign operations and entities through a U.S. flow-through tax entity, such as a partnership, a disregarded entity, or an S corporation (or its qualified subchapter S subsidiary).

Although a U.S. person's worldwide income is generally subject to U.S. taxation, the Code mitigates the negative double tax impact of foreign taxes imposed on foreign earnings either by way of a deduction under Section 164 or a foreign tax credit under Section 901.[59] For purposes of determining the amount of creditable foreign taxes, the Code distinguishes between the jurisdictional source of a taxpayer's gross income as well as the activity generating such income. Similar rules also apply to determine the amount of losses and deductions attributable to gross income generated from a particular source and activity.

These sourcing and activity grouping rules for income and gain and associated losses and deductions are critical for computing the amount of U.S. tax imposed on a person's

worldwide income. As further discussed below, Section 904 generally prevents or limits credits and deductions arising with respect to income from sources without the United States ("foreign-source income") from reducing a taxpayer's U.S. tax liability attributable to income from sources within the United States ("U.S.-source income"). And, now, only income effectively connected with a U.S. trade or business ("ECI") is eligible for the QBI deduction.[60] Section 199A(c)(3)(A)(i) cross-references the general Section 864(c) ECI definition that applies for nonresident aliens and foreign corporations to be subject to U.S. taxation on net income at graduated tax rates that would generally apply if such foreign person was a U.S. person.

For income to be ECI, the income-generating person must be engaged in a "U.S. trade or business" and the income must be "effectively connected" with such U.S. trade or business. Whether or not a foreign person conducts a U.S. trade or business is a factual determination under the relevant common law and administrative guidance standards.[61] The income of a foreign person that is effectively connected with a U.S. trade or business generally consists of such foreign person's U.S.-source income, and not such foreign person's foreign-source income.[62]

For U.S. businesses operated by a legal entity organized under U.S. law, testing for ECI under Section 199A should be more straightforward than testing for a foreign person's ECI.[63] The U.S. entity's eligible trade or business will certainly constitute a U.S. trade or business. Therefore, the only issue becomes whether the entity's income is U.S.-source or foreign-source. In other words, distinguishing between ECI and non-ECI for purposes of determining QBI will depend solely on the source of the income. The associated rules for allocating deductions and losses between U.S. and foreign-source gross income will also be critical, especially for deductions and losses considered attributable to both U.S. and foreign operations.

Sections 861 through 865 and associated regulations set forth the rules for allocating income, gains, losses, and deductions between U.S. sources and foreign sources. The following provides a summary of some of the important sourcing rules applying to the business-related income of U.S. persons.

Income from personal services is generally sourced in accordance with where the services are being performed.[64] If personal services are provided both inside the U.S. and abroad, the allocation of the associated income between U.S. and foreign sources is generally determined under a location-per-day methodology.[65] Interest income is generally sourced based on the tax residence of the debtor.[66] Rental income is sourced based on the location of the subject property, while royalty income is sourced based on the jurisdiction in which the underlying intangibles are being used by the licensee.[67] The source of gain from the sale of real property is based on the location of the property.[68]

[60] As previously mentioned, the Section 199A deduction also pertains to income from sources within the Commonwealth of Puerto Rico, although a discussion of Puerto Rico-sourced QBI is beyond the scope of this article.

[61] See Isenbergh, 900-2nd T.M., (Bloomberg BNA), *Foundations of U.S. International Taxation* ¶ II.C.

[62] Section 864(c). Additionally, foreign-source income and gain of a foreign person attributable to an office or other fixed place of business in the U.S. generally constitutes ECI. See Sections 864(c)(4)(B), 865(e)(2) (for sale of personal property, including inventory).

[63] Although beyond the scope of this article, it may be possible, given the text of the statute, that the Section 199A deduction could apply to the ECI of a nonresident individual, including that received through a partnership.

[64] Sections 861(a)(3), 862(a)(3).

[65] Reg. 1.861-4.

[66] Sections 861(a)(1), 862(a)(1).

[67] Sections 861(a)(4), 862(a)(4).

[68] Sections 861(a)(5), 862(a)(5).

[69] Section 865(a). Gain from the sale of personal property by a partnership subject to this general sourcing rule is sourced based on the residence of its partners. Section 865(i)(5).

[70] Section 865(e)(1).

[71] Section 865(d).

[72] Section 865(c).

[73] Inventory is produced by a taxpayer if it creates, fabricates, manufactures, extracts, processes, cures, or ages the inventory. Regs. 1.863-3(c)(1)(i)(A), 1.864-1.

[74] Sections 861(a)(6), 862(a)(6). This place of sale rule for sourcing gross income from inventory sales is subject to certain form- and substance-focused qualifications and exceptions. See Reg. 1.861-7(c).

[75] See Reg. 1.863-3. Most notably, a taxpayer could elect under the "50/50 method" to treat one-half of the gross income from inventory sales according to the location of its sales activities and the other half according to the location of its production activities. Reg. 1.863-3(b)(1). Many commentators had considered this as a "loophole" permitting taxpayers conducting the majority of its activities with respect to inventory in the U.S. to unfairly inflate foreign-source income. See Koontz & Kadet, "Effects of the New Sourcing Rule: ECI and Profit Shifting," Tax Notes (May 21, 2018).

[76] Reg. 1.863-3(c)(1).

[77] Reg. 1.863-3(c)(2).

[78] Reg. 1.863-3(c)(1)(ii).

[79] Reg. 1.861-8; Temp. Reg. 1.861-8T.

[80] Reg. 1.861-8(b).

[81] Reg. 1.861-8(b)(3).

[82] Reg. 1.861-8(a)(4).

[83] Temp. Reg. 1.861-8T(c)(1).

Gain from the sale of personal property is generally sourced in accordance with the residence of the seller.[69] Section 865, however, includes a list of types of property excepted from this general rule. Gain of a U.S. person from the sale of personal property attributable to an office or other fixed place of business in a foreign country will be foreign-source if such income is subject to at least a 10% income tax in the foreign country.[70] Gain from the sale of intangible property attributable to payments contingent on the productivity, use, or disposition of the intangible is subject to the royalty income sourcing rule.[71] For depreciable personal property, gain not in excess of prior claimed depreciation deductions is generally sourced according to how such deductions were sourced, and any excess gain is sourced according to the inventory property sourcing rule.[72]

The sourcing of income and gains from the sale of inventory property initially depends on whether the taxpayer produced or manufactured the inventory.[73] For the sale of inventory property not produced by the taxpayer, the income is sourced according to the location of sale.[74]

Inventory considered produced by the taxpayer is subject to Section 863(b), as amended by the TCJA. Under this rule, for tax years beginning after 2017, income from the sale of inventory produced (in whole or part) inside the U.S. and sold outside of the U.S., or vice versa, is allocated between U.S. and foreign sources based solely on where the production activities are performed. Thus, sourcing income and gain from the sale of manufactured inventory property now depends only on where it is manufactured. This rule replaces the prior inventory sale rule that permitted sourcing according to the location of both production and sales activities.[75]

Presumably, the existing rules for determining the source of inventory sales should apply to the extent not conflicting with new Section 863(b). These rules generally source income from "production activities" based on the location of the underlying "production assets."[76] Production assets include both tangible and intangible assets used directly to produce inventory. They do not include assets considered not producing inventory, such as accounts receivable, marketing intangibles (trademarks and customer lists), warehouses, the inventory itself, raw materials, cash, stock of a subsidiary and work-in-process. Tangible production assets and associated intangible production assets are located where the tangible production assets are physically located. Activities conducted in a location consisting of only packaging, repackaging, labeling, or other minor assembly are generally disregarded.[77] Once all the production assets are identified, the regulations source the inventory income based on the relative amount of U.S. and foreign production assets (using an adjusted basis averaging convention).[78]

After a taxpayer determines the source of gross income from its operations, it must then apportion its expenses, losses, and deductions (collectively referred to as "deductions" under the regulations) between its U.S. and foreign-source gross income, as well as among the various Section 904(d) foreign tax credit limitation categories or "baskets," discussed below. Under the general apportionment rule, a deduction is first allocated to one or more of certain enumerated classes of gross income to which it is "definitely related."[79] The regulations employ a fact-based analysis for testing whether a deduction is definitely related to one or more classes of gross income. In general, a deduction is definitely related to a class of gross income if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived.[80] Deductions for supportive functions, such as overhead, general and administrative, and supervisory expenses, may be allocated to a gross income class along with such other deductions to which they relate that can more readily be allocated to gross income.[81] These supportive function deductions could also be allocated among several gross income classes, including across all gross income classes, if supported under a reasonable basis.

Deductions allocated to a type of gross income class are then further apportioned between the "statutory grouping" and the "residual grouping" with respect to the gross income.[82] A statutory grouping of gross income is the gross income from a specific source or activity that must first be determined in order to arrive at taxable income from a specific source or activity, and gross income from other sources or activities is the residual grouping. Where a deduction is to a class of gross income that is included in more than one statutory grouping or in one statutory group and the residual grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping.[83] This apportionment must be accomplished in a

manner that reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. The regulations provide a non-exclusive list of bases and factors that should be considered in making this apportionment, consisting of comparing (1) units sold, (2) amount of gross sales or receipts, (3) cost of goods sold, (4) profit contribution, (5) expenses incurred, assets used, salaries paid, space utilized, and time spent that is attributable to the activities or properties giving rise to the class of gross income, and (6) amount of gross income.[84] If a deduction is not definitely related to any gross income, it must generally be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping.[85]

Certain deductions are excepted from this general allocation and apportionment methodology, including business interest and research and development expenses. Recognizing the fungible nature of cash proceeds of a borrowing, the regulations generally apportion business interest expense across all of a taxpayer's income-producing properties and the income derived from those properties.[86] This apportionment is generally conducted based on the relative bases of the creditor's assets, employing a "tax book value" methodology.[87] The regulations do, however, provide certain limited exceptions to this general fungible cash proceeds approach, including for allocating certain nonrecourse indebtedness to specific property and its associated gross income. The extensive requirements for this exception generally limit its application to nonrecourse purchase money financing for real property acquisitions.[88]

Research and experimental expenditures deducted under Section 174 that are expended to meet the legal requirements imposed in a particular jurisdiction that are not reasonably expected to generate more than a de minimis amount of gross income outside of such jurisdiction will be sourced to that jurisdiction.[89] Deductions for other, nongovernment mandated research and experimental expenditures are subject to complex apportionment rules based on product category and the taxpayer's elected apportionment methodology.[90]

Foreign Tax Credit

As previously mentioned, Section 901 provides a credit against U.S. tax attributable to foreign taxes imposed on foreign income. In order to be creditable under Section 901, the foreign tax must be an "income tax" in the U.S. sense.[91] Thus, value

[84] *Id.*

[85] Reg. 1.861-8(c)(3).

[86] Temp. Reg. 1.861-9T(a).

[87] Temp. Reg. 1.861-9T(g); see Reg. 1.861-9(e); Temp. Reg. 1.861-9T(e) (application of interest deduction allocation and apportionment rules to partnership and partners). Section 864(e)(2), as amended by the TCJA, repeals the prior permission for taxpayers to allocate interest expense based on the fair market value of assets.

[88] Temp. Reg. 1.861-10T(b).

[89] Section 864(g)(1)(A).

[90] Sections 864(g)(1)(B), (C); Reg. 1.861-17.

[91] Reg. 1.901-2(a).

[92] A tax is also not creditable to the extent that (1) it is reasonably certain that the tax will be refunded, credited, rebated, abated or forgiven, (2) the foreign taxing country imposes the tax to provide a "subsidy" to the taxpayer or a related person (and other persons), (3) the tax is or may be reduced by the taxpayer's liability for a different tax, or (4) the tax is "noncompulsory." Regs. 1.901-2(e)(2), (3), (4), (5); see also IRM 4.61.10.3.

[93] Reg. 1.901-2(f).

[94] The new tax under Section 951A on "global intangible low-taxed income" or "GILTI," added by the TCJA, ostensibly imposes a tax on the U.S. owners of certain foreign corporations attributable to the foreign corporation's return on intangible property. At a high level, the foreign corporation's return possibly subject to this tax is measured based on "tested income" in excess of a 10% return on the foreign corporation's tangible, depreciable (in the U.S. tax sense) assets.

[95] Section 904(c).

[96] Section 904(d)(2)(B)(i); Reg. 1.871-7(b). Section 904(d)(2)(B)(iii)(II) provides an exception to passive income basket treatment for relatively high taxed (as compared to the U.S. tax rate) foreign-source passive income.

[97] A branch, for this purpose, is defined by reference to the term "qualified business unit" under the foreign currency transaction rules. A qualified business unit generally includes activities of an entity or individual if such activities constitute a trade or business and a separate set of books and records is maintained with respect to the activities. Section 989(a); Reg. 1.989(a)-1.

[98] Section 904(f)(3)(A).

[99] Sections 701, 702, 704.

[100] Reg. 1.904-5(h)(1); see also Reg. 1.863-3(g)(2); but see Section 865(i)(5).

[101] Reg. 1.904-5(h)(2). A partner will be considered as owning 10% of the value of a partnership for a particular year if the partner has 10% of the capital and profits interest of the partnership. Reg. 1.904-5(h)(4).

[102] Sections 702(a)(6), 703(a)(2)(B), (b)(3), 901(b)(5); Regs. 1.703-1(a)(2)(iii), 1.703-1(b)(2)(i). Allocations of foreign tax credits may not have substantial economic effect under Section 704(b), and therefore must be made in accordance with the partners' interests in the partnership. Allocations of foreign tax credit are deemed to be made in accordance with the partners' interests in the partnership if (1) the credit is allocated and reported on the partnership return in proportion to the partners creditable foreign tax expenditure ("CFTE") category shares of income to which the CFTE relates, and (2) the allocation of all other partnership items which, in the aggregate, have a material effect on the amount of foreign credits allocated to a partner are valid. To satisfy the requirement, the partnership must determine the partnership's categories of CFTEs, determine the partnership's net income in each CFTE category, and allocate the partnership's CFTEs to each category. The process for determining the partnership income to which the CFTE relates is fairly complex and is set out in Reg. 1.704-1(b)(4)(viii) and Temp. Reg. 1.704-1T. See TD 9748 (Feb. 4, 2016).

added taxes, asset taxes, and goods and services taxes, for example, are not creditable taxes under Section 901 because they are not imposed on income and instead are imposed on a different basis, such as gross sales.[92] Foreign taxes are creditable only for the person on whom foreign law imposes legal liability for such tax, even if another person (for example, a withholding agent) remits or pays such tax.[93]

Section 904 limits the otherwise creditable taxes that a taxpayer may claim as a foreign tax credit under Section 901. Section 904(a) initially provides that the foreign tax credit may not exceed the same proportion of the tax against which such credit is taken that the taxpayer's taxable income from foreign sources (but not in excess of the taxpayer's entire taxable income) bears to its entire taxable income for the same tax year. This effectively means that a taxpayer may use foreign tax credits only to offset the U.S. tax imposed on foreign-sourced income. The creditability of foreign taxes is subject to further limitation depending on the Section 904(d) category or "basket" of income upon which the foreign tax was imposed. The current Section 904(d) income baskets consist of passive category income, general category income, as well as the new baskets enacted under tax reform for "GILTI"[94] and foreign branch income. Except to the extent attributable to GILTI basket income, foreign tax credits subject to limitation under Section 904 may be carried back one year and forward ten years.[95]

General category basket income consists of income not allocated to another basket. Passive category income generally includes dividends, interest, rents, royalties, and gains from certain property dispositions.[96] The new foreign branch income basket includes business profits attributable to one or more qualified business units in one or more foreign countries, but not including any passive category income. Although not entirely clear on the face of the statute, presumably this new foreign branch income basket will be applied by segregating the income of each foreign branch or certain groups of foreign branches into a separate basket.[97]

Section 904(f) also limits the ability of taxpayers to benefit from a foreign tax credit to the extent foreign-source losses have previously sheltered U.S.-source income. Specifically, Section 904(f)(5) sets forth a foreign loss ordering rule, which allocates losses in excess of gross income attributable to a particular foreign-source income basket proportionately among the other foreign-source income baskets. Foreign-source losses in excess of aggregate foreign-source income may be used to shelter U.S.-source income. However, Section 704(f)(1) requires the benefitting taxpayer to "recapture" this excess "overall foreign loss" in subsequent years by converting future foreign-source income into U.S.-source income. Once this overall foreign loss is extinguished, Section 704(f)(5) similarly requires any excess foreign-source income to be allocated in proportion to the foreign-source income against which the prior foreign-source losses from a basket had been deducted outside of its basket. The sale of property used predominantly in a trade or business outside of the U.S. may also trigger the recapture of an overall foreign loss.[98] Conversely, Section 904(g) provides a similar income recharacterization rule to the extent that excess U.S.-source losses (an "overall domestic loss") shelter foreign-source income.

The distinction between employee reasonable compensation and shareholder distributions could have critical significance to many S corporation shareholders in light of the new Section 199A deduction.

Application of Sourcing and Foreign Tax Credit Rules to Partnerships and S Corporations: With respect to partnerships, each partner must report its distributive share of partnership gains, income, deductions, losses, or credits on its own tax return.[99] The source and character of income and gain and associated losses and deductions included in each partner's distributive share are generally determined under a look-through approach based on the source and character determined at the partnership level.[100] However, for purposes of Section 904, the foreign-source income, gain, loss, and deductions of an individual who is a limited partner and owns less than 10% of the partnership's value are characterized as passive basket unless the partner is considered to hold the partnership interest in the ordinary course of its own trade or business.[101]

Partnerships do not directly claim a credit or deduction for foreign taxes. Instead, a partnership's foreign taxes are separately stated items and each partner may claim either a Section 901 foreign tax credit or Section 164 deduction with respect to its distributive or proportionate share of such foreign taxes.[102]

EXHIBIT 1
Computation of U.S. Corporate Income Taxes on Subpart F Income and GILTI

	Subpart F Income	*GILTI*
Gross Income (less foreign taxes under Sections 951A(c)(2)(A)(ii) and 954(b)(5))	$87.50	$87.50
Section 78 Gross-Up	$12.50	$12.50
Section 250 Deduction		– $50.00[a]
Taxable Income	$100.00	$50.00
Tentative U.S. Tax (21% corporate rate)	$21.00	$10.50
Section 960 FTC	– $12.50	– $10.00[b]
U.S. Tax on Z	$8.50	$0.50

a ($87.50 GILTI + $12.50 Section 78 gross-up) x 50% as per Section 250(a)(1)(B).

b $12.50 × 80% as per Section 960(d)(1). This computation assumes that the Section 78 gross-up constitutes GILTI Section 904(d) basket gross income, which surprisingly is not free from doubt. See Sheppard, "GILTI Gross-Up in the Basket," Tax Notes International, pages 689-690 (Apr. 30, 2018); Brewer & McBee, "The Good, the Bad, and the GILTI: Part 2, the Basket Question," Tax Notes (May 28, 2018).

For the sale of an interest in a U.S. partnership, it is not entirely clear whether a partnership as an entity or an aggregate approach applies for sourcing associated gain or income of a selling U.S. partner. That is, it is uncertain whether a selling U.S. partner is treated as selling an interest in the partnership (thereby entirely producing U.S.-source income or gain) or, alternatively, as selling an interest in the underlying partnership property (which could produce a mix of U.S.-source and foreign-source income or gain). Section 864(c)(8), as amended by the TCJA, clarifies that a partnership look-through approach applies for purposes of the ECI rules with respect to foreign partner sellers.[103] This rule, however, does not address U.S. partners. The regulations do address the Section 904(d) basket of any foreign-source income or gain from a sale of a partnership interest. Under these rules, the gain or income from the sale is passive basket, subject to look-through rule exceptions for "high-taxed income" and for 25% partnership owners.[104] Notwithstanding the foregoing technical matters, the sale of an interest in a U.S. partnership by a U.S. partner is not likely to be a taxable event in a foreign jurisdiction, so that the partner generally would benefit from additional foreign-source income or gain only if it was in a foreign tax credit carryforward position.

S corporations and their shareholders are treated as partnerships and partners for purposes of applying the foreign tax credit and sourcing rules.[105] Gain from the sale of S corporation stock is U.S.-source, even if an election is made to treat the stock sale as an asset sale for tax purposes under Section 338(h)(10) or Section 336(e).[106]

Impact of Foreign Operations on QBI and Vice Versa?

At first blush, it appears that a U.S. individual's foreign-source income and deductions and QBI deduction should not impact each other. Section 199A(a) generally computes the deduction based on the individual's QBI, subject to a ceiling for the individual's taxable income. QBI generally does not include foreign-source income. Taxable income does not take into account a foreign tax credit and a foreign tax credit may only offset foreign-source income.[107]

However, it is possible that excess U.S.-source or foreign-source deductions or losses could impact QBI. For example, the amount of a taxpayer's QBI deduction could be impacted if it is in an overall foreign loss position. Apply-

ing the existing rules, a taxpayer's excess foreign losses offset its U.S.-source income. This reduces the taxpayer's taxable income, a computational ceiling under Section 199A. Also, because this deduction seemingly is not effectively connected with a U.S. trade or business, it is not clear whether the foreign-source loss should be able to reduce QBI. Moreover, it is unclear how the recapture of an overall foreign loss should be treated under Section 199A. Should the foreign-source income recharacterized as U.S.-source income be treated as QBI if the prior foreign-source loss effectively reduced the prior QBI? The existing rules do not appear to compel this result given that the overall foreign loss recapture rules explicitly apply only for purposes of the foreign tax credit rules.[108] It is also possible that a taxpayer's QBI deduction could be impacted by a recharacterization of U.S.-source income as foreign-source under the overall domestic loss rules. Should the resourcing of this income from U.S. to foreign sources for foreign tax credit purposes impact a taxpayer's QBI? As with overall foreign losses, the overall domestic loss recharacterization rule applies only for foreign tax credit purposes.[109] Hopefully, forthcoming government guidance will address these issues.

Additionally, the sourcing rules applying to the sale of a U.S. partnership interest may become more significant. As mentioned above, it is currently uncertain whether a U.S. person's gain or income from the sale of an interest in a U.S. partnership is sourced according to a look-through approach to the partnership's assets. This issue does not matter for Section 199A purposes for any capital gain resulting from the sale. However, it is possible that this will matter for so-called "hot asset" gain under Section 751. The selling partner may prefer full U.S. sourcing of this income to claim an additional QBI deduction. However, a partner with foreign tax credit carryforwards may also prefer to employ a look-through approach to create additional foreign-source income.

Section 199A as Incentive to Maximize U.S.-Source Income?

Prior to the TCJA, taxpayers conducting U.S. and foreign operations in a flow-through tax structure were generally incentivized to treat as much income as possible as foreign-source rather than U.S.-source. This is because only foreign-source income may be offset by foreign tax credits, while U.S.-source income generally did not carry any additional benefit. Does the new Section 199A deduction alter this incentive? Consider the following example.

Assume partnership X provides non-SSTB services to customers located in the U.S., as well as in country A through partnership X's wholly owned country A hybrid branch, Y. Country A does not have a tax treaty with the U.S. Country A imposes an income tax on Y's service income, but does not impose a tax with respect to distributions made from Y to X. During the year, the X/Y business generates $100 of profits from personal services subject to income tax for both U.S. and country A purposes. Partnership X partners are individuals subject to U.S. tax at the highest marginal rate and have no foreign-source income other than that received from partnership X.

First, assume that country A imposes a 15% income tax, resulting in country A taxes of $15. If all the services were performed by X/Y employees inside the U.S., so that all income is U.S.-source, the X partners' aggregate U.S. tax liability will be $29.60 (($100 – $20 QBI deduction) × 37%). If X/Y employees instead provided all the services in country A, so that all income is foreign-source, the X partners' aggregate U.S. tax liability will now be $22 ($37.00 tentative tax ($100 × 37%) against which the $15 foreign tax credit may be used).

Now, assume that country A imposes a 5% tax only on the services income, resulting in $5 country A taxes. If all the services were performed by X/Y employees inside the U.S., the X partners' aggregate U.S. tax liability would remain $29.60 (($100 – $20 QBI deduction) × 37%). If X/Y employees instead provided all the services in country A, the X partners' aggregate U.S. tax liability will be $32 ($37.00 tentative tax ($100 × 37%) against which the $5 foreign tax credit may be used).

This example illustrates that the new Section 199A deduction could, in certain situations, incentivize a taxpayer to have more U.S.-

[103] For the law before the TCJA, see Rev. Rul. 91-32, 1991-1 CB 107; but see *Grecian Magnesite Mining*, 149 TC No. 3 (2017).

[104] Reg. 1.904-5(h)(3).

[105] Section 1373.

[106] Section 338(h)(16); Reg. 1.336-2(g)(3)(i).

[107] Sections 63, 904.

[108] Section 904(f)(1) ("For purposes of this subpart, . . . ").

[109] Section 904(g).

source income. Whether or not this is the case will most likely depend on the taxpayer's marginal tax rate, the applicable foreign tax rate imposed on earnings, and the creditability of associated foreign taxes.

Section 199A versus the Export Tax Incentive Regimes

FDII: Enacted by the TCJA, the new 37.5% deduction for foreign-derived intangible income ("FDII") provides a new incentive for exporters and service providers performing services for non-U.S. customers.[110] At a high level, this new deduction, which applies only to domestic C corporations, is available for qualifying export and outbound services income to the extent considered an extraordinary return on specified tangible property. The FDII deduction results in qualifying income being subject to a 13.125% effective corporate tax rate.

Eligible non-SSTBs will likely not have an incentive to structure their operations to receive the benefit of a FDII deduction, given that FDII-qualifying exports could often also constitute ECI QBI. The FDII deduction is available only for C corporations, so the QBI-eligible business would have to establish a C corporation structure for its export or outbound services business segment to be eligible. Although the C corporation's earnings could be subject to tax at 13.125% after applying the FDII deduction, the additional 20% dividend tax for C corporation distributions results in an effective tax rate on earnings of 30.5% (33.8% taking into account the 3.8% Section 1411 net investment income tax). This exceeds the 29.6% effective tax rate imposed on QBI.

An SSTB would be the more likely candidate for implementing a C corporation structure for its outbound services segment, at least in part to receive FDII deduction benefits. However, special care should be taken before making any decision to implement a C corporation structure (including to take advantage of the FDII deduction and other provisions available only for domestic corporations, such as the deduction and foreign tax credit benefits for GILTI and Subpart F income, described below), including assessing the impact on state and local taxes and exit planning and considering the sunset and possible repeal or alteration of the existing rules by a future Congress or administration.[111]

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[110] Section 250(a)(1)(A).

[111] The future availability of the FDII deduction in its current form is not free from doubt, given that it could conceivably be subject to challenge under the WTO rules as an impermissible export subsidy. See Kirwin, "EU Requests OECD Review of U.S. Tax Law's Harmful Provisions," Bloomberg BNA (Mar. 7, 2018) https://www.bna.com/eu-requests-oecd-n57982089605/.

[112] Eligible exports for this purpose include property manufactured or produced in the U.S. (and not more than 50% of the fair market value of which is attributable to articles imported into the U.S.) for sale, lease, or rental outside of the U.S. and, interestingly (at least in light of Section 199A), engineering and architectural services for construction projects located outside the U.S. Sections 993(a), (b), (c).

[113] Section 991.

[114] Section 995.

[115] These requirements include that at least 95% of the corporation's gross receipts are "qualified export receipts," at least 95% of the corporation's assets are "qualified export assets," the corporation only has one class of stock and the corporation maintains capital of at least $2,500. Section 992(a)(1); Reg. 1.992-1.

[116] Sections 995(a), (b). For C corporation shareholders of an IC-DISC, the IC-DISC is also treated as making a distribution of 1/17 of its annual earnings to the C corporation up to the $10 million threshold. Section 995(b)(1)(F)(i).

[117] Section 995(b)(1)(E).

[118] Section 995(f).

[119] Although beyond the scope of this article, the new 37.5% FDII deduction, as well as the reduction of the corporate income tax rate from 35% to 21% under the TCJA, reduces the incentive to implement an IC-DISC structure for a C corporation exporter. An IC-DISC sponsored by a closely held C corporation may avoid the double tax inefficiency of C corporation earnings for its shareholders by effectively converting corporation-level income into only shareholder-level qualified dividend income. This income under an IC-DISC structure is therefore only subject to tax at the 20% qualified dividend rate for deemed and actual IC-DISC distributions (plus the 3.8% 1411 net investment income tax). Without an IC-DISC structure, prior to the TCJA, the income would be subject to a 35% corporate income tax and distributions of after-tax proceeds would be subject to an additional 20% tax on the dividend income (plus the 3.8% 1411 net investment income tax). Now, this same structure results in income taxed at the corporate level at a 13.125% rate taking into account the FDII deduction and corporate distributions of after-tax proceeds taxed at the 20% qualified dividend tax rate (plus the 3.8% 1411 net investment income tax).

[120] Any disparate impact of the Section 1411 net investment income tax would also have to be taken into consideration.

[121] Given that qualified export receipt income often also could be eligible QBI ECI after the enactment of the new Section 863(b) inventory sourcing rule, the benefits of an IC-DISC could be combined with the benefits of the Section 199A deduction. For instance, the owners of a tax pass-through entity could be taxed at 29.6% on their QBI and 23.8% (20% qualified dividend rate + 3.8% Section 1411 net investment income tax rate) on dividends from the IC-DISC. Thus, if the IC-DISC acts as a commission agent on behalf of the tax pass-through entity, the blended tax rate imposed on business earnings will generally be 26.7% for an IC-DISC employing the "50-50" combined taxable income transfer pricing method of Reg. 1.994-1(c)(3) (50% of income QBI of tax pass-through entity and 50% of income dividends from IC-DISC, as per Regs. 1.994-1(c)(3), (d)(2)).

[122] Outbound CFC planning may not be preferred by certain existing and highly appreciated businesses after the TCJA's repeal of the "active trade or business exception" to Section 367(a). Alternatively, a U.S. individual may consider making an election under Section 962(b) to be taxed as a domestic corporation.

[123] This discussion does not consider the application of the Section 1411 net investment income tax.

[124] Sections 951, 951A; *Rodriguez*, 722 F.3d 306 (CA-5, 2013), *aff'g* 137 TC 174 (2011); Notice 2004-70, 2004-2 CB 724. Earnings subject to tax as Subpart F income or GILTI should not be subject to tax when distributed back to the U.S. as Section 959 previously taxed income. See Section 951A(f)(1)(A).

IC-DISC: While the new FDII deduction applicable to domestic corporations has received much attention, a pre-existing export incentive tax regime for interest-charge domestic international sales corporations, or "IC-DISCs," has often been overlooked. An IC-DISC is a separate corporation that often acts as a sales or services commission agent on behalf of the U.S. exporter.[112] The IC-DISC, however, is not subject to tax.[113] Instead, the shareholders of the IC-DISC are subject to tax for actual and deemed distributions out of the IC-DISC's untaxed earnings and profits, which are taxable as dividends to the shareholders.[114]

A U.S. corporation may elect to be treated as an IC-DISC so long as it complies with certain initial and ongoing qualification requirments.[115] Qualifying earnings of an IC-DISC up to $10 million may be eligible for tax deferral if not actually distributed.[116] Yearly earnings in excess of $10 million are treated as distributed to the IC-DISC shareholders.[117] IC-DISC share-holders are subject to an annual interest charge based on the amount of deferred tax liability attributable to retained untaxed IC-DISC earnings.[118]

Employed by a U.S. individual-owned partnership or S corporation operating company, an IC-DISC benefits the owners by effectively replacing business income taxed as ordinary income with qualified dividend income. The IC-DISC structure also provides a tax deferral opportunity for IC-DISC earnings not deemed to be distributed to its shareholders. Thus, although the IC-DISC rules are complex and require initial startup and continuing monitoring and administrative expenses, implementing IC-DISC structures can provide a meaningful benefit for exporting partnership and S corporation businesses.

Does the new QBI deduction diminish the incentive to implement an IC-DISC structure?[119] The IC-DISC structure still provides an advantage from a tax rate perspective given that the benefit of a 20% QBI deduction against U.S.-source income taxed at ordinary income rates should be less than having that income taxed at the 20% qualified dividend rate for IC-DISC deemed and actual distributions. For example, if $100 from the proceeds of the sale of property manufactured in the U.S. could be treated as QBI or as a dividend from an IC-DISC, the QBI treatment would result in U.S. tax of $29.60 (($100 – $20 QBI deduction) × 37% highest individual tax rate) and IC-DISC treatment would result in U.S. tax of $20 ($100 × 20% qualified dividend rate).[120] The possible deferral benefits also weigh in favor of an IC-DISC structure. However, the reduction in individual tax rates on ordinary income (for example, reduction of the top marginal rate from 39.6% to 37%) and the enactment of the Section 199A deduction reduce the marginal tax rate benefit of an IC-DISC for QTBs.[121]

Outbound U.S. Holding Corporation Planning

While this article addresses the application of the Section 199A deduction for existing U.S.-based and owned businesses operating across borders as a pure pass-through tax structure for U.S. tax purposes, it is worth noting that businesses looking to expand internationally may find that a U.S. holding corporation/controlled foreign corporation ("CFC") structure for foreign operations may be preferable after the changes to the Code enacted by the TCJA.[122] Consider the following example.[123]

Partnership X, which is owned by two U.S. individuals subject to U.S. income tax at the highest marginal rates, operates an active business internationally through Y, an entity organized in Ireland. Ireland imposes a 12.5% tax on Y's income and no withholding tax on Y dividends paid to X (or Z, as described below).

If Partnership X directly owns Y and Y is treated as a hybrid branch disregarded entity for U.S. tax purposes, Y's earnings will be subject to immediate taxation in Ireland at 12.5% and in the U.S. at 37%, subject to a foreign tax credit for Irish taxes paid. This results in Y earnings being subject to a 37% worldwide tax rate, assuming full creditability of the Irish tax for Section 901 purposes.

If Partnership X directly owns Y and Y is instead treated as a foreign corporation CFC for U.S. tax purposes, Y's earnings be will subject to Irish tax at 12.5% for which no U.S. foreign tax credit will be allowed. Y's earnings will also be immediately taxable in the U.S. at 37% to the extent they constitute either Subpart F income or GILTI.[124] Y earnings not subject to this immediate U.S. tax as Subpart F income or GILTI may be deferred until such time as they are distributed to X or otherwise considered invested in U.S. property under Section 956. Income attributable to an investment in U.S. property, like Subpart F income and GILTI, is taxed as ordinary income, while distributions of untaxed foreign earnings are taxed as dividends eligible for the preferential 20% qualified dividend rate. This results in an effective world-

wide tax rate of 44.9% imposed on Y income that is Subpart F income or GILTI[125] and 30% imposed on other Y income (assuming no investment in Section 956 U.S. property).[126]

Now assume that partnership X establishes a U.S. holding corporation, Z, for Y and Y is treated as a foreign corporation CFC for U.S. tax purposes. Ireland imposes a 12.5% tax on Y income. Y income that is Subpart F income or GILTI is immediately taxable to Z in the U.S. This immediate taxable income, though, is accompanied with associated tax benefits due to Z's C corporation tax classification. Subpart F income is eligible for deemed-paid "indirect" foreign tax credit benefits under Section 960. GILTI is eligible for the 50% deduction for GILTI under Section 250(a)(1)(B) and an 80% indirect foreign tax credit under Section 960. Any Y earnings not subject to immediate tax as Subpart F income or GILTI (or otherwise considered invested in Section 956 U.S. property) may be distributed to Z without any additional U.S. tax under the new Section 245A participation exemption dividends received deduction. Dividend distributions from Z to Y will be eligible for the 20% qualified dividend rate. Therefore, assuming full creditability in the U.S. for Ireland taxes and no Section 956 investment in U.S. property, the effective worldwide tax rate imposed on Y earnings will be (1) 36.8% for Subpart F income,[127] (2) 30.4% for GILTI,[128] and (3) 30% for other earnings.[129] A sample computation of the U.S. taxes imposed on Subpart F income and GILTI attributable to Y earnings is included in Exhibit 1.

This example illustrates the possible benefit of implementing a domestic C corporation holding company structure for CFCs that expect to generate sizable Subpart F income or GILTI. This structure may also be beneficial for CFC operations in non-treaty jurisdictions for which qualified dividend income rates on CFC dividends are not available.[130] Moreover, the CFC structure permits deferral for non-Subpart F income/non-GILTI that would be unavailable in a pure pass-through tax structure. If optimal for outbound, foreign-source-income-generating business operations, this C corporation holding company/CFC structure could be combined with a pass-through tax structure for U.S. operations to also take advantage of QBI deduction benefits for U.S.-source income.

Conclusion

Although many of the details of how it should apply remain open prior to the issuance of any government guidance, the new Section 199A deduction has the potential to provide owners of tax flow-through businesses with a significant benefit in the form of a 20% deduction against their business income. This benefit is available for qualifying businesses conducting purely U.S. operations, as well as for qualifying businesses operating in the U.S. and abroad. For those tax flow-through businesses conducting international operations, the new Section 199A deduction should now be considered in planning and modeling for the impact of business income that may be ECI (Section 199A deduction-eligible) and that may not be ECI (not Section 199A deduction-eligible, but which may result in, for example, foreign tax credit benefits). These businesses may also be able to effectively combine the benefit of the new Section 199A deduction with the benefit under other new and pre-existing tax regimes to further minimize taxes on business earnings. ■

[125] This is composed of immediate Irish tax of 12.5% and U.S. tax of 37% imposed on Subpart F income and GILTI (taking into account the deduction for Irish taxes paid under Sections 951A(c)(2)(A)(ii) and 954(b)(5)).

[126] This is composed of immediate Irish tax of 12.5% plus an additional 20% tax on dividends when proceeds are distributed to X.

[127] This is composed of immediate Irish tax of 12.5% and U.S. tax of 8.5% imposed on Subpart F income, plus an additional 20% tax on dividends when proceeds are distributed to X.

[128] This is composed of immediate Irish tax of 12.5% and U.S. tax of 0.5% imposed on GILTI, plus an additional 20% tax on dividends when proceeds are distributed to X.

[129] This is composed of immediate Irish tax of 12.5%, no immediate U.S. tax or U.S. tax when proceeds are distributed to Z via the Section 245A participation exemption dividends received deduction, and 20% tax on dividends when proceeds are distributed from Z to X.

[130] For these structures, the inbound non-qualified dividend subject to tax at the full 37% U.S. rate is replaced by a Section 245A participation exemption-eligible dividend to the C corporation holding company not subject to U.S. tax and a qualified dividend to the partnership or individual owners eligible for 20% qualified dividend rates.