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The Fog Is Starting to Clear: Proposed Regulations Under §199A

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On Aug. 16, 2018, the Treasury Department issued proposed regulations under Section 199A of the Internal Revenue Code, which was enacted as part of the 2017 tax legislation and generally allows a 20 percent deduction on income from pass-through entities, subject to certain limitations. The legislation left a lot of uncertainty regarding many issues, and the proposed regulations thankfully provide some clarity. Although the proposed regulations are not effective until they are finalized, taxpayers are permitted to rely on them until then.

On Dec. 22, 2017, P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act) was signed into law, which, among many changes to the Internal Revenue Code, enacted Section 199A. Section 199A allows a deduction to individuals, trusts, and estates of up to 20 percent of certain qualified business income. The deduction can effectively lower the top marginal tax rate on qualified business income from 37 percent to approximately 30 percent. For taxpayers above certain income thresholds, the Section 199A deduction for each trade or business is generally limited to the higher of two amounts: (1) 50 percent of the wages paid by that trade or business to its employees as shown on Form W-2 or (2) 25 percent of such wages *plus* 2.5 percent of the trade or business's "unadjusted basis" in its depreciable property. Although the wage and basis limitations must be computed separately for each "trade or business," the statute did not address how to determine what constitutes a single trade or business.

The statute also provided that income from certain types of trades or businesses does not qualify for the 20 percent deduction, including many service businesses and certain investment and management businesses.

Aggregation of Trades or Businesses.

One particularly important set of rules under the proposed regulations allows taxpayers to aggregate trades and businesses in certain circumstances for purposes of computing the wage and basis limitations. This is particularly relevant for owners of real estate, who often own individual properties through separate partnerships. For example, assume an individual owns two properties, each in a separate partnership, and (1) has a high unadjusted basis in one of the properties but no taxable income attributable to that property, and (2) has a low basis but high taxable income attributable to the other property. Absent special rules allowing the individual to combine the attributes of the two properties, the individual may end up with little (if any) deduction under Section 199A. This would be the case even if the individual's interests in the partnerships are owned through a holding company.

The preamble to the proposed regulations states that as a general matter, a trade or business cannot span multiple entities. However, an individual may be able to aggregate two trades or businesses for purposes of Section 199A if two out of the following three factors are met: (A) the trades or businesses provide products or services that are the same or customarily offered together; (B) the trades or businesses share facilities or significant centralized business elements; and (C) the trades or businesses are operated in coordination with, or reliance upon, each other. Thus, an individual owning interests in two rental real estate partnerships may be able to aggregate the two trades or businesses, assuming that all rental real estate is treated as the same "product" for purposes of factor (A) and that the businesses are centrally managed, thus satisfying factor (B).

In addition, in order to qualify for aggregation, the same person or group of persons must own 50 percent or more of each trade or business to be aggregated. For this purpose, an individual is treated as owning interests owned by certain family members. However, the proposed regulations currently provide no attribution rules for non-grantor trusts (which generally qualify for the deduction to the extent they retain income). Thus, individuals owning properties through multiple non-grantor trusts may need to reconsider their ownership structures in order to maximize the deduction.

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Wages Paid by Payroll Companies.

Many owners of rental real estate pay all employee wages through a separate payroll company, and the name of the payroll company appears on the employees' forms W-2 rather than the property-owning entity that deducts the wages for income tax purposes. Under a separate provision of the proposed regulations, wages may be allocated to the latter entity for purposes of Section 199A, provided that it is treated as the common law employer of the employees.

Basis Limitation After Tax-Free Dispositions.

Another significant rule in the proposed regulations relates to the calculation of a taxpayer's unadjusted basis for purposes of the 25 percent wages plus 2.5 percent basis limitation. For this purpose, basis of property is generally not reduced by depreciation deductions or other basis adjustments. However, if a taxpayer sells property and acquires replacement property as part of a tax-free like-kind exchange, the taxpayer's basis in the replacement property for this purpose is equal to its adjusted tax basis in the replacement property as of the date of acquisition (i.e., reduced by accumulated depreciation). Similarly, if a partner contributes property to a partnership, the partnership's basis in the property for purposes of computing the Section 199A deduction is equal to its adjusted tax basis on the date of the contribution.

Specified Service Trades or Businesses.

The regulations also provide further clarification regarding the definition of a "specified service trade or business," the income from which does not qualify for the deduction for taxpayers whose income exceeds certain thresholds. Such trades or businesses consist mainly of service professionals, such as doctors, lawyers, and accountants. The statute also provides that trades or businesses consisting of "brokerage services," or "investment management" are ineligible for the deduction. Prior to the issuance of the proposed regulations, there was some concern that real estate brokers and real estate management businesses would fall into these categories. The proposed regulations provide that real estate agents are not considered to be engaged in the business of brokerage services for this purpose, and thus are eligible for the deduction. Similarly, the business of "investment management" does not include directly managing real property.

The proposed regulations provide some clarification to a statute that is very complicated and replete with ambiguities. Although the proposed regulations are generally favorable to taxpayers, the treatment of like-kind exchanges and partnership contributions is both unfavorable and surprising.