Hot Topics –
ABA Real Estate Committee

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Agenda

• 2018-2019 Priority Guidance Plan

• Hot off the press

• Section 451(b): Inclusion based on financial accounting

• Section 512(b)(6): UBTI silos

• Section 163(j): Limitation on business interest expenses for infrastructure

• Section 461(l): Limitation on excess business losses

• Sections 274(a)(4) and 512(a)(7): Qualified transportation fringe benefits
2018-2019 Priority Guidance Plan

• TCJA
  – Section 163(j)
  – Section 168(k)
  – Section 199A
  – Section 451(b)
  – Section 512(a)(6)
  – Section 1061
  – Opportunity Zones
  – Sections 864(c) and 1446
  – Sections 274 and 512(a)(7)
2018-2019 Priority Guidance Plan

• Reducing Regulatory and Other Burdens
  – Section 707 regulations on allocating liabilities under the disguised sale rules
  – Section 754 elections
  – Validity of S elections when disproportionate distributions, inconsistent returns, or errors on Form 2553
  – Reg. 301.9100 relief for late regulatory elections

• BBA partnership audit rules

• Other guidance
SECTION 451(b): INCLUSION BASED ON FINANCIAL ACCOUNTING
Tax Considerations: Example 1

• Lessor and Lessee enter into a lease that is not a Section 467 rental agreement. Term is 3 years. Payment schedule is 100 year 1, 200 year 2, and 300 year 3. Assume, for financial reporting purposes, rent would be straight lined equal to 200/year over the term of the lease.
  – Pre-tax reform result: Lessor? Lessee?
  – Post-tax reform result: Lessor? Lessee?

• Other examples of non-Section 467 leases with book income prior to payment schedule?
Tax Considerations: Example 2

- Lessor and Lessee enter into a lease that is a Section 467 rental agreement. Term is 3 years. Payment schedule is 100,000 year 1, 200,000 year 2, and 300,000 year 3. Assume, for financial reporting purposes, rent would be straight lined equal to 200,000/year over the term of the lease. No Section 467 allocation schedule in the lease.
  - Pre-tax reform result: Lessor? Lessee?
  - Post-tax reform result: Lessor? Lessee?
Tax Considerations: Example 3

- Lessor and Lessee enter into a lease. For financial reporting purposes, the transactions is characterized as a capital lease and Lessor recognizes gain on the sale. However, for federal income tax purposes, the lease is characterized as a lease.
  - Pre-tax reform result: Lessor? Lessee?
  - Post-tax reform result: Lessor? Lessee?
Tax Considerations: Section 451

- Section 451: Taxable year of inclusion
- Application of new Section 451(b) to the recognition of income from Section 467 rental agreements and non-Section 467 rental agreements.
  - Conference Report footnote 872 stated that “this does not require the recharacterization of a transaction from sale to lease, or vice versa, to conform to how the transaction is reported in the taxpayer’s applicable financial statement.”
• Lessor and Lessee enter into a single lease agreement with multiple performance obligations. Under the single agreement, part of the transaction is subject to Section 451, however, other performance obligations are not subject to Section 451 (e.g., Section 467 or Section 460). For financial reporting purposes (e.g., because of ASC 606, a minimum gain is required for the non-Section 451 performance obligations that would not be supported by appraisal).

• Does Section 451(b)(4) apply to the transaction?
Tax Considerations: Example 4, cont.

• **Alternatives:**

  – Because a non-Section 451 performance obligation is part of the single agreement, Section 451(b)(4) would not apply to agreement.

  – Because a non-Section 451 performance obligation is part of the single agreement, Section 451(b)(4) would not apply to the non-Section 451 performance obligation.

  – Section 451(b)(4) allocation would apply to the non-Section 451 performance obligation.
SECTION 512(b)(6): UBTI SILOS
Section 512(b)(6)  UBTI Silos

• Before TCJA
  – Tax exempt entity generally did not pay tax on its income
  – Exception:  UBTI
  – Losses from one unrelated trade or business could offset income from a different unrelated trade or business

• Under TCJA
  – Losses from one unrelated trade or business cannot offset income from a different unrelated trade or business

• When is there more than one trade or business?
  – Are all investment activities a single trade or business?
Section 512(b)(6): UBTI Silos

Tax-Exempt Entity

- Hedge Fund
  - Debt-financed property rented 7 times

- UTP
  - Trades stock on margin
  - PE Fund
    - PE activity #1
    - PE activity #2
  - Real Estate Fund
    - RE activity #1
    - RE activity #2

- Other debt-financed property rented 10 times
UBTI Silos: Notice 2018-67

- No delay in applying Section 512(b)(6)
  - Effective for tax years beginning after 2017
  - But does not apply to pre-2018 NOLs
- Contemplating future regulations
  - Investment activities as a single trade or business
  - Bright line rule, not facts-and-circumstances test
  - UBTI from provision of fringe benefits under Section 512(a)(7): not an unrelated trade or business
• Until proposed regulations are issued
  – Reasonable and good faith interpretation of the statute
  – Consider all facts and circumstances
  – Reasonable to use NAICS 6-digit codes
  – Reasonable to look to fragmentation principle of Section 513(c)
  – Special rules for partnerships
    • Qualified Partnership Interests
    • Historic investments
• Reasonable to look to other code sections? Sections 132, 162, 183, 414, and 469?
UBTI Silos: Notice 2018-67

- Can aggregate items from Qualified Partnership Interests
  - Aggregate through tiers
  - Aggregate items from unrelated partnerships

- Qualified Partnership Interest
  - Held directly by the tax exempt entity
  - Satisfies the de minimis test or the control test
UBTI Silos: Notice 2018-67

- **De Minimis Test:**
  - Tax exempt directly holds no more than 2% of profits and capital
    - Average % at beginning and end of year
    - Must combine related interests (disqualified persons, supporting organizations, controlled entities)
  - May rely on K-1
    - % of profits **must** be reported on the K-1
UBTI Silos: Notice 2018-67

• Control Test
  – Tax exempt directly holds no more than 20% of capital
    • Average % at beginning and end of year
    • Must combine related interests (disqualified persons, supporting organizations, controlled entities)
    • May rely on K-1
UBTI Silos: Notice 2018-67

• Control Test
  – No control or influence over the partnership
    • No power to require the partnership to perform (or prevent the partnership from performing) any act that significantly affects the partnership operations
    • No power to appoint or remove the partnership’s officers, directors, trustees, or employees
    • The tax exempt’s officers, directors, trustees, and employees cannot have rights to participate in the management of the partnership or conduct the partnership’s business
  • All facts and circumstances
UBTI Silos: Notice 2018-67

- Historic investments: partially grandfathered

- If partnership interest was acquired before August 21, 2018, the partnership interest may be treated as a single trade or business
  - Allows aggregation of items within that partnership, including from lower-tier entities
  - Cannot automatically aggregate items from two unrelated partnerships

- Does this rule apply when the tax exempt makes additional capital contributions after August 21, 2018?
UBTI Silos: NOLs

- Post-2017 NOLs are subject to silo rules
- Pre-2018 NOLs are not
- Which NOLs are absorbed first?
  - Pre-2018 NOLs expire after 20 years
  - Post-2017 NOLs cannot offset more than 80% of taxable income
  - BUT why waste a pre-2018 NOL on UBTI that would otherwise be offset by a post-2017 NOL?
UBTI Silos - NOLs

• 2017: ($80) NOL generated

• 2018: ($80) NOL generated from Business #1

• 2019
  – Business #1 generates $100 of net income
  – Business #2 generates $100 of net income

• Net income = $40
UBTI Silos - NOLs

Option 1: Apply the 2017 NOL before the 2018 NOL

- Half of the 2017 NOL offsets Business #1 income;
  half offsets Business #2 income

- Business #1 silo:
  - $100 income minus ($40) of the 2017 NOL = $60
  - Apply the ($80) of 2018 NOL to the $60 of remaining income:
    - $0 income*
    - ($20) carryforward of 2018 NOL*

- Business #2 silo: $100 income minus ($40) of the 2017 NOL
  - $60 of income
UBTI Silos - NOLs

• Option 1:
  – $0 of income from Business #1
  – ($20) carryforward of the 2018 NOL from Business #1
  – $60 of income from Business #2

*Results are worse if only $48 of the Business #1 NOL from 2017 may be applied
Option 2: Apply the 2018 NOL before the 2017 NOL

• Silo #1
  – $100 net income from 2019
  – ($80) NOL from 2017 (fully absorbed)
  – $20 resulting income / loss

• Silo #2
  – $100 net income from 2019

• Total income before application of the 2017 NOL = $120
• All ($80) of the 2017 NOL may offset taxable income
• Only $40 of income is subject to tax
SECTION 163(j): INFRASTRUCTURE
Infrastructure Safe Harbor

• **Scope:** Taxpayer with a trade or business that
  • Is conducted by a party contractually obligated to fulfill the terms of a “specified infrastructure arrangement”;
  • Is conducted in connection with fulfilling the terms of the specified infrastructure arrangement; and
  • Would not otherwise be treated as a real property trade or business under Sections 163(j)(7)(B) and 469(c)(7)(C).
    – Would be eligible to make an election to be treated as a real property trade or business under Section 163(j)
    – A “specified infrastructure arrangement” is defined as real property under the Rev. Proc.
Infrastructure Safe Harbor

- Specified Infrastructure Arrangement
  - Contract or contracts with a term in excess of five years
  - Between a government and a private trade or business
  - Private trade or business has contractual responsibility to provide: designing, building, constructing, reconstructing, developing, redeveloping, managing, operating, or maintaining “qualified public infrastructure property”

Infrastructure Safe Harbor

• Qualified Public Infrastructure Property
  
  – “Infrastructure property” either
    
    • Owned by the government or
    
    • Not property of a “regulated utility” and is owned by private trade or business that operates under an arrangement where rates charged for use are subject to regulatory or contractual control by a government or government approval
  
  – Once operational, available for use by the general public
Infrastructure Safe Harbor

• Infrastructure property
  – Airports
  – Docks and wharves
  – Maritime and inland waterway ports, and waterway infrastructure
  – Mass commuting facilities
  – Facilities for the furnishing of water
  – Sewage facilities
  – Solid waste disposal facilities
  – Facilities for the local furnishing of electrical energy or gas
  – Local district heating or cooling facilities
  – Qualified hazardous waste facilities
Infrastructure Safe Harbor

- Infrastructure property (cont.)
  - High-speed intercity rail facilities
  - Hydroelectric generating facilities
  - Qualified public education facilities
  - Flood control and stormwater facilities
  - “Surface transportation facilities”
    - Road, bridge, tunnel, passenger railroad, surface freight transfer facility, and other facilities
  - Rural broadband service facilities
  - Environmental remediation costs on Brownfield and Superfund sites
Infrastructure Safe Harbor

• Infrastructure Example
  – Developer in a trade or business enters into contract with Government to design, build, finance, maintain, and operate a light rail system over a 30 year period. Cost of station and tracks is $3B and cost of rail cars is $1B.

  • How many trades or businesses does Developer have under Section 163(j)?
  • Can financing for rail cars be included in Section 163(j) real property trade or business?
  • What if majority of cost was the non-infrastructure property?
SECTION 461(I): LIMITATION ON EXCESS BUSINESS LOSSES
Section 461(l) – Excess Business Losses

- $250,000 limitation on Excess Business Losses
  - $500,000 when filing joint return
- Excess Business Loss = business deductions – business income
- Excess Business Losses become an NOL carryforward in future years
- Applies to non-corporate taxpayers, not to C corporations
- Pass-through business income / losses
  - Apply at the owner level, not the entity level
- Expires in 2026
Section 461(l) – Excess Business Losses

• What items are attributable to a trade or business?
  – Wages?
  – Guaranteed payment for services? For capital?
  – Section 1231 property?
    • Always?
    • Never?
    • Only if there is a loss?
    • Only if the gain/loss is ordinary?
  – Gain/loss from sale of stock of S corporation?
  – Gain/loss from sale of partnership interest?
Section 461(l) – Excess Business Losses

Relationship with Section 469

• Section 469 applies before Section 461(l)

• Section 469 can result in bunching of losses that are taken into account when taxpayer disposes of the interest in the activity
  
  – Gain from disposition might not be “business” income
Section 461(l) – Excess Business Losses

Example

• Stella is a lawyer and she has invested in a real estate partnership

• In each of Y1-Y10, Stella has
  
  – $1M of income from her legal services
  
  – ($1M) of real estate losses suspended under Section 469

• At the end of Y10, Stella has taken into account $10M of income and has a
  ($10M) passive activity loss carryforward
  
  – Section 461(l) has not yet applied to the losses

• At the beginning of Y11, Stella sells her real estate investment
Section 461(l) – Excess Business Losses

• Upon Year 11 sale of the real estate investment
   – The ($10M) of PALs are no longer limited by Section 469
   – Are those business losses in Year 11? Is this based on whether they were business losses in Y1-Y10?
   – If they are business losses in Year 11, they are subject to Section 461(l) in Year 11
   – If Stella recognizes gain from the sale of the investment, is the gain business gain?
SECTIONS 274(a)(4) AND 512(a)(7): QUALIFIED TRANSPORTATION FRINGE BENEFITS
Sections 274(a)(4) and 512(a)(7): QTFs

• Before TCJA
  – Employees excluded Qualified Transportation Fringe Benefits (QTFs) from income under Section 132
    • Cap: $260/month
  – Employers deducted expenses incurred to provide QTFs

• After TCJA
  – Employers cannot deduct expenses incurred to provide QTFs, to extent the amount is not taxable income for the employee
  – For tax exempt employers: this amount constitutes taxable income
Sections 274(a)(4) and 512(a)(7): QTFs

- Notice 2018-99
- Amount of deduction that is disallowed / income that is taxed
  - Based on employer’s expense, not the value to the employee
  - Does not include
    - Depreciation
    - Expenses related to adjacent property
    - The excess amount that employee recognizes as taxable income
- Only applies to parking provided to employees
  - Not partners, 2% shareholders, or independent contractors
Sections 274(a)(4) and 512(a)(7): QTFs

• How to measure portion of parking provided to employees
  – Include % of spaces reserved for employees
    • May retroactively reduce this amount
  – Exclude % of spaces reserved for non-employees
  – For non-designated parking
    • Primary use test: 50% safe harbor
    • Base on percentage of spaces used for employees; empty spaces treated as non-employee parking
    • If do not satisfy primary use test, must reasonably determine employee use during normal business hours on a typical business day