IRC §199A SUPPLEMENT

The following items were issued on January 18, 2019, relating to the qualified business income (QBI) deduction under IRC §199A:

- Notice 2019-07, providing more information on rental real estate under IRC §199A;
- New information on the IRC §199A regulations issued in August 2018 and made final on January 18, 2019;
- Rev. Proc. 2019-11; and
- Newly-proposed regulations under IRC §199A.

RENTAL REAL ESTATE — NOTICE 2019-07

On January 18, 2019, the IRS issued a Notice that provides a safe harbor under which a rental real estate "enterprise" will be treated as a trade or business solely for purposes of IRC §199A and the regulations thereunder. (Notice 2019-07)

The Notice emphasizes that if an enterprise fails to satisfy these requirements, the rental real estate enterprise may still be treated as a trade or business for purposes of IRC §199A if the enterprise otherwise meets the definition of trade or business under Prop. Treas. Regs. §1.199A-1(b)(14). That regulation defines a trade or business as a trade or business under IRC §162 other than the trade or business of performing services as an employee.

Relevant passthrough entities (RPEs) may also use this safe harbor to determine whether a rental real estate enterprise is a trade or business.

Comment

An essential requirement is that the taxpayer must perform 250 or more hours of rental services in a taxable year with respect to the rental enterprise.

WHAT IS A RENTAL REAL ESTATE ENTERPRISE?

A rental real estate enterprise is defined as an interest in real property held for the production of rents. It may consist of multiple properties.

Commercial and residential property may not be part of the same enterprise.

Comment

Thus, for purposes of the safe harbor, a taxpayer with both residential and commercial properties must meet the requirements separately with respect to each.

SAFE HARBOR

There are three requirements to meet the safe harbor:

1. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
2. 250 or more hours of rental services are performed per year with respect to each rental enterprise; and
3. Contemporaneous records are maintained, including time reports, logs, or similar documents, regarding:
   - Hours of services performed;
   - Description of services performed;
   - Dates services were performed; and
   - Who performed the services.

> ***Comment***
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> The contemporaneous record requirement is waived for 2018 only.

RENTAL SERVICES

Rental services are all services performed but do not include financial or investment activities, such as:

- Arranging financing;
- Procuring property;
- Studying reports on operations;
- Planning, managing, or construction of long-term capital improvements; or
- Hours spent traveling to and from the real estate.

> ***Comment***
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> The prohibition against counting time spent on long-term capital improvements is a bit problematic. The Notice makes clear that time spent on repairs does count. So, if the property owner has work done to the property that would be capitalized but for the fact that the property owner elects to expense it under the repair regulations, is that a countable repair or a non-countable capital improvement?

WHO PERFORMS THE SERVICES?

The Notice states, "Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners."

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Comment

This is hugely problematic. First, if the taxpayer can count an agent's hours of services, then, presumably, the taxpayer can count an agent's agent's hours of services. So, if the property owner hires a property manager and the property manager hires a gardener, the property owner can count the hours spent by both the property manager and the gardener.

But property managers generally don't charge based on hours, they charge based on a percentage of rents collected. Gardeners generally charge a flat fee.

The next question, then, is do the property manager and gardener have to maintain logs of the work they perform and provide them to the taxpayer/property owner?

This is simply not the way they do business, and this alone could nullify the safe harbor.

EXCLUDED REAL ESTATE

There are two forms of property excluded from the safe harbor:

- Property used as a residence by the taxpayer for any part of the year under IRC §280A (vacation home rules); and
- Property subject to a triple net lease.

Property that is considered subject to a triple net lease includes "a lease agreement that requires the lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant."

Comment

This clause is poorly worded. First, it appears that, to be a triple net lease, the lessee must hit both requirements: they must pay a *portion* of taxes, fees, and insurance (apparently *any* portion), *and* they must be responsible for maintenance.

Second, while the Notice makes clear that the first requirement is met with just a portion, it doesn't make clear whether the lessee must be responsible for all, any, or a certain portion of maintenance (all tenants perform some maintenance, such as vacuuming, on their unit).

SIGNED STATEMENT

To take advantage of the safe harbor, the taxpayer must attach a signed statement, under penalties of perjury, that the requirements of the safe harbor have been met.

Comment

Given that perjury is classified as a felony, why would anyone sign such a statement?

The Notice makes clear that the taxpayer can meet the trade or business requirement without the safe harbor. This didn't need to be said; it's statutory.

Thus, the IRS could only provide a 250-hour requirement if it is their belief that 250 hours of service rises to the level of a trade or business. So, if the taxpayer devotes 250 hours, they meet the trade or business requirement and don't need the safe harbor and don't need to sign under penalties of a felony.

EFFECTIVE DATE

Notice 2019-07 is effective for taxable years beginning after December 31, 2017.

Comment

This means that taxpayers had to comply in 2018 with rules that they didn't know they had to comply with. To be fair, the IRS did provide 2018 relief from the requirement to have contemporaneous logs, the most onerous requirement.

AUGUST 2018 REGULATIONS NOW FINALIZED

Generally, deductions attributable to a trade or business are taken into account for purposes of computing QBI, assuming the requirements of §199A and Treas. Regs. §1.199A-3 are otherwise satisfied.

For purposes of §199A only, deductions such as the deductible portion of the tax on self-employment income under IRC §164(f), the self-employed health insurance deduction under IRC §162(l), and the deduction for contributions to qualified retirement plans under IRC §404 are considered attributable to a trade or business are taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business.

It is noteworthy that the preamble to the final regulations makes the following statement:

"The Treasury Department and the IRS decline to address whether deductions for unreimbursed partnership expenses, the interest expense to acquire partnership and S corporation interests, and state and local taxes are attributable to a trade or business as such guidance is beyond the scope of these regulations."

REV. PROC. 2019-11

Rev. Proc. 2019-11 was issued on January 18, 2019, and provides methods for calculating W-2 wages:

- For purposes of §199A(b)(2), which, for certain taxpayers, provides a limitation based on W-2 wages to the amount of the deduction for QBI; and
- For purposes of §199A(b)(7), which, for certain specified agricultural and horticultural cooperative patrons, provides a reduction to the §199A deduction based on W-2 wages.

The revenue procedure provides three methods for calculating W-2 wages:

- The unmodified box method;
- Modified box 1 method; and
- Tracking wages method.

The unmodified box method is a simplified calculation, while the modified box 1 method and the tracking wages method provide greater accuracy.

It is important to note that the W-2 wages calculated under these three methods are not necessarily the same W-2 wages that are properly allocable to QBI and eligible for use in computing the §199A deduction. After computing W-2 wages under Rev. Proc. 2019-11, the taxpayer must next determine the extent to which W-2 wages are property allocable to QBI.

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In calculating W-2 wages for a taxable year under the three methods above, the taxpayer includes only those Forms W-2 that are for the calendar year ending with or within the taxable year of the taxpayer. Special rules for short taxable years are discussed below.

UNMODIFIED BOX METHOD

W-2 wages are calculating by taking, without modification, the lesser of:

- The total entries in Box 1 (wages, tips, and other compensation) of all Forms W-2 filed with the SSA by the taxpayer for its employees; or
- The total entries in Box 5 (Medicare wages and tips) of all Forms W-2 filed with the SSA by the taxpayer for its employees.

MODIFIED BOX 1 METHOD

The taxpayer makes modifications to the total entries in Box 1 of employees' Forms W-2. W-2 wages under this method are calculated as follows:

- Total the amounts in Box 1 of all Forms W-2 filed with the SSA by the taxpayer for its employees; minus
- Amounts included in Box 1 of Forms W-2 that are not wages for federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under IRC §3402(o) (for example, supplemental unemployment compensation benefits within the meaning of Rev. Rul. 90-72); plus
- The total of the amounts that are reported in Box 12 of Forms W-2 for its employees and that are properly coded D, E, F, G, and S (elective deferrals and salary reduction contributions).

TRACKING WAGES METHOD

The taxpayer actually tracks total wages subject to federal income tax withholding and makes appropriate modifications. W-2 wages under this method are calculated as follows:

- Total amount of wages subject to federal income tax withholding that are paid to employees of the taxpayer and that are reported on Forms W-2 filed with the SSA by the taxpayer for the calendar year; plus
- The total amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

APPLICATION IN CASE OF SHORT TAXABLE YEAR

W-2 wages of the taxpayer for the short taxable year include only those wages paid during the short taxable year to the taxpayer's employees, only those elective deferrals (within the meaning of IRC §402(g)(3)) made during the short taxable year by employees, and only compensation actually deferred under IRC §457 during the short taxable year with respect to employees.

In the case of a short taxable year, the tracking wages method must be used and must be applied as follows:

- Only those W-2 wages subject to federal income tax withholding and that are actually or constructively paid to employees during the short taxable year and reported on Form W-2 for the calendar year ending with or within that short taxable year; and
- Only the portion of the total amounts reported in Box 12, Codes D, E, F, G, and S on Forms W-2, that are actually deferred or contributed during the short taxable year are included in W-2 wages.

PROPOSED IRC §199A REGULATIONS

The proposed regulations issued on January 18, 2019, provide guidance on:

- The treatment of previously suspended losses that constitute qualified business income (QBI); and
- The determination of the IRC §199A deduction for taxpayers that hold interests in:
  - Regulated investment companies (RICs);
  - Charitable remainder trusts (CRTs); and
  - Split-interest trusts.

TREATMENT OF PREVIOUSLY SUSPENDED LOSSES

- Under §199A, previously disallowed losses or deductions (including under IRC §§465, 469, 704(d), and 1366(d)) allowed in the taxable year are generally taken into account for purposes of computing QBI except to the extent the losses or deductions were disallowed, suspended, limited, or carried over from a taxable year ending before January 1, 2018.
- The newly-proposed regulations amend Treas. Regs. §1.199A-3(b)(1)(iv) to provide that previously suspended losses are treated as losses from a separate trade or business.
- To the extent that losses relate to a PTP, they must be treated as losses from a separate PTP.
- Treas. Regs. §1.199A-3(b)(1)(iv)(B) provides that attributes of the disallowed losses are determined in the year the loss is incurred.

REGULATED INVESTMENT COMPANIES (RICs) WITH INTERESTS IN REITs AND PTPs

REITs

The proposed regulations provide rules under which a RIC that receives qualified REIT dividends may pay §199A dividends:

- Non-corporate shareholders receiving §199A dividends would treat them as qualified REIT dividends under §199A(e)(3), provided the shareholder meets the holding period requirements for its shares in the RIC;
- The rules under which a RIC would compute and report §199A dividends are based on the rules for capital gain dividends in IRC §852(b)(3) and exempt-interest dividends in IRC §852(b)(5); and
- The amount of a RIC's §199A dividends for a taxable year would be limited to the excess of the RIC's qualified REIT dividends for the taxable year over allocable expenses.

PTPs

The IRS continues to consider permitting conduit treatment for qualified PTP income received by a RIC to further the purposes of §199A(b)(1)(B). At this point, the IRS is seeking public comment to assist in resolving these novel issues with a view to developing regulations permitting conduit treatment for qualified PTP income.

Further guidance on this topic will be forthcoming.

SPECIAL RULES FOR TRUSTS AND ESTATES

In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant unadjusted basis immediately after acquisition (UBIA) of depreciable property must be allocated among the trust or estate and its various beneficiaries.

Specifically, each beneficiary's share of the trust's or estate's QBI, W-2 wages, and UBIA are determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. (Treas. Regs. §1.199A-6(d)(3)(ii))

Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages.

In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.

The threshold amount is determined at the trust level after taking into account any distribution deductions. (Treas. Regs. §1.199A-6(d)(3)(iv))

To prevent the creation of multiple trusts to manipulate the threshold, a trust formed or funded with a principal purpose of receiving a deduction under §199A will not be respected for purposes of determining the threshold amount under §199A. (Treas. Regs. §1.199A-6(d)(3)(vii))

CHARITABLE REMAINDER TRUST BENEFICIARY'S ELIGIBILITY FOR THE DEDUCTION

The IRS believes that, because a charitable remainder trust described in IRC §664 is not subject to income tax, and because the excise tax imposed by §664(c) is an excise tax and not an income tax, the trust neither has nor calculates a §199A deduction and the threshold amount described in §199A(e)(2) does not apply to the trust.

However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient's own threshold amount for purposes of §199A, taking into account any annuity or unitrust amounts received from the trust.

Therefore, a taxable recipient of a unitrust or annuity amount from a charitable remainder trust may take into account QBI, qualified REIT dividends, and qualified PTP income for purposes of determining the recipient's §199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists of such §199A items under Treas. Regs. §1.664-1(d).

Split-interest trusts

The IRS has determined that special rules for split-interest trusts other than charitable remainder trusts, such as non-grantor charitable lead trusts or pooled income funds, are not necessary, despite public comment from the August regulations to the contrary.

Put simply, split-interest trusts apply the rules for non-grantor trusts and estates set forth in Treas. Regs. §1.199A-6(d)(3) to determine any applicable §199A deduction for the trust or its taxable beneficiaries.

Separate shares within a trust

Separate shares within a trust are not treated as separate trusts for purposes of applying the threshold amount. Instead, the trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount.

The purpose of the separate share rule in IRC §663(c) is to treat distributions of trust DNI to trust beneficiaries as independent taxable events solely for purposes of applying IRC §§661 and 662 with respect to each beneficiary's separate share.

Only trusts with retained DNI will be eligible for the §199A deduction. Note the following:

- A trust, regardless of the number of separate shares it has for its beneficiaries under the separate share rule of IRC §663(c), will be treated as a single trust for purposes of applying the threshold amount under §199A; and
- To the extent that a taxable beneficiary of a trust receives a distribution of DNI from the beneficiary's separate share of the trust which includes §199A items, the beneficiary would apply its own threshold amount to those §199A items in computing its §199A deduction in accordance with the rules of Treas. Regs. §1.199A-6(d).

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