Impact of Recent Guidance on Rental Real Estate
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Basic Overview of Sec. 199A Deduction

• 20% deduction for non-corporate taxpayers for qualified items of income (QBI) from passthrough business activities (e.g., partnerships and S corporations) that are qualified trades or businesses (QTBs).
  – PLUS 20% of qualified REIT dividends and qualified publicly traded partnership (PTP) income.
• QTB does not include a specified service trade or business (SSTB) or trade or business of performing services as an employee.
• Reduces tax rate on QBI to an effective rate of 29.6%.
• Penalty for substantial understatement change is now based on 5% threshold if you claim the Sec. 199A deduction.
Overview (cont.)

• Deduction is the combined qualified business income amount (combined QBI), not to exceed 20% of taxable income reduced by net capital gains.

• Combined QBI is the sum of 20% of the QBI from each QTB, not to exceed the greater of (1) 50% of the QTB’s W-2 wages (the wage limit) or (2) 25% of the QTB’s W-2 wages plus 2.5% of the tax basis of the unadjusted basis immediately after acquisition (UBIA) for certain qualified property (the basis limit).
  – More on UBIA later

• Wage/basis limits kick in for taxpayers with income above thresholds.

Sec. 199A – Threshold Amounts

• Threshold amounts
  – Exception for a specified service trade or business does not apply if the taxpayer has less than or equal to $315,000 (MFJ) or $157,500 (other) of taxable income before the deduction.
  – Benefit is phased out over the next $100,000 (MFJ) or $50,000 (other) of taxable income before the deduction.

• W-2 wage/adjusted basis limits do not apply to taxpayers under these income thresholds

• SSTB limitations do not apply under the threshold amount
Current Guidance

• **Final regulations**
  – Finalize August 2018 proposed regulations and are generally applicable to tax years ending after February 8, 2019
  – However, taxpayers may rely on the August 2018 proposed regulations (in their entirety) for tax years ending in 2018

• **Proposed regulations on RICs and previously suspended losses**
  – Rules on previously suspended losses as QBI, REIT dividends paid by RICs, and charitable remainder trusts and split-interest trusts
  – To apply to taxable years ending after the date final regulations are published—taxpayers may apply the proposed regulations (in their entirety) before final regulations are published

• **Rev. Proc. 2019-11**
  – Finalizes proposed revenue procedure on methods for calculating W-2 wages
  – Applies for to tax years ending after December 31, 2017

• **Notice 2019-7**
  – Contains a proposed revenue procedure providing a safe harbor for treating rental real estate enterprise as a TOB for purposes of section 199A
  – The proposed revenue procedure applies for tax years ending after December 31, 2017, although taxpayers may apply the safe harbor until the proposed revenue procedure is published in final form
Final Regulations – Highlights and Hot Topics

• QBI:
  – Definition of net capital gain

• SSTB:
  – Special hedging rule – income, gain, or loss from a hedging transaction (as defined in § 1.1221-2(b)) entered into in the normal course of business is treated as income, deduction, gain, or loss from that trade or business

• Trade or business – facts and circumstances using Sec. 162 principles
  – Determining if more than one trade or business
  – Disregarded entities
  – Renting to related persons
  – Accompanying Notice on rental real estate activities

• Clarify mixed businesses

• Expansion of aggregation of trades or businesses to relevant passthrough entities (RPE)
  – Under the aggregation rule, residential and commercial operations are treated as activity are treated as separate trades or businesses. See, e.g., Example 17 of § 1.199A-4(d).

• Modifications to UBIA
QBI: Types of Income

• QBI only includes items of income, gain, deduction, and loss to the extent such items are both effectively connected with a U.S. trade or business (within the meaning of section 864(c)) and included or allowed in determining taxable income for the taxable year.

• QBI does not include:
  – Net capital gains (including net Sec. 1231 gains treated as capital)
  – Dividends and dividend equivalents
  – Certain commodity gains and losses
  – Certain foreign currency gains and losses
  – Certain notional principal contract income
  – Interest income that is not properly allocable to a trade or business such as interest on working capital and reserves (interest income on accounts or notes receivable on services or goods provided in the ordinary course of business is business related)

• QBI includes gain or loss attributable to assets of a partnership giving rise to ordinary income under section 751(a) or (b).
Other Exclusions from QBI

• QBI does not include:
  – Reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business.
    • An S corporation is required to pay reasonable compensation to shareholders who also serve as officers, directors or employees.
    • Partnerships and sole proprietorships are not required to pay reasonable compensation.
  – Any guaranteed payment described in Sec. 707(c) paid to a partner for the use of capital or for services rendered with respect to the trade or business.
  – Payment described in Sec. 707(a) to a partner for services rendered with respect to the trade or business.
  – Interest income on partner or shareholder loans will not be QBI, but the interest expense will offset the trade or business’s QBI if such deduction is properly allocable to the trade or business – unfavorable tax rate arbitrage.
Real Estate: Notice 2019-7

• Safe Harbor requires:
  – Separate books and records for each rental real estate enterprise
  – For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services per year with respect to the rental enterprise
  – For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year, 250 or more hours of rental services per year with respect to the rental real estate enterprise
  – Contemporaneous records, including time reports, logs, or similar documents, regarding the following:
    • hours of all services performed,
    • description of all services performed,
    • dates on which such services were performed, and
    • who performed the services
Real Estate: Notice 2019-7 (cont.)

• Safe harbor does not apply to:
  – Real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on this safe harbor) as a residence for any part of the year under section 280A.
  – Real estate rented or leased under a triple net lease.
    • Triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities.

• Commercial and residential real estate may not be part of the same rental real estate enterprise.
Trade or Business: Dealing with DREs

PRS

A

50%

B

50%

Residential

Residential

Commercial

Commercial

Residential

Commercial
Determining the UBIA of Qualified Property

- **UBIA** is generally property’s adjusted basis on the placed in service date as determined under section 1012, determined without regard to depreciation or other cost recovery adjustments.

- **Qualified property** is tangible property subject to depreciation under section 167(a) –
  - Held by, and available for use in, the trade or business at the close of the taxable year;
  - Used at any point during the taxable year in the trade or business’s production of QBI; and
  - The depreciable period for which has not ended before the close of the taxable year.
Determining UBIA (cont.)

• **Depreciable period** is the period beginning on the placed in service date and ending on the later of:
  – The date that is 10 years after such date, or
  – The last day of the applicable recovery period that would apply to the property under section 168(c), determined without regard to ADS or bonus depreciation.

• **Partner’s share of the UBIA** of qualified property is determined in accordance with how the partnership allocates depreciation under § 1.704-1(b)(2)(iv)(g) on the last day of the taxable year.
UBIA: Non-recognition Transactions

- Qualified property transferred in a transaction “described in §168(i)(7)(B)” (e.g., §§721 and 351) generally retains the transferor’s UBIA
- Transferee also generally steps into shoes of transferor in determining depreciable period
- Carryover basis is “decreased by the amount of money received by the transferor in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction” – the “Cash Boot Rule”
Contributions to Partnerships

- **Facts:** On December 1, 2019, C contributes rental real estate TOB that includes one item of qualified property (QP) to PRS in exchange for a 30% interest.
  - Before the contribution, PRS also operates a rental real estate TOB
  - After the contribution, PRS operates a single TOB
  - Both C and PRS used the QP in a trade or business in 2019, but only PRS holds the QP at the close of the taxable year.

- **Issue:** Can A, B, and C treat the PRS’s TOB after C’s contribution as the same TOB in which each partner owned an interest before the contribution?
  - If not, the partners could lose the benefit of section 199A for the first eleven months of the year.
  - Does it matter whether the contributed RE was commercial and the contributed RE was residential?
Cash Boot Rule: Questions

• What if qualified property as well as other property is transferred in a transaction subject to the Cash Boot Rule?
• Should similar rules apply to transfers of property other than cash?
• How is the Cash Boot Rule affected by application of the disguised sale rules under §707(a)(2)(B)?
• How are liabilities taken into account in applying the Cash Boot Rule?
• Should gain recognized by transferor be relevant?
Under former §708(b)(1)(B), a partnership was considered terminated if within a 12-month period there was a sale or exchange of 50 percent or more of total interests in partnership capital and profits.

As part of same law that enacted §199A (the TCJA), §708(b)(1)(B) was repealed for taxable years beginning after December 31, 2017.

Prior to the repeal of § 708(b)(1)(B), the recovery period of depreciable property restarted following a technical termination because §168(i)(7)(B) contained, in the flush language, a special rule excluding a technical termination from the step-in-the-shoes provision of §168(i)(7)(A).

– “Subparagraph (A) shall not apply in the case of a termination of a partnership under §708(b)(1)(B).”

– However, this special rule was removed from §168(i)(7)(B) when §708(b)(1)(B) was repealed.

Question: What is the impact of a prior year's technical termination on an asset's UBIA?
UBIA – §743(b) Basis Adjustment

• Portion of partner’s §743(b) basis adjustment, called an “excess section 743(b) basis adjustment,” is treated as qualified property.
  – Amount that represents partner’s §743(b) basis adjustment with respect to the same item of qualified property, as determined under §§1.743-1(b) and 1.755-1, but calculated as if AB of all of partnership’s property was equal to UBIA of such property.
  – **Absolute Value Limitation:** Excess §743(b) basis adjustment cannot exceed absolute value of total §743(b) basis adjustment with respect to the qualified property.
  – Depreciable period of excess section 743(b) basis adjustment (for §199A purposes) follows recovery period of §743(b) adjustment under §1.743-1(j).

• Question: What if the transferee’s tentative excess §743(b) basis adjustment is negative $100,000, but the actual §743(b) basis adjustment is positive $30,000?
**Facts:**
- PRS operates a rental real estate trade or business.
- On August 1, 2019, F sell its entire 30% interest in PRS to G for cash.
- PRS has one item of QP with a recovery period of ten years and a remaining depreciable period of five years.
- PRS has an election under section 754 in effect. Assume G’s excess section 743(b) basis adjustment is $20.

**Observation:**
- F has no share of the depreciation from QP on the last day of 2019.
- How much UBIA of QP is allocated to G? ($30 plus $20)
- What is the depreciable period of G’s UBIA of QP? (five years and ten years)
§163(j): General Rules

• Based on BEPS Action PLAN 4
• A taxpayer’s deduction for business interest expense (BIE) for any year is limited to the sum of
  – the taxpayer’s business interest income (BII); and
  – 30 percent of the taxpayer’s adjusted taxable income (ATI).
• Generally, ATI is a taxpayer’s taxable income without regard to
  – non-business items;
  – BII or BIE;
  – deductions with respect to NOLs and section 199A; and
  – for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.
Guidelines

• The limitation is determined at the partnership level.
  – Carryforward applied at partner level

• Exceptions for certain businesses, including electing real property trades or businesses (RPTOB), and an exemption for certain small businesses.
Small Businesses & the RPTOB Election

- Section 163(j)(3) exempts certain small business (other than a tax shelter as defined in section 448(a)(3)) from section 163(j) if they meet the gross receipts test of section 448(c).
- Section 163(j)(7)(B) provides that a trade or business does not include any electing RPTOB described in section 469(c)(7)(C).
- The preamble to the proposed regulations states that small businesses that are exempt under section 163(j)(3) may not make an election to be treated as a RPTOB.
  - This prohibition is not included in the statute or in the proposed regulations.
Real Property

- Proposed regulations under section 469(c)(7)(C) included in proposed section 163(j) package
- Provides three categories of real property: land, buildings and other inherently permanent structures
- Structure is similar to the § 1.856-10 regulations: definition of type of real property, safe harbor list of real property, facts and circumstances test for real property
- Certain assets are specifically carved out of real property including:
  - Property produced for sale is not real property (*e.g.*, bricks, nails, paint and window panes), but what about if the building itself or units in the building are produced for sale (*e.g.*, condos)
  - Cultivating and harvesting of plants, crops or trees
  - Machinery that serves an active function (*e.g.*, HVAC, elevator, escalator) is not real property
- REITs use the definition of real property under § 1.856-10
Section 163(j) and Tiered Partnerships

• The proposed regulations reserve guidance on application of section 163(j) to tiered partnerships, including
  – Guidance on EBIE in tiered partnerships
  – Whether carryforwards should be allocated through UTPs
  – How and when a UTP’s basis should be adjusted when an LTP is subject to a 163(j) limitation

• For example, if an LTP allocates EBIE to a UTP, UTP’s basis in LTP is reduced by the amount of the EBIE, notwithstanding that the EBIE is not currently deductible.
  – It is not clear whether the EBIE and the basis adjustment should tier up to UTP’s partners.
Self-Charged Lending Transactions

• The proposed regulations reserve guidance on rules for the proper treatment of BII and BIE with respect to lending transactions between a passthrough entity and an owner of the entity (“self-charged lending transactions”).

• The proposed regulations note that Treasury and the IRS intend to adopt certain rules to re-characterize, for both the lender and borrower, the BIE and corresponding BII arising from a self-charged lending transaction that may be allocable to the owner.

• This would prevent BII and BIE from entering or affecting the 163(j) limitation calculations for both the lender and the borrower in these situations.

• The rules would include an approach adopting rules similar in scope as those contained in § 1.469-7, dealing with the treatment of self-charged lending transactions for purposes of section 469.
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