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2017 TAX LEGISLATION

Q & A: Final Regulations Under IRC Sec. 199A

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TABLE OF CONTENTS

Page

INTRODUCTION

On January 18, 2019 the Treasury Department finalized regulations that were issued in proposed form in August 2018 under Section 199A, which deals with the new 20% deduction for "Qualified Business Income" (QBI). They also issued Notice 2019-7, which contains a proposed revenue procedure providing a safe harbor for treating rental real estate enterprises as qualified businesses, and issued new proposed regulations dealing with suspended losses, RICs, and certain trusts.

Following is a question-and-answer discussion of the key provisions in the new guidance.

1. SPECIFIED SERVICE TRADE OR BUSINESS (SSTB)

Unless the taxpayer's income is under the $157,500/$315,000 threshold, QBI does not include income from several types of service businesses enumerated in the Code, known as SSTB's.

Q: What changes were made to the definition of "the field of health"?

A: The final regs remove the requirement that the medical services be provided directly to the patient. For example, a radiologist reading a patient's x-ray's, etc. and rendering a diagnosis would be engaged in an SSTB. The regulations also provide examples of certain facilities that are not considered to be performing services in the field of health (i.e., not an SSTB), such as an ambulatory surgical center that does not employ physicians, nurses, or medical assistants.

Q: What changes were made to the SSTB "de minimis" rules?

A: Under the proposed regs, where a trade or business had 50 percent or more common ownership and shared expenses with an SSTB, the trade or business was treated as incidental and part of the SSTB if its gross receipts represented no more than 5 percent of the total combined gross receipts of both activities in a tax year. The final regs dropped this rule. However, an example in the regulations makes it clear that if receipts from an SSTB exceed 10 percent of the total receipts and the taxpayer does not keep separate books and records for the SSTB and non-SSTB activities, the entire business is treated as an SSTB.

Q: What changes were made to the anti-avoidance rule for determining an SSTB?

A: The proposed regs provided that an SSTB includes any trade or business that provides 80 percent or more of its property or services to an SSTB if there is 50 percent or more common ownership of the businesses. The final regs remove the 80 percent rule but clarify that in any case where a trade or business is providing services to a 50 percent commonly-owned SSTB, that portion of the service provider's business attributable to the related SSTB will itself be treated as SSTB with respect to the related parties.

2. UNADJUSTED BASIS IMMEDIATELY AFTER ACQUISITION

Unless the taxpayer's income is under the $157,500/$315,000 threshold, the 20% deduction is limited to 50% of the taxpayer's share of W-2 wages or, if greater, the sum of 25% of W-2 wages and 2.5% of the unadjusted basis of depreciable property (UBIA). The final regs made substantial taxpayer-friendly changes to the determination of UBIA.

Q: What changes were made to calculating UBIA for property contributed to a partnership or S corporation in a nonrecognition transaction?

A: Qualified property contributed to a partnership or S corporation in a nonrecognition transaction should generally retain its UBIA on the date it was first placed in service by the contributing partner or shareholder. The proposed regs provided that only the transferor's adjusted basis, net of depreciation, could be taken into account.

Q: What changes were made to calculating UBIA for property received in a like-kind exchange under Section 1031?

A: The proposed regs only allowed the adjusted basis of the relinquished property (net of depreciation) plus any increase for boot and other costs to be taken into account. Under the final regs, the UBIA of qualified like-kind property that a taxpayer receives is the UBIA of the relinquished property. However, if a taxpayer either receives money or property not of a like kind to the relinquished property (other property) or provides money or other property as part of the exchange, the taxpayer's UBIA in the replacement property is adjusted.

Q: What changes were made with respect to special basis adjustments under Section 754?

A: The proposed regs provided that the special basis adjustment is not included in the definition of UBIA. The final regs provide that Sec. 743(b) basis adjustments should be treated as qualified property to extent the basis adjustment reflects an increase in the fair market value of underlying qualified property, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property. In other words, the step-up attributable to depreciation claimed by the partnership is not taken into account. Since the underlying property must itself be "qualified", it would preclude step-ups to buildings whose depreciable periods have expired from being treated as UBIA.

Furthermore, basis adjustments under Section 734 (where a partner's interest is redeemed by the partnership) are not considered in calculating UBIA.

Example: ABC Partnership owns a 39-year property acquired 13 years ago with an original cost of $900,000 and accumulated depreciation of $300,000. D purchases a one-third interest from A and the purchase price reflects a fair market value of $1,200,000 for the building. ABC makes an election under Sec. 754. D's Sec. 743(b) adjustment for the building is $200,000 (one-third of the excess of the value over the adjusted basis). D may treat the amount of the step-up attributable to the partnership's UBIA ($1,200,000 - $900,000 X 1/3 = $100,000) as additional UBIA.

3. AGGREGATION OF QUALIFIED BUSINESSES

The proposed regs allowed taxpayers to aggregate qualified businesses if certain requirements are met, thus permitting the W-2 wages and UBIA amounts to be shared among businesses to maximize the deduction.

Q: What changes were made to the aggregation election provisions?

A: The proposed regs only allowed the taxpayer (i.e., individual, estate or trust) to elect to aggregate. Under the final regs, a relevant pass-through entity (RPE) is permitted to aggregate its qualifying businesses owned directly and through lower-tier entities. An owner or upper-tier RPE cannot separate the aggregated businesses of a lower-tier RPE, but may aggregate additional businesses with the lower-tier RPE's aggregation if the rules are otherwise satisfied.

The regs also provide that failure to aggregate in Year 1 does not preclude aggregation in subsequent years. An initial aggregation cannot be made on an amended return with the exception of the 2018 tax year.

4. SAFE HARBOR FOR RENTAL REAL ESTATE ENTERPRISES

The code and regs under Section 199A do not provide a bright-line test for determining when a rental real estate activity is considered a trade or business for purposes of the QBI deduction.

Q: What guidance has been issued for rental real estate enterprises?

A: The IRS issued Notice 2019-7, which contains a proposed revenue procedure providing a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of Section 199A. The requirements are as follows:

(A) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;

(B) For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services (see below) are performed per year with respect to the rental enterprise. After 2022, the 250-hour test must be met in any 3 out of 5 consecutive years.

(C) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

(D) Triple net-lease activities are excluded

(E) The taxpayer or RPE must attach a statement signed under penalties of perjury that these requirements have been satisfied

The services alluded to above include (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.

It's important to note that this revenue procedure is in proposed form, and provides for a safe harbor; it does not preclude a rental enterprise from meeting the definition of a trade or business if the requirements are not met.

5. EFFECTIVE DATES

The final regs are effective for years ending in 2019, but taxpayers may rely on either the final or proposed regs for 2018.

The safe harbor is proposed to apply to tax years ending after December 31, 2017. Until such time that the proposed revenue procedure is published in final form, taxpayers may rely on the safe harbor.

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