AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
Building on Experience
100 YEARS

October 1, 2018

VIA ELECTRONIC SUBMISSION
www.regulations.gov

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

RE: Notice of Proposed Rulemaking titled "Qualified Business Income Deduction," REG-107892-18, 83 Fed. Reg. 40884

Dear Sir or Madam,

On behalf of the Associated General Contractors of America (AGC), I respectfully submit the following comments in response to the notice of proposed rulemaking concerning the deduction for qualified business income under new Internal Revenue Code (IRC) Section 199A (referred to as the "proposed regulations").

AGC is the leading association for the construction industry in the United States representing more than 26,000 firms, including over 6,500 leading general contractors, and over 9,000 specialty-contracting firms, as well as over 10,500 service providers and suppliers through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's commercial buildings and industrial facilities, highway and public transportation infrastructure, water and wastewater systems, flood control and navigation structures, defense installations, multi-family housing, and more. The construction industry has played a powerful role in sustaining economic growth in the United States, in addition to producing structures that add to productivity and quality of life.

AGC was supportive of the efforts of Congressional tax writers in creating a new deduction for pass-through businesses during the consideration and passage of the *Tax Cuts and Jobs Act* (TCJA).[1] The construction industry has traditionally faced the highest effective tax rate of any industry in the U.S. Prior to passage of TCJA, according to analysis by the Department of the Treasury (Treasury), the construction industry paid a 30.3 percent effective tax rate, compared to a 23.3 percent average effective tax rate for all industries.[2] Because the majority of construction firms are organized as pass-through entities, the new 20 percent pass-through deduction under Section 199A is essential to ensuring that the construction firms organized as pass-throughs remain competitive relative to both businesses in other industries, as well as

[1] Section 199A was enacted on December 22, 2017 by § 11011 of "An Act to provide for reconciliation pursuant to titles II and C of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97, as amended by § 101 of Division T of the Consolidated Appropriations Act, 2018, P.L. 15-141, commonly referred to as the "Tax Cuts and Jobs Act."

[2] *The President's Framework for Business Tax Reform: An Update*, a Joint Report by The White House and the Department of the Treasury, April 2016. Available at: https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf

construction firms organized as C-Corporations. AGC thus has a substantial interest in ensuring that the new deduction be broadly available to construction firms, subject to the limitations imposed by Section 199A, and consistent with the law.

In general, AGC applauds the efforts of Treasury and the IRS for their measured and thoughtful approach to the proposed regulations, which, if implemented appropriately, have the potential to promote investment, business development, and business expansion in the construction industry, as businesses expand, purchase equipment, hire more workers, bid on future projects, and reduce debt. In particular, AGC is supportive of the approach adopted by Treasury and IRS in defining Specified Service Trades or Business (SSTBs). AGC does, however, have some concern about other aspects of the proposed regulations, including using IRC Section 162 to define "trade or business," and the new "presumption" standard for independent contractors, as outlined below.

Summary of Relevant Statutory Provisions

Congress created Section 199A as part of the *Tax Cuts and Jobs Act* to provide a deduction of up to 20 percent of qualified business income (QBI) for taxable years beginning after 2017 and before 2026.[3] Taxpayers whose income exceeds the "threshold amount" of $157,500 ($315,000 for a joint return, and subject to a phaseout)[4] are subjected to additional conditions. The business must meet the definition of a qualified trade or business (QTB).[5] A QTB is any trade or business other than an SSTB,[6] or the trade or business of performing services as an employee.[7] Additionally, the deduction is limited to half of the business's W-2 wages, or 25 percent of wages plus 2.5 percent of the unadjusted basis of the business's depreciable capital.[8]

Construction is Not a Specified Service Trade or Business

Under Section 199A(d)(2)(A), SSTBs are defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.[9] While, as discussed further below, it is important to read this section as a whole to determine the proper definition of SSTBs, there is a distinction between two types of SSTBs in this section (those that are specifically "listed" such as health, law, or accounting, and those whose primary asset is the reputation or skill of one or more of its employees or owners). AGC believes that construction is wholly distinct from either the "listed" SSTBs, or "reputation and skill" SSTBs, and that all the active conduct of a construction trade or business should be excluded from any definition of a SSTB.

The proposed regulations acknowledge this in two important ways. The proposed regulation defines "consulting," in part, as:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(vi) of this section only, the performance of services in the field of consulting means the provision of professional advice and counsel to

[3] Section 199A(i)
[4] Section 199A(e)(2)(A)
[5] Section 199A(d)(1)
[6] Section 199A(d)(1)(A)
[7] Section 199A(d)(1)(B)
[8] Section 199A(b)(2)(B)
[9] Section 1202(e)(3)(A) (applied without regard to the words "engineering, architecture,") or which would be so described if the term "employees or owners" were substituted for "employees" therein.

> clients to assist the client in achieving goals and solving problems…**Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services** (Emphasis added). [10]

AGC applauds Treasury for drawing the distinction between a trade or business engaged in consulting by providing advice and counsel to clients, versus the services provided by a construction contractor. While a construction firm will oversee decisions on design, preconstruction, procurement, and building, it is still inherently in the business of construction.

The IRS and Treasury have also traditionally understood construction-related services as a trade or business apart from other services. Under the now repealed domestic production activities deduction, the IRC defined Domestic Production Gross Receipts (DPGR) to include the gross receipts of the taxpayer which were derived from, in the case of a taxpayer engaged in the active conduct of a construction trade or business, the construction of real property performed in the United States by the taxpayer in the ordinary course of such trade or business.[11] In regulation, Treasury defined construction activities (in general) as:

> "Activities constituting construction are activities performed in connection with a project to erect or substantially renovate real property, including activities performed by a general contractor or that constitute activities typically performed by a general contractor, for example, activities relating to management and oversight of the construction process such as approvals, periodic inspection of the progress of the construction project, and required job modifications."[12]

In the same regulation, Treasury further allowed that:

> "If the taxpayer performing construction activities also provides, in connection with the construction project, administrative support services (for example, billing and secretarial services) incidental and necessary to such construction project, then these administrative support services are considered construction activities.[13]

Treasury, thus, has a long history of allowing services ancillary to construction, including project management, to be classified as "construction," which is distinct from other services, and AGC is pleased to see the proposed regulations continue to acknowledge this distinction.

The "Reputation and Skill" Clause Should be Interpreted Narrowly

AGC applauds Treasury for interpreting the "reputation and skill" clause for SSTBs narrowly, which aligns with Congressional intent. The proposed regulations limit the meaning of the "reputation or skill" clause to pass-through businesses engaged in the business of (1) receiving income for endorsing products or services, (2) licensing or receiving income for the use of an individual's image, likeness, name, signature voice, trademark, or any other symbols associated with the individual's identity, or (3) receiving appearance fees or income from appearances in the media. [14]

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[10] Prop. Treas. Reg. § 1.199A-5(b)(2)(vii)
[11] Section 199(c)(4)(A)(ii), repealed by P.L. 115–97
[12] Treas. Reg. 1.199-3(m)(2)(i)
[13] Treas. Reg. 1.199-3(m)(2)(iv)
[14] Prop. Treas. Reg. § 1.199A-5(b)(2)(xiv)

As Treasury correctly notes in the preamble (in response to comments Treasury received proposing an "activity-based standard under which no service-based businesses would qualify for the section 199A deduction"):

> "An SSTB definition this broad would not comport with the statute and would deny a section 199A deduction to businesses that the statute does not appear to exclude. If the "reputation or skill" clause was intended to exclude all service businesses from section 199A, there would have been no reason to enumerate specific types of businesses in section 199A(d)(2); that language would be pure surplusage."[15]

AGC strongly agrees with this analysis, and notes that the additional options outlined in the preamble of the proposed regulations, as suggested by various commenters, would be inherently complex, unworkable, or subjective.[16] Additionally, AGC strongly agrees with Treasury's position that the "reputation or skill" clause "was intended to describe a narrow set of trades or businesses, not otherwise covered by the enumerated specified services, in which income is received based directly on the skill and/or reputation of employees or owners."[17] Interpreting it otherwise could vitiate the deduction for thousands of construction firms, which is clearly beyond the scope of what Congress intended.

Defining Trade or Business Using Section 162 for Purposes of Qualifying for the Section 199A Deduction and Aggregating Businesses

Section 199A provides a deduction applicable to QBI, and Section 199A(C)(1) states that QBI means, "for any taxable year, the net amount of qualified items of income, gain, deduction, and loss **with respect to any qualified trade or business** of the taxpayer" (Emphasis added). The proposed regulations permit (but do not require) aggregation of commonly controlled businesses. To qualify, businesses must meet certain criteria, including that a business "must itself be a trade or business as defined in Prop. Treas. Reg. § 1.199A–1(b)(13)" which defines "trade or business" as a "Section 162 trade or business other than the trade or business of performing services as an employee" or the rental or licensing of tangible or intangible property to a related trade or business if the rental or licensing and the other trade or business are commonly controlled under the proposed aggregation rules.[18]

In March, AGC was a signatory to a letter by the Parity for Main Street Employers Coalition calling for Treasury to allow taxpayers to "group activities conducted through S corporations and partnerships, as under Section 469, when they calculate qualified business income under Section 199A."[19] AGC still believes that allowing businesses to aggregate using Section 469 is appropriate, but we acknowledge that Treasury concluded that "the grouping rules under section 469 are not appropriate for determining a trade or business for section 199A purposes."[20] In the preamble, Treasury notes that the grouping rules under

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[15] 83 Fed. Reg. at 40899

[16] Along with the above mentioned "activity based standard" which would disqualify virtually all service-based businesses from receiving the 20 percent deduction, Treasury also notes that it received proposals for "a balance sheet test that would compare the value of assets other than goodwill and workforce in place to the value of such goodwill and workforce in place," and "a standard based on whether the trade or business involves the provision of highly-skilled services." 83 Fed. Reg. at 40899

[17] Ibid.

[18] 83 Fed. Reg. at 40886

[19] March 19, 2018 Parity for Main Street Employers letter to Hon. David Kautter and Mr. William Paul re: Request for Rules Allowing for Aggregation or Grouping of Entities for Purposes of Calculating the Deduction under Section 199A, available at: http://mainstreetemployers.org/wp-content/uploads/2016/02/Business-Community-Letter-on-Aggregation-under-199A.pdf

[20] 83 Fed. Reg. at 40894

Section 469 are inappropriate because: 1) Section 469 refers to "activities" rather than "trades or businesses,"; 2) Section 469 is a loss limitation rule; and 3) Section 469 groupings may include SSTBs otherwise excluded under Section 199A.[21]

As many commenters have noted, defining a "trade or business" using Section 162 is difficult for dealing with real estate and rental property. This is important for construction contractors because they sometimes receive an ownership stake in a finished project as part of their compensation. As a result, it is not unusual for a construction firm to have significant real estate holdings. Additionally, the incidence of taxation on the owners of real estate has a direct impact on the overall construction industry. Any benefits or disadvantages created by the tax code that affect the ownership, construction, or reconstruction of real estate will also affect construction jobs and related opportunities correspondingly.

The use of Section 162 for determining if there is a trade or business produces an ill-defined standard and creates considerable uncertainty. Court cases have held that the taxpayer must be involved in the activity with continuity and regularity. [22] No objective measure exists under this standard. The problems associated with an incorrect determination are compounded given the increase in the penalty for understatement of income tax where a Section 199A deduction is taken in error.[23]

Given the direct benefits under TCJA afforded to those receiving REIT dividends and holding interests in publicly traded partnerships (PTPs),[24] an expanded definition of a qualified trade or business should apply for rental real estate activities. Those receiving qualified REIT dividends and PTP income generally are not actively involved in the rental operations, yet are entitled to receive the Section 199A deduction. This, along with the inclusion of the limitation under Section 199A(b)(2)(B)(ii) in the final legislation, [25] suggests an intention to confer the benefits of the deduction to a broad range of real estate activities. Consequently, QBI, with respect to real estate rental activity, should be given a broad interpretation.

As an alternative to Section 162, AGC proposes that Treasury allow pass-through firms to use the definition of trade or business as defined in IRC Section 1411 (the net investment income tax created in the *Affordable Care Act*) for purposes of aggregation.[26] Relying on this definition of trade or business would allow for real estate holding to be aggregated into the business (subject to the additional aggregation rules in the proposed regulations). Section 1411 also defines "trade or business" (as opposed to "activities"), is well established in regulation, and would ease administration by unifying the definition of trade or business for purposes of calculating the net investment income tax, as well as the Section 199A deduction. The regulations under Section 1411 also includes a Safe Harbor rule for real estate professionals.

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[21] Ibid.

[22] See e.g. *Commissioner v. Groetzinger*, determining a trade or business under Section 162 "requires an examination of the facts in each case," and that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify."

[23] Section 6662(d)(1)(C), added by P.L. 115-97, reduced the threshold for underpayment penalties from 10 percent of the tax required to be shown on the return for the tax year, to 5 percent, for taxpayers claiming a deduction under Section 199A.

[24] Section 199A(b)(1)(B)

[25] Allowing for businesses to qualify for the Section 199A deduction based on 25 percent of W-2 wages and 2.5 percent of the unadjusted basis of depreciable property.

[26] 26 CFR 1.1411-5

New "Presumption Standard" for Independent Contractors/Former Employees

In the preamble, Treasury noted that it had received comments from taxpayers and practitioners that "it may be beneficial for employees to treat themselves as independent contractors…in order to benefit from the deduction under section 199A."[27] Treasury also notes that, while Section 530(b) of the Revenue Act of 1978 prohibits Treasury from issuing regulations related to employment status for purposes of employment taxes, the prohibition does not apply to Section 199A.[28]

In response, Treasury proposes to create a new "presumption" standard for former employees who subsequently become independent contractors (regardless of their classification for employment tax purposes). Under this new standard:

> "An individual that was properly treated as an employee for Federal employment tax purposes by the person to which he or she provided services and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services."[29]

Furthermore, the presumption may only be rebutted by the independent contractor "upon a showing by the individual that, under Federal tax law, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee."[30]

While AGC is sympathetic to concerns about misclassification, we have concerns with this proposal as outlined in the proposed regulations. The proposal would create a dual-standard for worker classification under the tax code, where a worker could be classified as an independent contractor for employment tax purposes, and an employee for purposes of claiming a deduction under 199A. Under this regulatory environment, an independent contractor could face a worst-case scenario of being liable for self-employment taxes, *and* unable to claim a 20 percent deduction on income that would otherwise qualify as QBI under Section 199A.

The construction industry is a unique industry that is project-based with a transitory workforce. Due to the nature of the industry, the use of independent contractors in the construction industry is common and serves a legitimate business purpose. According to a 2010 study by Navigant Economics, construction workers are often called from project to project, working for multiple construction companies frequently, for relatively brief periods.[31] The report also states that many construction companies are not large enough to keep specialized workers fully occupied at all times, or need the ability to respond to changes in demand, and thus benefit from engaging workers on a project-by-project basis.

While we acknowledge that the regulatory burden for this new "presumption standard" would fall primarily on former employees / independent contractors, rather than employers, AGC is sensitive of this burden due to the unique characteristics of the construction industry. A common career progression for craft workers and skilled tradesmen and women is to learn a specialized skill as an employee before striking out on their own as an independent contractor, where the services they provide would certainly be "substantially the same" as those they provided as an employee. It would be unfortunate if those

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[27] 83 Fed. Reg. at 40901
[28] Ibid.
[29] Prop. Treas. Reg. § 1.199A-5(d)(3)
[30] Ibid.
[31] *The Role of Independent Contractors in the U.S. Economy*, Jeffrey A. Eisenach, Navigant Economics, December 2010

individuals deciding to take this entrepreneurial step have a higher regulatory hurdle to clear if one of the businesses they contract with was a former employer.

If Treasury decides to proceed with this new "presumption standard" under Section 199A, then AGC strongly recommends creating an exemption for certain independent contractors from having to refute the presumption to the IRS, which would otherwise be a subjective determination depending on specific facts and circumstances. The exemption should consider the following factors:

1) **Income**. Broadly speaking, Section 199A set up a two-tiered regulatory framework for those under and over the threshold amount of $157,500 / $315,000. Individuals with income below the threshold amount are not subject to restrictions on SSTBs, W-2 wages, or depreciable capital. Exempting individuals with income below the threshold amount would be consistent with this lighter-touch regulatory approach to smaller businesses under Section 199A.
2) **Sources of Income**. The exemption should acknowledge that an independent contractor with multiple sources of income is exempt from the presumption standard.
3) **Industry Practice**. The exemption should consider industry practice, and whether the independent contractor is acting consistently with long-standing recognized practice in the industry of which he or she is a member.
4) **Timeframe**. Under the proposed regulations, it is unclear if the presumption standard applies to taxpayers in perpetuity. Treasury should make clear that independent contractors providing services to a former employer after a certain period of time are exempt from the presumption standard.

It is important to note that even with an exemption, independent contractors would still be subject to the regulatory and legal framework for worker classification under the IRS and the Department of Labor. Both agencies can and do challenge independent contractor classification, imposing penalties on both employers and individuals for misclassifying workers. Creating an exemption of the "presumption standard" using the criteria listed above would simply exempt *obvious* independent contractors from an additional, unnecessary layer of regulatory scrutiny.

Conclusion

On behalf of AGC, thank you for considering our comments on the proposed regulations. Ensuring that the proposed regulations for Section 199A are workable, clear, and in line with Congressional intent is integral to the broader success of the *Tax Cuts and Jobs Act*. If you have any questions please direct them to Matthew Turkstra, Director of Tax, Fiscal Affairs, and Accounting at 202-547-4733, or matt.turkstra@agc.org.

Sincerely,

Matthew Turkstra
Director, Tax, Fiscal Affairs, and Accounting