Section 199A Regulations

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Fact Situation 1

Corp. X, a calendar year S corporation solely owned by Individual A, owns 4 rental properties, 2 duplexes, a multi-tenant commercial building which includes space used by some tenants only as office space and space used by one tenant for light manufacturing and storage of inventory, and a mixed-use project which includes a grocery store and restaurants on the first floor and 4 apartments on the second floor. With respect to the multi-tenant commercial building, the leases for the office space do not require tenants to pay any of the real estate taxes or property insurance, but do obligate them to reimburse the taxpayer for the maintenance the taxpayer provides in the tenant’s space, and the lease for the light manufacturing/storage space requires the tenant to perform or engage others to perform and to pay for all maintenance in the tenant’s space and to pay all taxes, operating expenses and casualty insurance (in addition to rent and utilities) allocable to the space on a square foot basis. No tenants in the duplexes or mixed-use property are obligated to pay any share of the taxes or casualty insurance. During the tax year A spends 200 hours providing “rental services” (as defined in the proposed safe harbor) to the duplexes, 200 hours providing rental services to the commercial building and 200 hours providing rental services to the mixed-use project. Corp. X and A are exploring use of the safe harbor. A considers himself engaged in a single business (rental of real estate).

Queries:

- What properties may or must be included in the same enterprise?
- May the taxpayer consider the duplexes and the residential portion of the mixed-use property to be a single enterprise? Must he?
- May the taxpayer consider the restaurant and grocery store portion of the mixed-use property and the office space portion of the multi-tenant commercial building to be a single enterprise? Must he?
Fact Situation 1 (cont’d)

• May any portion of the multi-tenant commercial building be included in the safe harbor determination? Or, is the building excluded from the safe harbor because part is subject to what some may consider a triple net lease?

• How did Treasury arrive at 250 hours for the trade or business safe harbor requirement?

• If the taxpayer does not opt to treat each property as a single enterprise, is it only commercial and residential properties that would not be included in the same enterprise? Or, does the use of the word “similar” in Section 3.02 mean that a taxpayer must assess degrees of similarity among properties within the commercial and residential categories?

• How is a taxpayer (who does not treat each property as a single enterprise) to treat mixed-use properties such as those that are part retail, part residential?

• What if a property has both triple net tenants and those that are not? Is the taxpayer to bifurcate the single property for purposes of determining the “enterprise”? Or is the property excluded from the protection of the safe harbor entirely?

• In the definition of “triple net lease,” what does the tenant being “responsible” for “maintenance activities” mean? Does that mean the tenant must both perform or engage the work and pay for it? Or is a tenant “responsible” for “maintenance activities” if the taxpayer performs/engages the work, and the tenant is only obligated to reimburse the taxpayer for the cost of the work?

• Is the definition of “triple net” in the proposed safe harbor intended to be exclusive? The text says refers to what a triple net lease “includes.”
Fact Situation 2

Corp. X is a calendar year S Corporation incorporated by individual A as its sole shareholder on January 1, 2018. Assume that Individual A’s basis in his or her stock is negligible.

For the next 10 years, Corp. X has $1 million of taxable income each year, all of which qualifies for the 20% section 199A deduction.

Corp. X retains all of that income during the years in question. There are no distributions.

A retains 100% of the stock during this entire period, reports $1 million of income for each of these years, and takes the full 20% section 199A deduction, thereby paying tax on $800,000 of income each year.

At the end of year 10, A sells all of his or her stock for $10 million.

Query:

• Assuming there are no unusual circumstances (capital contributions, death, etc.), is it safe to assume that A will have no gain or loss on the sale of his or her stock under Reg. §1.199A-1(e)(1)?
Fact Situation 3

Individuals A, B and C each own one-third of the profits and capital in each of LP1 an LP2, both of which are classified as partnerships for tax purposes. Each of LP1 and LP2 own a residential apartment building. LP1 and LP2 have no employees.

A, B and C each also own one-third of the stock of X Corp., a calendar year S corporation. X Corp. employs all of the individuals who manage and operate the two buildings, including employees who provide cleaning, trash removal, repair services, leasing, purchasing of supplies, accounting, information technology, and human resources. LP1 and LP2 pay X Corp. arm’s length fees under service agreements for these services.

The ownership of LP1, LP2, and X Corp. remains unchanged throughout the year.

LP1 and LP2 may be aggregated with each other under Reg. §1.199A-4(b)(1) because the requirements in clauses (i) through (iv) of that paragraph are met. The requirements of clause (v) are also met because the trades or businesses are the same and the businesses share significant centralized business elements including personnel, accounting, legal, purchasing, and human resources.
Fact Situation 3 (cont’d)

Queries:

• Can LP1 and LP2 be aggregated with X Corp.? The requirement of subclause (A) of clause (v) is not met because the business of X Corp. is different from the businesses of LP1 and LP2. Subclause (B) of clause (v) (shared facilities or significant centralized business elements) is probably met.

• Regarding subclause (C) of clause (v), which requires that “[t]he trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies),” would it be sufficient if X Corp. derives all of its revenue from the provision of services to LP1 and LP2? Or that LP1 and LP2 rely on X corp. as their exclusive provider of the services referenced above? Or the fact that X Corp. provides services that are fundamental to LP1’s and LP2’s business? If not, what else is needed? Would it suffice if the executives paid by X Corp. also manage LP1 and LP2?
Fact Situation 4

For many years through 2018, Business 1 has been owned and operated by LP1, and Business 2 has been owned and operated by LP2. Each of LP1 and LP2 is a partnership for tax purposes owned by the same three individuals. LP1 and LP2 have no payroll.

All of the personnel needed to manage and operate LP1 and LP2 receive their wages from X Corp., a calendar year S Corporation owned by the same three individuals. X Corp. operates at breakeven or with a small profit, varying from year to year. The fees charged by X Corp. to LP1 and LP2 are computed on the basis of time sheets which track the hours spent by each employee in working in the Businesses or for the benefit of LP1 and LP2, with the hours attributable to each employee then being multiplied by a rate per hour equal to the sum (on an hourly basis) of the direct wages and benefit costs attributable to the employee.

Assume that LP1 and LP2 cannot be aggregated with X Corp.

Absent aggregation, the wages of X do not result in a significant deduction under Section 199A because X does not have significant QBI. LP1 and LP2 have substantial QBI but no wages, and relatively low UBIA in light of the circumstance that their properties were acquired many years ago.
Fact Situation 4 (cont’d)

Query:

- If LP1 and LP2 decide to reflect on their books and tax returns the fees paid by each to X Corp. in 2019 for services (or perhaps the portion of such fees attributable to direct labor costs relating to work in the businesses) as wages, the Section 199A deductions available to the three individuals owning LP1 and LP2 may be increased. Can LP1 and LP2 do this? More generally, would the IRS consider the issuance of further guidance (such as a published ruling) to the effect that, so long as the aggregate of the wage expenses claimed by LP1, LP2 and X Corp. as a group did not exceed the wages received by all of their employees (that is, an anti-duplication rule), any reasonable allocation of the wage expenses among LP1, LP2 and X Corp. will be respected?
Fact Situation 5

X Corp. is a calendar year S Corporation owned by individuals A and B that has conducted a manufacturing business in the same location for over 40 years.

Y LLP is a calendar year tax partnership owned by A and B that initially purchased the real estate on which X Corp.’s manufacturing business is operated and has leased that property to X Corp. during that entire period.

Y LLP’s rental of the property qualifies as a trade or business under Reg. §1.199A-1(b)(14), and A and B have elected to aggregate X Corp. and Y LLP under Reg. §1.199A-4(b).

Both X Corp. and Y LLP have been consistently profitable over the years, and have qualified for the full section 199A deduction since 2018 based upon X Corp’s substantial W-2 payroll.

On May 31, 2019, (i) A and B sell all of their stock in X Corp. to Z Corp., a publicly held C corporation, [which terminates X Corp.’s S Corporation election as of May 30, 2019 under I.R.C. §1362(e)(1)] and (ii) Y LLP sells all of the real estate to Z Corp. and liquidates [which terminates the partnership for tax purposes under I.R.C. §761].
Fact Situation 5 (cont’d)

Queries:

- Can X Corp. and Y LLP still be aggregated under Reg. §1.199A-4(b) for the portion of calendar year 2019 during which individuals A and B operated the business? The common ownership requirement is satisfied for the majority and as of the last day of their respective taxable years. However, that is not true if the relevant “taxable years” are those of individuals A and B.

- Does it make a difference if the sale of X Corp.’s stock is to unrelated individual C, who continues the S Corporation election in effect? What if Y LLP uses the proceeds from the sale of the real estate to purchase another piece of property that it rents to unrelated outside parties?

- What if the transactions take place on December 31, 2019? December 30, 2019?

- What is the abuse that the “majority of the taxable year” and “last day of the taxable year” aggregation requirements were intended to prevent?
Fact Situation 6

X LLC is a calendar year LLC taxed as a partnership, which is owned by individuals doctors A, B, C, and D, that owns and operates an outpatient surgery center.

A, B, D, and D are also owners of a separate entity, Medical Practice PC, through which they conduct the practice of medicine.

X LLC does not employ physicians, but does employ nurses, physician extenders and other medical assistants in connection with the operation of the surgery center.

The patients of the surgery center are only billed by the surgery center for facility costs (or the so-called “technical component”), and any fees for the medical procedures themselves are billed separately by Medical Practice PC (or by another medical provider if not employed or otherwise engaged through Medical Practice PC) to the patients. There is no separate charge to patients for any medical services provided by X LLC through its nurses, physician extenders, and/or medical assistants.

Queries:

• Under this set of facts, is the ambulatory surgical center operated by X LLC a qualified trade or business (“QTB”) or a specified service trade or business (“SSTB”) for purposes of the Section 199A deduction?
Fact Situation 6 (cont’d)

• Does it make a difference if the nurses, physician assistants and other medical assistants are not employed directly by X LLC, but rather X LLC enters into agreements with other professional medical organizations (including, perhaps, Medical Practice PC) or directly with medical professionals to provide all medical care? What if the nurses, physician extenders and medical assistants are provided through a PEO Arrangement?

• Does it make a difference if X LLC is partially owned (or majority-owned) by a third party private organization that provides surgical center services? For example, if X LLC is owned 51% by a private national surgical center company, and 49% of X LLC is collectively owned by A, B, C, and D, does that affect the classification of the ambulatory surgical center business operated by X LLC as a QTB or SSTB?

• Will the results differ if X LLC is engaged in the business of providing dialysis services or other ancillary medical services (as opposed to ambulatory surgical center services), so long as the amounts received by X LLC are only for the facility fee or technical component and any fees for actual medical procedures are billed directly by the medical provider to the patient?
Fact Situation 7

Bank X is a calendar year S Corporation, which as part of its ordinary trade or business accepts deposits and makes various types of loans to customers, including mortgage loans. As a part of the loan operations, Bank X services the loans by accepting and processing loan payments which may include segregating the loan payment between principal, interest, homeowners insurance and other expenses associated with the mortgage.

For the home mortgage loans, Bank X may bundle and securitize the loans creating a liquid asset which is used to assist with managing bank regulatory capital and liquidity requirements of Bank X. The securities are a more liquid asset than the individual loans. Thus, it has available a liquid asset that can be sold to meet such capital and liquidity needs for the bank if necessary. Generally, Bank X retains approximately 80% of the securities so created.

After the loans are securitized, Bank X continues to hold the servicing rights related to the loans, whether sold or not, so that the loan customers remain the same. The loan customer still remits its loan payments to Bank X and Bank X processes these loan payments.

In addition to the facts above, from time to time Bank X purchases loans from a mortgage servicing pool with the specific purpose of reducing Bank X’s cost of funds. To explain, if a loan in the mortgage pool becomes delinquent, Bank X, as the mortgage servicer, is still required to submit the payment amount to the security holder even if the loan is delinquent. Bank X’s cost of funds are generally lower than the cost of funds of the mortgage pool so that Bank X, by purchasing the loan from the mortgage pool, is able to substitute its lower cost of funds for the cost of funds for the mortgage pool. Generally, Bank X purchases only 1-2% of serviced loans from the mortgage pool and approximately 80% of loans so purchased are retained by Bank X.
Fact Situation 7 (cont’d)

Queries:

• Is it safe to assume that Bank X is not a “dealer in securities” under I.R.C §199A(d)(2)(B) and Reg. §1.199A-5(b)(2)(xiii)(A) with regards to loans securitized and sold as described above because it originated the loans? Or because Bank’s customers are the borrowers to which it originally lent the money? Do Bank X’s activities related to the purchase, securitization, and sale of mortgage loans for capital management and liquidity reasons remove the “dealing in securities” designation from these activities of Bank X?

• Is it safe to assume that when Bank X’s intent is to reduce its cost of funds by the purchasing of delinquent loans from its servicing portfolios and subsequent sale of a minority of these loans also does not involve “dealing in securities,” inasmuch as it is not purchasing or selling securities to its borrower-customers? Or because it is not really in the “ordinary” course of its trade or business?
Fact Situation 8

Bank Z is a calendar year S Corporation. Part of its core activities involves receiving deposits and making loans. Thus, for this trade or business of Z Bank, it should not be treated as an SSTB described in I.R.C. §199A(d)(2)(A), as further clarified in Reg. §1.199A-5(b)(2)(ix). As part of owning such loans, Bank Z has to service the loans (e.g. collect payments, manage escrow accounts, etc.)

Besides originating loans, Bank Z also services loans within Ginnie Mae mortgage-backed security (MBS) servicing pools it is eligible to purchase as a servicer, and periodically purchases loans from within those mortgage pools. The main reason Bank Z purchases a loan is to reduce its cost to service the loan. In order for Bank Z to conduct this activity and to properly meet established regulatory requirements for capital and liquidity ratios, it must have the ability to sell such loans for liquidity purposes. Inherent in the ability to make loans is the ability to sell loans.

For bank liquidity purposes, Bank Z securitizes with Ginnie Mae some of its purchased loans, i.e. creates a MBS with multiple purchased loans. The primary purpose of these securitization events is to provide Bank Z with liquidity and/or comply with bank regulatory requirements. Bank Z typically retains the rights and obligations to service the underlying loans in exchange for a fee in order to maintain the overall relationship with the borrower.

Approximately 20% of the MBSs created in the previous paragraph are sold in the secondary market to meet regulatory capital requirements and/or for other business reasons.
Fact Situation 8 (cont’d)

Query:

• Is it accurate to say that Bank Z is not “dealing in securities” under I.R.C §199A(d)(2)(B) and Reg. §1.199A-5(b)(2)(xiii)(A) with regard to loans it purchases and later may sell as described above?¹

Reg. §1.199A-5(b)(2)(xiii)(A) provides that for purposes of Code §199A:

“[D]ealing in securities . . . Means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business . . .” [emphasis added]

¹Reg. §1.199A-5(b)(2)(xiii)(A) has an exception that originated loans will not be considered in any SSTB “dealing in securities” analysis.
Fact Situation 9

X Corp. is a calendar year S Corporation and Y LLP is a calendar year tax partnership.

X Corp. and Y LLP meet all of the other requirements for aggregation, and the only issue is whether they satisfy the “same person or group of persons” test under Reg. §1.199A-4(b)(1)(i).

Queries:

• If Individual A owns 1% of X Corp. and 99% of Y LLP and Individual B owns 99% of X Corp and 1% of Y LLP, we understand that X Corp. and Y LLP can be aggregated. How about if individual A’s daughter, instead of A owns the 99% of Y LLP? How about A’s uncle while the matriarch of the family is till living?

• If 50 unrelated persons each own 1% of X Corp. and Y LLP, can they be aggregated? What if the percentage ownerships differ, but each of the 50 unrelated individuals owns at least a nominal interest in both entities?

• Is the “same person or group of persons” test under Reg. §1.199A-4(b)(1)(i) the same as the “50 percent or more common ownership for the trades or businesses” test under Reg. §1.199A-5(c)(2)?
Fact Situation 10

Each of LP1 and LP2 is a calendar year partnership for tax purposes. LP1 is owned 99% by individual A and 1% by individual B. LP2 is owned 99% by individual C and 1% by B. Each of A, B and C is otherwise unrelated to the other individuals.

Queries:

- Assuming that all requirements of Treas. Reg. §1.199A-4(b)(1) other than the common ownership requirement in clause (i) are met, does the 1% common ownership by B of LP1 and LP2 permit the businesses conducted by LP1 and LP2 to be aggregated by B? Would it be relevant if B acquired his or her interest in LP1, LP2 or both with a purpose of maximizing section 199A deductions through use of the aggregation rule?

- Would the answer be different if LP1 and/or LP2 were an S Corporation? Would the answer be different if there was a third partnership, LP3, that was owned 50% by individual A and 50% by individual B?
Fact Situation 11

Y LLP is a calendar year tax partnership that conducts a substantial engineering or architecture business ($50 million of gross receipts), a relatively small component of which involves providing accounting services in order to control costs on projects designated by Y LLP.

Some customers elect not to use Y LLP to provide such accounting services, as Y LLP charges separately for that service. The accounting service generates $3 million of gross receipts. The accounting services are treated as a separate profit center by Y LLP.

Query:
- Are there any factors which would preclude the accounting service as being treated as a separate trade or business?
Fact Situation 12

Corp. X, Corp. Y and Corp. Z are all calendar year S corporations. Corp X acts as the common paymaster for all three corporations during calendar years 2018 through 2020. Wages are allocated for purposes of section 199A based upon the number of hours recorded by each employee with respect to each of the respective corporations.

On January 1, 2021, the three corporations engage a payroll company. The payroll company insists that each employee be allocated exclusively to one, and only one, corporation. In order to accommodate the new payroll company arrangement, the three corporations allocate the employees accordingly. The allocations are similar, but not identical, to the allocations that would have occurred under the prior system.

Query:
• What would the procedure be for the three corporations to change to the new allocation system for purposes of Reg. §1.199A-3(b)(5)?