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WASHINGTON, DC

Public Interest Comment<sup>1</sup> on  
The Internal Revenue Service Proposed Rule  
Qualified Business Income Deduction

Docket ID No. REG-134652-18  
RIN: 1545-BP12

April 8, 2019

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## The George Washington University Regulatory Studies Center

The George Washington University Regulatory Studies Center improves regulatory policy through research, education, and outreach. As part of its mission, the Center conducts careful and independent analyses to assess rulemaking proposals from the perspective of the public interest. This comment on the Internal Revenue Service (IRS) proposed rule on the Qualified Business Income Deduction does not represent the views of any particular affected party or special interest, but is designed to evaluate the effect of the IRS proposal on overall consumer welfare.

### Introduction

Section 199A of the Tax Cuts and Jobs Act of 2017 reduced the maximum corporate income tax rate from 35 percent to 21 percent. Most businesses, however, are sole proprietorships and partnerships; their income is passed through to the owners and taxed at the owner's marginal personal income tax rate. The tax reform legislation provided a deduction equal to 20 percent of qualified business income for owners of businesses operated through sole proprietorships, partnerships, S corporations, trusts, or estates.

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<sup>1</sup> This comment reflects the views of the authors, and does not represent an official position of the GW Regulatory Studies Center or the George Washington University. The Center's policy on research integrity is available at <http://regulatorystudies.columbian.gwu.edu/policy-research-integrity>.

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The legislation also provided a 20 percent credit for individuals and some trusts and estates for qualified income from real estate investment trusts (REITs) and publicly traded partnerships (PTPs). These entities typically pass through both income and tax liabilities to the owners. Final regulations implementing most aspects of Section 199A were published in the *Federal Register* on February 8, 2019.<sup>3</sup>

The current rulemaking addresses several topics not addressed in those final regulations.<sup>4</sup> The proposed regulation specifies how to treat previous suspended losses when calculating the 199A deduction, allows the deduction to be passed through to investors who own REITs through a regulated investment company (RIC) (such as a mutual fund), declines to pass through the deduction to investors who own PTPs through a RIC, and specifies special calculations applicable to some trusts and estates.

This comment focuses on the proposed rule's treatment of distributions from REITs and PTPs owned by RICs. We offer three suggestions that could help the IRS better identify the consequences of alternative approaches:

- 1. Use a pre-199A baseline in the economic analysis.** The IRS is deciding whether income from REITs and PTPs owned by RICs should benefit from the same 199A deduction that the statute provides for income from REITs and PTPs owned directly by individual taxpayers. The IRS cannot know whether *extending* the 199A deduction is economically efficient unless it knows whether the 199A deduction itself moves the tax code toward or away from economic efficiency. To discover this, the economic analysis must compare the efficiency of the tax code with and without the 199A deduction.
- 2. Assess social benefits and costs of the 199A deduction.** The overall economic benefit of the 199A deduction (and the marginal benefit of extending it to REITs and PTPs owned by RICs) is the increase in the value of output from REITs and PTPs because the reduced tax rate lowers their cost of capital. The social cost of this deduction is the reduction in output from other sectors of the economy that must bear a higher tax burden to fund the deduction.
- 3. Reconsider the decision to treat PTPs differently.** If the economic analysis we suggest shows that the 199A deduction is economically efficient, we see little reason to treat RIC distributions of PTP income differently from RIC distributions of REIT income. The notice of proposed rulemaking (NPRM) argues that allowing the 199A deduction would create excessive complexity for taxpayers due to its interaction with other tax rules that apply to

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<sup>3</sup> Department of the Treasury, Internal Revenue Service, "Qualified Business Income Deduction, Final Regulations," 80 Fed. Reg. 2952 (2019). (Hereinafter referred to as "Final 199A Regulations.")

<sup>4</sup> Department of the Treasury, Internal Revenue Service, "Qualified Business Income Deduction, Notice of Proposed Rulemaking," 84 Fed. Reg. 3015 (2019). (Hereinafter referred to as "NPRM.")

PTPs. Individual taxpayers, however, are free to decide whether the tax savings are worth shouldering the additional complexity.

## Background

The proposed regulations would allow RICs that own REITs to pay out the REIT dividends as 199A dividends to their shareholders, and shareholders who are individuals could take a 20 percent tax credit against these dividends. The IRS declined, however, to extend similar “conduit” treatment to shares of PTPs held by RICs.

*REITs.* REITs are companies that own, operate or finance income-producing real estate in a range of property sectors. These companies have to meet a number of requirements to qualify as REITs. Most REITs trade on major stock exchanges, and they offer a number of benefits to investors.<sup>5</sup> Modeled after mutual funds, REITs provide all investors the chance to own real estate, receiving dividend-based income and capital gains.<sup>6</sup> Congress created the REIT structure in 1960 and specifically excluded REITs from corporate taxation, preserving the pass-through nature of the structure.<sup>7</sup> There are approximately 167 publicly traded REITs.<sup>8</sup> According to the National Association of Real Estate Investment Trusts (NAREIT), the total of number of all REITs is 226, with an aggregate market capitalization of more than \$1 trillion.<sup>9</sup>

*PTPs.* A PTP is a type of limited partnership managed by two or more partners (individuals, other partnerships, or corporations) and traded consistently on an established securities market. It is funded by limited partners who bring capital but have no management responsibilities. Publicly traded partnerships combine the benefits of publicly traded securities and limited partnerships. Essentially, a publicly traded partnership offers beneficial taxation and also advantageous liquidity. Partners avoid paying corporate income taxes at the federal and state levels.<sup>10</sup> PTPs are pass-through entities that are treated as partnerships for taxation purposes. The partnership is not taxed, but the dividend income distributed to partners is taxed at the individual’s tax rate.

PTPs are frequently referred to as Master Limited Partnerships (MLPs).<sup>11</sup> The National Association of Publicly Traded Partnerships (NAPTP) recently rebranded itself as the Master

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<sup>5</sup> National Association of Real Estate Investment Trusts (NAREIT), “What’s a REIT,” <https://www.reit.com/what-reit>.

<sup>6</sup> Ibid.

<sup>7</sup> Stephen J. Maresca et. al., “Midstream Energy MLPs Primer 3.0,” Morgan Stanley Research (April 17, 2013), p.17.

<sup>8</sup> Sure Dividend, “2019 List of All 167 Publicly-Traded REITs,” <https://www.suredividend.com/reit-list/>

<sup>9</sup> NAREIT, “U.S. REIT Industry Equity Market Cap,” <https://www.reit.com/data-research/reit-market-data/us-reit-industry-equity-market-cap>

<sup>10</sup> Upcounsel, “Publicly Traded Partnership: Everything You Need to Know,” <https://www.upcounsel.com/publicly-traded-partnership>.

<sup>11</sup> “NAPTP Becomes the Master Limited Partnership Association,” CISION PR Newswire (September 8, 2015).

Limited Partnership Association (MLPA).<sup>12</sup> Both PTPs and MLPs are partnerships that have chosen to be taxed as a partnership but are publicly traded.<sup>13</sup> MLPs are partnerships that trade on public exchanges or markets. For tax efficiency they are structured as pass-through partnerships, rather than as public corporations. They trade in the form of units (akin to the common stock of C-corporations). MLPs pay no corporate level taxes, which are borne by unit holders (shareholders) at their individual tax rate.<sup>14</sup>

There are 114 operating MLPs in the USA today, with an aggregate market capitalization of over \$554 billion.<sup>15</sup> The MLP market is a shrinking market. Before the 2017 tax law was passed, MLPs were being converted to C-corporations at a slow but steady rate. Since the passage of the tax act in 2017, the pace of conversions has increased.<sup>16</sup>

Between 2005 and 2015, the share of MLPs owned by institutional and foreign investors increased.<sup>17</sup> Corporate, trust, and IRA/SEP investors increased as a share of total from 37 percent in 2005 to 44 percent in 2015. Foreign investors increased their share from 2 percent in 2005 to 6 percent in 2015. The share of individual ownership of MLP unit shares decreased from 46 percent in 2005 to 34 percent in 2015.

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<sup>12</sup> For purposes of this PIC, we use PTP and MLP interchangeably.

<sup>13</sup> Maresca et. al, "Midstream Energy MLPs Primer 3.0," p. 56

<sup>14</sup> Ibid., p. 3

<sup>15</sup> MLP Association, "List of Current MLP and MLP Funds," <https://www.mlpassociation.org/mlp-101/list-of-current-mlps/> (March 1, 2019).

<sup>16</sup> Simon Moore, "Why We're Seeing MLP Conversions After The Tax Changes," *Forbes*, (July 28, 2018). <https://www.forbes.com/sites/simonmoore/2018/07/28/why-were-seeing-mlp-conversions-after-the-tax-changes/#365b62145125>.

<sup>17</sup> Alerian, "Why Foreign Ownership in MLPs Is Up 300% Over the Last 10 Years" (November 8, 2016). <https://www.alerian.com/why-foreign-ownership-in-mlps-is-up-300-over-the-last-10-years/>.

Figure 1: Ownership trends for MLPs

Foreign and Institutional Investment Has Grown  
MLP Unit Ownership Breakdown



Source: PWC as of December 31, 2015

Source: Alerian, “Why Foreign Ownership in MLPs Is Up 300% Over the Last 10 Years” (November 8, 2016).

**RICs.** RICs are investment vehicles that allow investors to hold one security with a diversified portfolio of other funds, including REITs and MLP/PTPs. RICs are taxable as corporations for federal income tax purposes. Many unit trusts and most mutual funds are organized as RICs for tax purposes. If a RIC adheres to very specific requirements regarding portfolio diversification, types of assets, distribution minimums, and year-end reporting, it avoids taxation at the corporate level. Investors in RICs own units of the trust, not the underlying securities.<sup>18</sup>

If a RIC has certain items of income or gain, subchapter M also provides rules under which a RIC may pay dividends that a shareholder in the RIC may treat in the same manner (or a similar manner) as the shareholder would treat the underlying item of income or gain if the shareholder realized it directly. Although this treatment differs fundamentally from the pass-through treatment of partners or trust beneficiaries, the IRS refers to this as “conduit treatment.” Under the proposed regulation, shareholders in a RIC with investments in pass-through entities like REITs could deduct 20 percent

<sup>18</sup> Invesco Ltd., “Understanding Regulated Investment Companies,” <https://www.invesco.com/pdf/U-RIC-FLY-1-E.pdf>.

of the REIT income. PTPs are the only asset a RIC can own that qualify for pass-through tax treatment but not the 199A deduction.<sup>19</sup>

## A pre-199A Baseline Would Allow the IRS to Identify the Most Efficient Alternatives

The proposed regulation is economically significant<sup>20</sup> and hence subject to OIRA review under the April 11, 2018, Memorandum of Agreement (MOA) between the Department of the Treasury (Treasury) and the Office of Management and Budget (OMB).<sup>21</sup> As such, the regulation, supporting economic analysis, and the way the analysis affects decisions could set a major precedent for future significant tax regulations. The MOA notes that all provisions of Executive Order 12,866 not explicitly modified by the MOA apply to tax regulatory actions reviewed by OMB.<sup>22</sup>

The IRS's very brief economic analysis compares the results of the proposed regulation with a "no action" baseline that assumes the 2017 statute is in place, but no regulation is issued.<sup>23</sup> Essentially, the IRS takes responsibility only for analyzing the effects of the regulatory changes it is making.

This approach runs directly counter to the regulatory impact analysis guidance in OMB Circular A-4, which emphasizes that a pre-statute baseline is preferable:

In some cases, substantial portions of a rule may simply restate statutory requirements that would be self-implementing, even in the absence of the regulatory action. In these cases, you should use a pre-statute baseline. If you are able to separate out those areas where the agency has discretion, you may also use a post-statute baseline to evaluate the discretionary elements of the action.<sup>24</sup>

In the case of tax regulations, use of a pre-statute baseline is essential. If the IRS seeks to determine whether alternative regulatory options move the tax system toward or away from economic efficiency, it must first know the efficiency consequences of the portion of the underlying statute that the regulation implements. If the statute makes the tax system more economically efficient, then regulations that implement the statute neutrally are likely to enhance efficiency. But if the statute makes the tax system less economically efficient, then non-neutral implementing regulations crafted to limit the inefficiency created by the statute could be the most efficient option.

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<sup>19</sup> NPRM, pp. 3016-7.

<sup>20</sup> NPRM, p. 3020.

<sup>21</sup> Brent McIntosh and Neomi Rao, Memorandum of Agreement, The Department of the Treasury and the Office of Management and Budget, Review of Tax Regulations Under Executive Order 12866 (April 11, 2018).

<sup>22</sup> Treasury-OMB Memorandum of Agreement, p. 2.

<sup>23</sup> NPRM, p. 3020.

<sup>24</sup> Office of Management and Budget, "Circular A-4: Regulatory Analysis" (September 17, 2003), pp. 15-16.

Since the IRS economic analysis is silent on the efficiency of the 199A deduction, it can only say that the proposed regulation “encourages decision-making that is economically efficient *contingent on the provisions of the overall Code.*”<sup>25</sup> Since the IRS has not evaluated the economic efficiency of the underlying statutory provisions, this qualification is tantamount to saying that the IRS does not really know the efficiency consequences of the proposed regulatory provisions.

The proposed regulations regarding 199A treatment of distributions from REITs and PTPs owned by RICs provide a salient case in point. Prior to the 2017 tax reform, corporate income was taxed more heavily than REIT and PTP income. The 2017 tax reform narrowed this difference by reducing the corporate income tax rate. Regulators need to know whether a preferential tax rate for REIT and PTP incomes is economically efficient in order to determine whether expanding or limiting the availability of the 199A deduction is the more efficient regulatory option.

For the purpose of assessing this proposed rule, the IRS need not evaluate the entire 2017 tax reform compared to the pre-reform baseline. But it should evaluate the efficiency of the 199A deduction, then evaluate the efficiency of extending the 199A deduction to income from REITs and PTPs owned by RICs.

We provide some illustrative calculations below that indicate the underlying logic of the analysis we suggest. Table 1 compares the tax rates applicable to C-corporation income and to REIT and PTP income before and after the 2017 tax reform.<sup>26</sup> The total marginal tax burden on C-corporation income is the sum of the corporate income tax rate plus the individual taxpayer’s marginal rate on capital gains or qualifying dividends. The total marginal tax burden on income from REITs and PTPs is the individual’s regular marginal income tax rate, adjusted for the effect of any 20 percent 199A credit that is allowed. Therefore, the second two columns of the table show post-reform tax rates on REIT and PTP income with and without the 199A credit.

Prior to the 2017 tax reform, investors paid a higher tax rate on corporate income than on REIT or PTP income because of the relatively high U.S. corporate income tax rate. After the 2017 reform, the tax rate comparison depends critically on whether REIT and PTP income receives the 199A credit. Without the credit, REIT or PTP income received by taxpayers in the highest three brackets is taxed at close to the same rate as C-corporation income they receive. REIT or PTP income received by taxpayers in the lowest brackets is taxed at a much lower rate than C-corporation income. The 199A deduction changes this result dramatically, producing significantly lower tax rates on REIT and PTP income than on C-corporation income for taxpayers in all brackets.

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<sup>25</sup> NPRM, p. 3020, emphasis added. This caveat also appears multiple times in the IRS economic analyses of the final 199A regulations published on the same data, because the IRS employed a post-statutory baseline to assess the effects of those regulations. See Final 199A regulations, pp. 2981, 2982, and 2983.

<sup>26</sup> For illustrative purposes, it uses the rates applicable to a taxpayer filing as a single individual.

Table 1: Comparison of tax rates for C-corporation and REIT/MLP income

Tax Category	2017	Post-reform without 199A deduction	Post-reform with 199A deduction
<b>C-corporation (effect of corporate income tax plus individual qualified dividend/capital gains rate)</b>			
Upper income	48.0%	36.8%	36.8%
Middle upper income	45.8%	32.9%	32.9%
Lower upper income	45.8%	32.9%	32.9%
Upper middle income	45.8%	32.9%	32.9%
Middle income	45.8%	32.9%	32.9%
<b>REIT/MLP (individual marginal tax rate on nonqualified dividends)</b>			
Upper income	39.6%	37.0%	29.6%
Middle upper income	35.0%	35.0%	28.0%
Lower upper income	33.0%	32.0%	25.6%
Upper middle income	28.0%	24.0%	22.0%
Middle income	25.0%	22.0%	17.6%

Source: Authors' calculations based on tax rate schedule in Internal Revenue Service, *1040 Instructions: 2018 Tax Year*; Kyle Pomerleau, "2017 Tax Brackets," <https://taxfoundation.org/2017-tax-brackets/>; Todd Campbell, "Dividend Tax Rates in 2017: How Much Will I Owe?," <https://www.fool.com/retirement/2017/01/28/dividend-tax-rates-in-2017-how-much-will-i-owe.aspx>. Tax brackets for 2017 and post-2017 do not necessarily cover the exact same income ranges.

In the current proceeding, the IRS faces the choice between allowing the 199A deduction for REIT and PTP income only where the statute explicitly provides for the deduction, or expanding the 199A deduction by allowing it for REIT and PTP income distributions from RICs. If there is no economic efficiency reason to tax REIT and PTP income at a lower rate than C-corporation income, then the efficient option is likely to limit the deduction to the cases provided for in the statute where investors directly hold REITs and PTPs. If taxing REIT and PTP income at a lower rate than C-corporation income promotes economic efficiency, then the efficient option is likely to allow the deduction when investors receive REIT and PTP income from RICs.

But the IRS cannot know which option promotes efficiency unless its economic analysis assesses the efficiency of the underlying policy of taxing REIT and PTP income at a lower rate than C-corporation income. Using a pre-199A baseline would generate this analysis; using a post-199A baseline does not.



## Estimating Benefits and Costs of Preferential Tax Treatment

One way of assessing the efficiency of extending preferential tax treatment of REITs or PTPs is to compare the benefits and costs of this policy to the U.S. economy.

The preferential tax treatment creates a transfer from taxpayers in general to the owners of investments that receive the preferential treatment. This transfer is neither a benefit nor a cost. But the reduction in tax rates for the recipients of the transfer could cause an expansion of output in the affected industry by lowering its cost of capital; the value of this output expansion is the benefit of the preferential tax treatment. Other taxpayers will pay higher tax rates in order to finance the transfer. The value of output lost because other sectors of the economy contract in response to these higher tax rates is the cost of the policy.

The economic analysis in the NPRM makes no attempt to quantify the number of taxpayers affected, the amount of revenue affected, or the effects on output or GDP for either the entire statutory provision 199A or the tweaks represented by this regulation. Here we present some illustrative calculations and observations that may assist the IRS in developing such an analysis, using available data on MLPs and REITs.

### MLPs

Aggregate data on dividends paid out by MLPs are difficult to find. However, using available data on MLP prices, market capitalization, and dividend yields, we estimated the amount of dividends paid out annually by MLPs. Multiplying the price per unit share by the dividend yield rate provides an estimate of the dividend paid per unit. Dividing the market capitalization of the fund by the price of the fund provides an estimate of the number of units owned of the fund. Multiplying the number of units with dividend per unit provides an estimate of the annual dividends paid per fund. Finally, summing the annual dividends paid by each fund provides an estimate of total dividends paid by MLPs.

### Box 1: Equations used to estimate total dividends

$$1. \quad D_i = P_i * DY_i$$

Where  $D_i$  is dividends per unit of fund  $i$  from  $\{1...114\}$ ;  
 $P_i$  is price per unit for fund  $i$  from  $\{1...114\}$ ; and  
 $DY_i$  is dividend yield for fund  $i$  from  $\{1...114\}$ .

$$2. \quad U_i = MC_i/P_i$$

Where  $U_i$  = Units owned of fund  $i$  from  $\{1...114\}$ ;  
 $P_i$  is price per unit for fund  $i$  from  $\{1...114\}$ ; and  
 $MC_i$  = market capitalization of fund  $i$  from  $\{1...114\}$ .

$$3. \quad \text{Total Annual Dividends} = \sum_1^{114} (D_i * U_i) = \sum_1^{114} AD_i$$

Where  $D_i$  is dividends per unit of fund  $i$  from  $\{1...114\}$ ;  
 $U_i$  = Units owned of fund  $i$  from  $\{1...114\}$ ;  
 $AD_i$  = Annual dividends from fund  $i$  from  $\{1...114\}$ .

Using the complete list of 114 publicly traded MLPs in 2019,<sup>27</sup> we estimate that with a market capitalization of approximately \$554.9 billion, MLPs paid dividends of approximately \$40.3 billion in 2018. The cumulative dividend yield is 7.3 percent.

As noted above, an estimated 44 percent of MLP investors are institutional (RIC) taxpayers and 34 percent are individual taxpayers. Taxpayers who own MLPs through RICs would pay taxes on \$17.748 billion in dividends;<sup>28</sup> individuals who own MLPs directly would pay taxes on \$13.714 billion. Table 2 compares the taxes paid on MLP incomes using 2017 tax rates, 2018 tax rates with no 199A deduction, and 2018 tax rates with the 199A deduction. Allowing the 199A deduction for distributions from MLPs held by individuals leads to a revenue loss of approximately \$1 billion (\$1.371 billion minus \$357 million). The incremental impact of extending the 199A deduction to distributions from MLPs held by RICs would be a revenue loss of approximately \$1.3 billion (\$1.775 billion minus \$461 million).

<sup>27</sup> Suredividend.com provides an up to date list of publicly traded MLPs.

<sup>28</sup> A not insignificant portion of the institutional investments would be held by pension plans and tax-favored accounts like IRAs, which presumably would not benefit from the 199A deduction. Thus, our calculations likely over-estimate the revenue loss. The IRS could likely provide a more accurate and granular analysis using the Statistics of Income database.

Table 2: 2017 Tax reform impacts on MLP investors

Tax Category	2017 and earlier	2018 without 199A deduction	2018 with 199A deduction
<b>MLP tax rates</b>			
Held by RICs	39.6%	37.0%	29.6%
Held by individuals	39.6%	37.0%	29.6%
<b>MLP expected tax paid (in billions)</b>			
Held by RICs	\$7.028	\$6.567	\$5.253
Held by individuals	\$5.431	\$5.074	\$4.059
<b>Expected revenue loss vs. 2017 (in millions)</b>			
Held by RICs		\$461.444	\$1,774.786
Held by individuals		\$356.571	\$1,371.425

Source: Authors' calculations based on methods and data sources described in text.

Because we do not have data showing how much MLP income was received by taxpayers in different tax brackets, we assume that all MLP income was received by taxpayers in the highest tax bracket. Thus, our estimates of total tax revenues and revenue losses are at the high end of the possible range. The IRS could likely conduct a more granular analysis using its *Statistics of Income* database.

## REITs

We ran a similar analysis for publicly traded REITs using the SureDividend.com data. As with the MLP example, we multiplied the price per unit share by the dividend yield rate to estimate the dividend paid per unit. Dividing the market capitalization of the fund by the price of the fund provides an estimate of the number of units owned of the fund. Finally, multiplying the number of units by the dividend per unit provides an estimate of the annual dividends paid per fund. Summing the annual dividends paid per fund provides total dividends paid by publicly traded REITs.

Using the complete list of 167 publicly traded REITs in 2019,<sup>29</sup> we estimate that with a market capitalization of approximately \$1.05 trillion, REITs paid dividends of approximately \$44.645 billion in 2018. The cumulative dividend yield is 4.2 percent. This result matches with expectations from economic theory. REITs are less risky investments than MLPs and therefore do not offer the same level of return as MLPs (7.3 percent for MLPs vs 4.2 percent for REITs).

Retail and individual ownership of REITs amounts to only 21 percent of the REIT market. The remaining 79 percent are institutional investors. Approximately 80 million Americans own shares

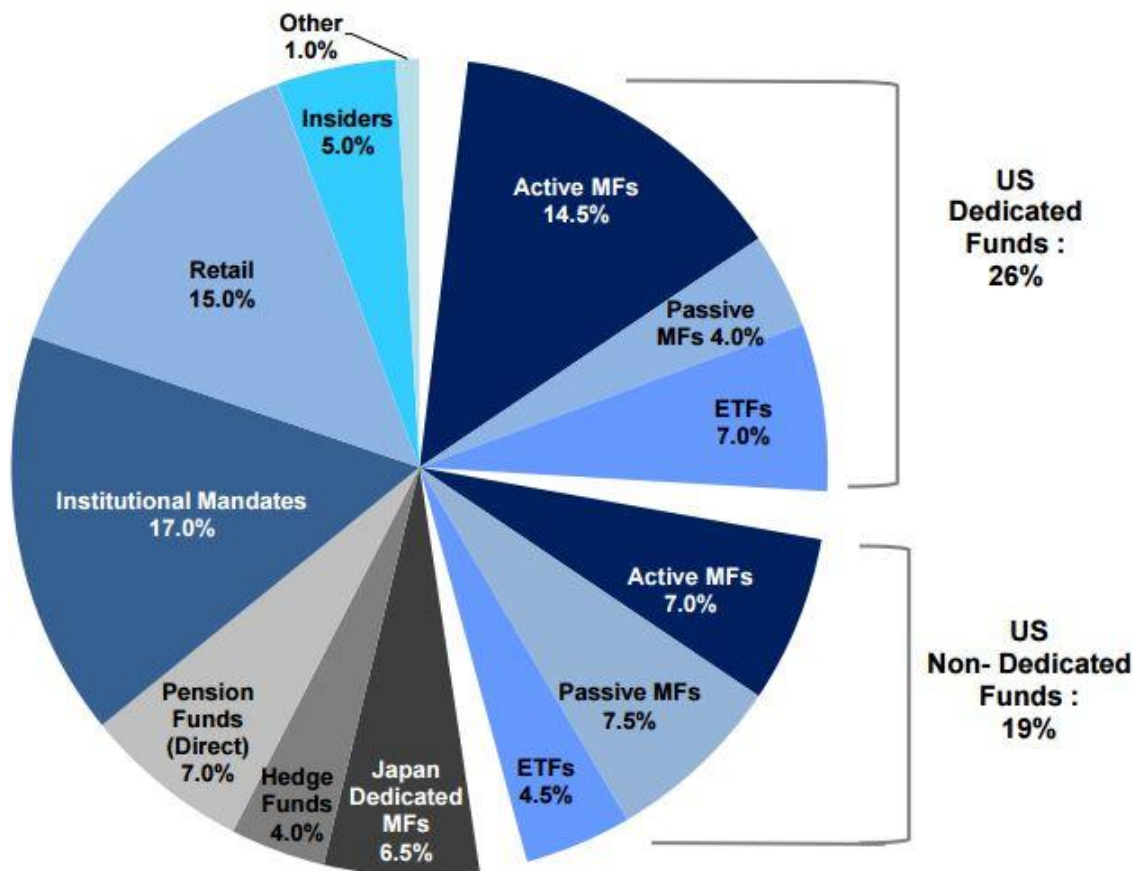
<sup>29</sup> Suredividend.com provides an up to date list of publicly traded REITs.

in REITs through pension funds, IRAs and SEP accounts as part of the institutional investor total.<sup>30</sup> Given the size of the REIT market, institutional investors will be most heavily affected by the tax law changes.

Figure 2 breaks out the owners of REIT shares by investor category. REITs have a very diverse investment base with no one category of investor representing more than 17 percent of the total. Retail investors are 15 percent of the total, while the largest institutional investor classes are institutional mandates and dedicated active U.S. mutual funds at 17 and 14.5 percent respectively.

Figure 2 - REIT Ownership by Investor Source:

Figure 4. REIT Ownership by Investor Source



Source: Citi Research, SNL, Lipper, FactSet

Source: Wayne Duggan, "The Top REITs That Mutual Funds Are Buying And Selling," Bezinga.com (September 15, 2015). Note: "MF" stands for "mutual funds."

<sup>30</sup> Wayne Duggan, "The Top REITs That Mutual Funds Are Buying and Selling," Bezinga.com (September 15, 2015). Pension plans and tax-favored accounts like IRAs presumably would not benefit from the 199A deduction. Thus, our calculations likely over-estimate the revenue loss. The IRS could likely provide a more accurate and granular analysis using the Statistics of Income database.

As noted above, an estimated 79 percent of REIT investors are institutional (RIC) taxpayers and 21 percent are individual taxpayers. Total REIT dividends are estimated to be \$44.645 billion, which works out to a 4.2 percent yield. The institutional investors account for \$35.270 billion of the total dividends. Individual taxpayers who own REITs through RICs earn \$9.376 billion in dividends. Table 3 compares the taxes paid on REIT dividends using 2017 tax rates, 2018 tax rates with no 199A deduction, and 2018 tax rates with the 199A deduction.

Table 3: 2017 Tax Reform Impacts for REITs

Tax Category	2017 and earlier	2018 without 199A deduction	2018 with 199A deduction
<b>REIT Tax Rates</b>			
Held by RICs	39.6%	37.0%	29.6%
Held by Individuals	39.6%	37.0%	29.6%
<b>REIT Expected Tax Paid (in millions)</b>			
Held by RICs	\$13,966.83	\$13,049.82	\$10,439.85
Held by Individuals	\$3,712.70	\$3,468.94	\$2,775.15
<b>Expected Revenue Loss vs 2017 (in millions)</b>			
Held by RICs		\$917.01	\$3,526.98
Held by Individuals		\$243.76	\$937.55

Extending the 20 percent deduction to REITs owned in RICs would increase the expected tax revenue loss by \$2.6 billion (\$13.0 billion less \$10.4 billion). The incremental loss from the 199A deduction for individuals is \$694 million (\$3.47 billion less \$2.78 billion).

### Additional Required Research

To assess social benefits and costs, the IRS would need to estimate how the tax rate reduction would affect the value of output produced by the segment of industry receiving the lower tax rate due to the 199A deduction and how the taxes needed to finance the transfer would affect the value of output produced by the rest of the economy. It appears that Treasury may be developing relevant analytical methods when it seeks to estimate the “nonrevenue impacts” of regulations. The NPRM on “Rules Regarding Certain Hybrid Arrangements” states that Treasury used confidential tax data to estimate how proposed regulatory changes would alter the effective tax rates of affected taxpayers, then calculated how the change in tax rates could be expected to alter real economic activity.<sup>31</sup> To develop separate figures for the benefits and costs of extending the 199A deduction, the IRS and Treasury should perform this type of calculation both for the groups of taxpayers who

<sup>31</sup> Department of the Treasury, Internal Revenue Service, “Rules Regarding Certain Hybrid Arrangements,” Fed. Reg. 83:284 (Dec. 28, 2018), p. 67626.

receive lower tax rates due to the 199A deduction and for all other taxpayers who implicitly pay higher taxes to fund the transfer.

### Differential treatment of PTPs vs. REITs owned by RICs

The NPRM's economic analysis covers only the REIT provision. It asserts that allowing RICs to pay out REIT income as 199A dividends promotes economic efficiency because it makes implementation more neutral; investors receive the 199A deduction on REIT income regardless of whether they own REITs directly or through a RIC.<sup>32</sup> In reality, for reasons discussed above, the economic analysis provides insufficient basis for determining whether this extension of the 199A deduction promotes or undermines economic efficiency.

The IRS did not propose similar treatment for income from PTPs held by RICs. This decision treats investors who own PTPs through RICs less advantageously than investors who own PTPs directly. This disparity seems to violate neutrality, but the economic analysis section is silent on this point.

The IRS justifies this decision based on the unique nature of the phase-out limitations for PTP income. PTP income is broken out into separate specified service trades or businesses (SSTBs). SSTBs, for purposes of the IRS, include the processing, production, extraction, drilling, mining, refining, transportation, warehousing and shipping of commodities, like oil and gas.<sup>33</sup> A taxpayer may earn SSTB income, by investing in a PTP, which qualifies for the 199A deduction if the taxpayer's income falls below the threshold amount, but not for taxpayers with taxable income above the top of the phase-out range. For taxpayers with taxable income in the phase-out range, a portion of PTP income attributable to an SSTB is qualified PTP income.<sup>34</sup> According to the IRS, the complexity and potential confusion the 199A deduction might create for RIC investors is arguably inconsistent with the relative simplicity that the tax system has historically provided for RIC investors.

However, a RIC investor would face additional paperwork and complexity only if he or she sought to take the 199A percent deduction against PTP income. The individual's tax calculation may become more difficult, but the taxpayer can decide whether to shoulder the additional burden in exchange for tax savings. The taxpayer could avoid additional complexity by not taking the 199A credit against PTP income paid out by a RIC.

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<sup>32</sup> NPRM, p. 3020.

<sup>33</sup> U.S. Treasury Regulations §1.199A-5(b)(2)(xiii)(B)(3) through (5).

<sup>34</sup> NPRM, p. 3017.

Therefore, if the IRS determines that allowing RICs to pay out REIT distributions as 199A dividends is the economically efficient tax policy, we see little reason not to apply the same policy to PTP distributions by RICs.

## Conclusion

The economic analysis in the NPRM is insufficient to determine whether extending the 199A deduction to investors who own REITs and PTPs through RICs is the efficient tax policy. Consequently, the analysis is insufficient to justify the proposed differential treatment between RIC shareholders of PTP units versus direct unitholders of PTPs.

A complete economic analysis would start by choosing the appropriate baseline for comparison, which in this case would be the state of the world without the 199A deduction. The analysis should estimate number of affected taxpayers, the changes in tax rates, and the magnitude of the changes in expected tax revenue from the 199A deduction written into the statute and the additional extensions to REIT and PTP units held by RICs. Finally, it should assess the economic impact of such changes by evaluating the change in the value of output produced by the sectors experiencing the reduced relative tax burden and by the sectors that would bear a relatively higher tax burden to fund this tax reduction. Only then can the IRS determine whether the proposed tax treatment of income from REITs and PTPs improves or impairs economic efficiency.