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| SECTION 199A  TO BE OR NOT TO BE A TRADE OR BUSINESS  AND THOUGHTS CONCERNING THE REAL ESTATE INDUSTRY  by Cameron L. Hess, CPA, Esq.  The fickle Section 199 domestic production deduction, which benefitted the real estate construction industry, has left us like a jilted lover. New to town, however, is Section 199A and she has a very different personality.  Former Section 199 (Domestic Production Deduction.)  Briefly, the former Section 199, which ended December 31, 2017, generally provided a 9% deduction based on the lesser of qualified production activities income or taxable income.[[1]](#footnote-1) The deduction was further limited to 50% of wages paid in connection with domestic production gross receipts.[[2]](#footnote-2)  The former Section 199 was available for all taxpayers, including corporations. Specifically included were estates and trusts, and for owners of pass-through entities (partnerships and S Corporations) and for beneficiaries of estates and trusts (receiving distributions) attribution rules allowed the deduction to be passed out.[[3]](#footnote-3)  Former Section 199 included a critical term: domestic production gross receipts. While reduced for cost of sales and other expenses to determine production income, this term included receipts from any lease, rental, license, sale, exchange or disposition of qualifying production property, provided that the property was manufactured, produced, grown or extracted by the taxpayer.[[4]](#footnote-4) “Qualifying production property” included tangible personal property, computer software and sound recordings. In addition, included were film production, certain utility (electricity, natural gas or potable water) produced, and the active conduct of construction, including real property, and engineering and architectural services.  In identifying gross receipts, the former Section 199 simply identified that it applied only taking into account items attributable to the active conduct of a trade or business.  New Section 199A (Individual and Pass-through Business Deduction)  Section 199A under the Tax and Jobs Act was signed into law before Christmas and is effective January 1, 2018. It offers a far more attractive twenty-percent (20%) “above the line” deduction against qualified business income. While corporations are no longer eligible,[[5]](#footnote-5) the new Section 199A followed former law to be available to individuals, trusts and estates (including beneficiaries) aka “non-corporate taxpayers”, in connection with any trade or business.  Section 199A is no longer tied to domestic production. Section 199A is open to all businesses that do ***not*** involve either (i) securities investment management or a (ii) 1202(e)(3)(A) professional service organization (but permitting engineering and architecture services to qualify for Section 199A).[[6]](#footnote-6) The business may be undertaken by an individual, trust, estate or any pass-through entity (including an S corporation). If in a permitted entity, trust or estate, the qualification as a trade or business activity is recognized both to the entity and the owners or beneficiaries. While generally contained within Section 199A, these concepts are borrowed directly from international tax law.[[7]](#footnote-7)  Section 199A also introduces completely new terms.  One term is called the “Combined Qualified Business Income Amount” (or, for short “C-QBIA”). C-QBIA is a very simple term. It simply means tentative allowable deduction equal to twenty percent (20%) of the combined total of all Qualified Items from a Qualified Trade or Business. This tentative deduction is subject to several limitations, including taxpayer’s taxable income.  In identifying Qualified Items, Section 199A clearly states such amounts do not include items of capital gains and losses, dividends, interest, certain annuities and other like items not customarily considered trade or business income.  While all of the foregoing would *seem* to benefit the real estate industry and removes the requirement that taxpayer must produce property to qualify, Section 199A is far more complex than its predecessor. In addition, Section 199A may be available for additional sectors of the real estate industry; however, it does not necessarily treat all businesses within the same sector of the industry equally. Many of the differences occur due to two features: (i) the Qualified Trade or Business Requirement and (ii) Deduction Limitations.  Real Estate Industry.  As it will become apparent from the discussion below, Section 199A is not limited to the real estate industry; however, it will have a major benefit for many taxpayers engaged in real estate.  First, specifically included in the statute, are provisions which now allow the 20% deduction for investors in real estate investment trusts and qualifying cooperatives on their qualifying dividends.[[8]](#footnote-8) Second, the allowance of an alternate limitation against the 20% deduction, discussed below, which allows the deduction to the extent of the sum of 25% of wages and 2.5% of depreciable property basis, will significantly benefit hotels, motels and qualifying real estate rental property businesses. It will even benefit health-clubs and other businesses that are capital intensive, requiring significant property and equipment.  Qualified Trade or Business  While Section 199A retained the former Section 199 basic requirement that there be a trade or business, it refers to that term slightly differently and in two different contexts. What is unchanged is that to qualify for the 20% deduction under Section 199A the income must be derived from activities of the trade or business “carried on” by the taxpayer.  The concept of what is “carried on” by the taxpayer, however, is not self-apparent as to whether this was meant to narrow the terminology under former Section 199. Unchanged is that Section 199A does provide look-through rules that impute active trade or business activities of a partnership, limited liability company or other pass-through entity[[9]](#footnote-9) (“pass-through entities”) to its individual investor owners. Likewise, there is attribution to beneficiaries of a trust or estate.  However, the question arises as to whether the revised language is somehow intended to address who conducts the activities. Namely, is there a difference between whether an individual or pass-through entity directly conducts the activities or indirectly operates by contracting to have activities performed through an independent manager or outside service company. At least by case law, this should not make a difference.  In particular, the Ninth Circuit supported that there need not be employees or activity by the taxpayer him or itself, and an outside provider may instead conduct the business activities under a grant of authority from the taxpayer. Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff’d. per curiam 221 F.2d 227 (9th Cir. 1955).  In that decision, which is a highly interesting read, a Swedish citizen, connected by birth to the first California supreme court justice, had issued a war-time power of attorney which authorized a California broker to manage his California properties with the broker, holding “the power to buy, sell, lease, and mortgage real estate for and in the name of the petitioner, managed the petitioner's real properties and other financial affairs.” This authority alone in connection with the broker’s activities was found to be a trade or business with respect to the taxpayer, notwithstanding that the taxpayer remained overseas serving military duty and did not direct the activities.  On the other hand, the Internal Revenue Service may not follow the Ninth Circuit if there is any difference in the facts. In Rev. Rul. 75-374, 1975-1 C.B. 261 the ruling asked whether co-tenants to an apartment community should be considered to be partners or merely co-tenants, wherein there was imputed in the decision whether their activities constituted a trade or business. In that ruling, the Service analyzed Treasury Regulation Section 301.7701-1(a)(1). Under regulations, a partnership would be recognized if the participants undertake to carry on a trade, business, financial operation, or venture and divide the profits therefrom.  Based on that regulation, the Service concluded that the mere coownership of property that is maintained, kept in repair, and rented and leased does not constitute a separate entity for federal tax purposes. In reaching that opinion, the Service neither mentioned the Ninth Circuit court decision nor addressed attribution. The import of that ruling is possibly that the Service only deals differently to address the standard to determine a partnership is without allowing attribution. However, in the context of Section 199A, the ruling leaves a degree of uncertainty.  Consequently, for rental properties, where outside management is employed, there may be an issue of uncertainty as to the application of Section 199A. On the other hand, there are two possible responses. First, if a taxpayer (or pass-through entity) demonstrates some level of taxpayer control over decisions and policy over third party contractors or management and contractors, the Service may be inclined to find attribution. Second, at least within the Ninth Circuit, there is a position that attribution is allowed under Lewenhaupt to find an active trade or business if the outside management activities constitute a trade or business.  Under either standard, the level of real estate activities should be something beyond mere ownership. There should be some showing of the performance of services that are considerable, continuous and regular. (Herbert v. Commissioner, 30 T.C. 26 (1958))[[10]](#footnote-10)  Furthermore, it would appear that the passive activity loss rules should not be determinative as to what is a trade or business. Conceptually, Section 469 was designed to determine an “active” trade or business, wherein Section 469 itself does not dispute the existence of a trade or business, but asks whether the level of activities are sufficient to label a business active or passive or, by statutory definition is deemed passive, unless otherwise prescribed. More to the point, Section 199A, itself, does not refer to any part of Section 469 passive activity rules as guidance but refers to Section 469 in the ordering rules, as discussed below.  So, where does this take us? Absent guidance, there are both case law and IRS position statements as to what is a trade or business. For rentals of multi-family and commercial rentals, these questions require further guidance. There is a possible risk of disparate treatment of similar taxpayers with respect to (i) who qualifies due to third party activity attribution and (ii) what activities will be considered substantial, considerable and regular.  Qualified Items of Income.  It is also important to look at other terms of the statute.  As previously stated, qualified items of income will not include capital gains and losses, dividends, interest and annuity income. That’s well enough and even under former Section 199 domestic production deduction such income would not have qualified. Furthermore, Section 199A expressly excludes from treatment as qualified income any income that is considered foreign personal holding company income (interests, dividends, rents and royalties) – referencing provisions for Subpart F income. It also redefines the exclusion to not be limited to a “controlled foreign corporation.”  It would seem that the focus is to assure that no benefit will be granted to foreign passive holding company income, regardless of control. However, this provision seems somewhat unnecessary, except to complete the exclusion of foreign income not limited to income from a foreign trade or business. If Congress intended something different, further guidance will be needed.  In addition, with respect to pass-through entities, it is required that an adjustment be made to deduct from business income amounts paid as reasonable compensation and as a guaranteed or equivalent payment to partners for services.  Effectively Connected.  Section 199A provides that the trade or business must be “effectively connected” with the conduct of a US trade or business. While intended to identify that the benefit is not from foreign trade or business income, one has to look at the term “effectively connected” as it has had a long history – and the result may not be as Congress intended.  In particular, the IRS in publications and on its web site states that the concept of “effectively connected” specifically **excludes** “real property income, such as rents, other than gains from the sale of real property.” ([www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income](http://www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income))  The problem, however, is that this position appears to run contrary to statutes and regulations applying this concept. And if Section 199A is an expansion of Section 199 – which included rental income (if property is produced by the taxpayer), it would be wholly contrary to the intent of the statute in removing the production requirement from former Section 199 to eliminate rentals. Accordingly, it is uncertain whether the IRS would apply its position unreasonably.  More specifically, in the framework of the statutes determining effectively connected income, the regulations under Section 871, do not exclude either rents or real estate from being effectively connected with a United States trade or business. Rather, under Treas. Reg. 1.871-10, the election to treat rental income as effectively connected is expressly stated that it ***may*** be made regardless of whether real property activities give rise to a trade or business or not. It states:  The election may be made whether or not the taxpayer is engaged in trade or business in the United States during the taxable year for which the election is made or whether or not the taxpayer has income from real property which for the taxable year is effectively connected with the conduct of a trade or business in the United States. (Treas. Reg. 1.871-10(a).)  For Section 871, the point of this election was to both change characterization and to provide a safe harbor for rental real estate trade or business activities. The fact that Section 199A offers no such safe harbor does not eliminate the right for rental activities to be an active trade or business. However, the IRS’s position may create greater issues for the application of Section 199A to rental activities.  So, where does this leave the term “effectively connected”? Certainly, it limits the deduction to activities that occur only within the United States. And, as a borrowed term, it allows taxpayers to cite conceptually as to the term “trade or business” with reference to case law under Section 871. But beyond that, the statute’s addition of this term, rather than retaining the former terms under Section 199 which simply referenced activities in the United States, may provide more confusion.  Wage Limit; Wage-Basis Limit; Small Taxpayers  The other hurdle for the real estate industry is the impact of alternate limits that reduce the allowable portion of the 20% deduction. Section 199A provides more options, but slightly modified terminology that may shift which enterprises will qualify for Section 199A.  Under Section 199A, there are three alternative limitations to C-QBIA. The deductible C-QBIA amount allowed is the greater of the amount under the following three limits: (i) the Small Taxpayer Exception, (ii) a Simple Wage Limit or (iiii) a Wage-Basis Limit.   1. Small Taxpayer Exception. Small taxpayers are not limited by wages or tax basis. For taxpayers with not more than $157,000 ($314,000, married filing jointly) in taxable income, there is no further limit on the amount of C-QBIA. If there are qualified items of income, the 20% deduction is allowed.   If taxable income exceeds the taxable income limit, there is a progressive phase-out of the tentative deduction, based on the percentage of the excess as relates to $50,000 ($100,000 if married, filing jointly) of taxable income above the limit. Accordingly, the exemption is phased out to zero above $207,000 ($414,000, married filing jointly) in taxable income. For example, if a single individual has taxable income $25,000 above the limit, then only one-half (25/50) of the Q-BIA amount will be deductible.  This small taxpayer exception is especially beneficial to taxpayers with small enterprises who engage in a “fix and flip” of houses, if taxable income is below the limits. In addition, self-managed rental property, involving owner documented considerable, continuous and regular activities may qualify.   1. Simple Wage Limit. Except for small taxpayers, generally the 20% deduction is limited to 50% of total reported wages. And, consistent with former Section 199, the allowable Section 199A reported wages are only recognized if the annual Form W-2 reports are timely filed.   For purposes of determining wages, regulations under the former Section 199 identified that includable wages may be paid by another person, but the wages must be in connection with employees of taxpayer. Presumably this was to address employee leasing arrangements, wherein employees worked under the direction of a taxpayer, but were covered by the leasing agency. (Treas. Reg. 1.199-2.) This portion of the regulations should apply to Section 199A.  For real estate contractors, property maintenance and management companies, set up as a proprietorship or pass-through entity having in-house employees, the simple wage limit provides substantial deduction. This simple wage limit is a boon to service enterprises connected to the real estate industry. Conversely, as discussed below, neither this limit nor the wage-basis limit may provide much benefit to many in the home builder industry.   1. Wage-Basis Limit. Alternatively, the 20% deduction may be limited to the sum of (i) 25% of wages and (ii) 2.5% of unadjusted basis of depreciable property.   The wage-benefit limit, as explained further below, will have a significant benefit to larger property investment companies that are organized as a pass-through entity, whether or not the enterprise involves a service or rental of units. For example, a large apartment or commercial property syndication will qualify.  Wages.  Except for small taxpayers, one limit will be wages. For wages to be counted, Section 199A states that it must be “paid by such person with respect to employment of employees by such person.” (Section 199A(b)(4)(A)) Simply translated, it appears to mean that wages paid by a third party does not appear to count. For example, for rental properties, if all wages are paid by an affiliate management company, and charged to the investment, it appears that none of the wages would be counted as qualifying by the statute.  In interpreting these provisions, there is a significant risk that the Service will construe the wage limit narrowly. While there are few cases on former Section 199, and none as to wages, the Courts made it clear with former Section 199 that the provisions for a deduction may be construed narrowly.[[11]](#footnote-11)  Basis Limit.  Where the basis limit applies – under the combined wage/base limit, the amount of wages, while important, is not exclusive to qualification. An additional amount of a deduction will be allowable to the extent of 2.5% of unadjusted basis of depreciable property.  This combined wage-basis limit may be beneficial for qualifying rental owners.  For this measure, all property used in the trade or business is counted at 2.5% of its tax basis before depreciation. However, the “countable use” period is limited. Basis is counted from the date placed in-service to the later of 10-years or useful life. The technical term as to useful life is “the last day of the full year in the applicable recovery period, which means that under the ½-year or mid-month convention, the final year is generally not counted. For example:  • A building placed in service 1/1/2018 (or as early as 1/1/2009) would qualify for 27-years or 39-years from the start date;  • Carpet placed in service 1/1/2018 (or earlier) would count for 10-years from the date placed in service.  Example. Joe Benson bought an apartment building for $1.5 million on January 1, 2013. His basis in the building is $1 million. There are no other assets. There are no wages – he self-manages. Assume the small taxpayer exemption does not apply.  Assuming that the taxpayer’s activities qualify as an active trade or business, under the wage-basis limit, and zero wages, the amount deductible will be limited to $25,000. (2.5% x $1 million.) Whether Joe owns the apartment building directly, in an S Corporation or an LLC will not be relevant – if the 20% is allowed, it will be allowed under all options.   |  | | --- | | **Note**. Regarding the basis limit, the statute does not expressly address the effect of claiming on the property either the Section 179 election to expense an asset or an election to take first year additional (bonus) depreciation. The statute only refers to property that would qualify for depreciation under Section 168.  There is no commentary as to what was intended. One reading is that the basis of the depreciable property purchased should always qualify for the 2.5% basis limit regardless of any election to expense or election to depreciate the property in full the first year. The Service may concur that is the correct reading as to exactly what Congress had intended. However, until guidance is issued, taxpayers should be warned to not presume this outcome. |   Section 469.  The Act provides that the 20% deduction is applied after application of Section 469.  Given that the suspension of losses would in fact increase other trade or business income, for years in which there are suspended losses, the benefit of the 20% deduction should be greater. Conversely, for years in which prior-year suspended losses are released or are available for offset, a determination will need to be made whether these losses arise from a trade or business – and will reduce both taxable income and C-QBIA.  Taxable Income Limit.  The enactment of Section 199 was not intended to create a deficit in taxable income – or a net operating loss. In fact, the deductible amount will be limited taxable income based on the following:   1. Adjusted Taxable Income: The C-QBIA will first be limited to Twenty percent (20%) of adjusted taxable income. Generally adjusted taxable income is the taxpayer’s taxable income reduced by reported net capital gain. Certain adjustments are made for special items like agricultural cooperative dividends. 2. Taxable Income. Next, the amount allowable will be limited to not exceed one hundred percent (100%) of the taxpayers’ reported taxable income.   The effect is that the deduction will not be allowed to result in a net operating loss, nor exceed 20% of taxpayer’s taxable income, before net capital gains. For example, if there are prior-year net operating losses, the allowable net operating losses will first reduce both taxable income and the 20% adjusted taxable income amount; any excess C-QBIA will not qualify for a carryforward and will be disallowed.  In addition, to the extent allowable, the deduction, while an “above the line” deduction, is not considered a deduction in determining adjusted gross income – essentially it is in addition to the standard deduction or itemized deduction. This means that any phase-out due to excess adjusted gross income will occur regardless of the impact of the 20% deduction on taxable income. The 20% deduction is not listed as a preference item for alternative minimum tax purposes.  Home Builders.  While there are a number of different real estate industries, the 20% deduction will be of particular concern for home builders who were previously using the Section 199 domestic production deduction. There are a lot of uncertainties and it is possible that home builders may be treated inconsistently under these new rules.  First, as with prior law, given the division of labor, land holding entities have zero amounts paid directly as wages and have zero amounts of depreciable property. Much of the construction work will be done through subcontractors (who may qualify for the 20% deduction.) This outcome would probably not change even if the contract was arranged as a cost-plus, so long as the employees are those of the subcontractor, not the home builder. Accordingly, without wages or depreciable property, it is possible that the amount of the deduction will be zero.  Second, while a home builder could change the business model to create wages; the problem may remain that the wages paid through an affiliate corporation, not the land holding entity from whom wages are generated, may not be considered to be wages of the taxpayer. Accordingly, whether the 20% deduction will be allowed will depend on arbitrary differences in how wages are paid and by whom.  Third, few builders will meet the small taxpayer exception, if they undertake more than a few homes. Taxable income usually substantially exceeds the limits.  Lastly, those who operate through C corporations will not qualify. On the other hand, the 21% corporate tax rate will certainly reduce their tax burden.  Accordingly, for home builders there are only limited opportunities. First, smaller builders may be willing to operate through a corporation and take profits by way of a reasonable salary, to avail the 21% tax rate. However, this does nothing to encourage the use of the 20% deduction allowed to pass-through entities. Second, if there are employee supervisors – such as the project manager, there may be a position for a small deduction – provided wages can be allocated to the pass-through entity.[[12]](#footnote-12)  \*\*\*\*\*  Obviously, this is an area for which further guidance is needed. Our office is actively advising many in the real estate industry regarding Section 199A, finding that qualification requires careful analysis.  *Cameron Hess is a partner with the law firm of Wagner Kirkman Blaine Klomparens & Youmans LLP (WKBK&Y). WKBK&Y’s practice focuses on real estate, tax, business, estate planning and litigation. Mr. Hess may be reached at (916) 920-5286 or at chess@wkblaw.com.* |

1. Section 199(a) of the Internal Revenue Code as effective through December 31, 2017. Under former Section 199(d)(2), for individuals, the term taxable income was substituted for adjusted gross income, determined after application of sections 86, 135, 137, 219, 221, 222 and 469. [↑](#footnote-ref-1)
2. Section 199(b). [↑](#footnote-ref-2)
3. Section 199(d). [↑](#footnote-ref-3)
4. Section 199(c)(4). [↑](#footnote-ref-4)
5. Under the Tax and Jobs Act, all corporations are instead granted a 21% flat corporate tax rate, wherein the former tiered rates up to 35% have been eliminated. [↑](#footnote-ref-5)
6. As revised, excluded services include accounting, actuarial science, financial services and consulting. Excluded services also include performing artists and athletics and any trade or business that relies on the “reputation or skill” of one or more employees. In reading, Section 199A allows other types of businesses not permitted under Section 1202; While Section 199A borrowed from Section 1202, these two sections have no overlap wherein Section 1202 is only qualified business stock in a C Corporation. Section 1203(c). [↑](#footnote-ref-6)
7. For example, under IRC Section 875, the activities of a partnership, estate or trust engaged in any trade or business within the United States will be attributed to its partners and, in the case of an estate or trust, to its beneficiaries. [↑](#footnote-ref-7)
8. While not covered in much detail by the statute, the statute identifies that the 20 percent deduction will be allowed as to the income from publicly traded partnerships. While not clearly stated, presumably this is in reference to only those allowed to be treated as pass-through entities, meeting the 90% qualified dividends requirement. [↑](#footnote-ref-8)
9. Pass-through entities also include a REIT and qualified cooperative for that portion of dividends consisting of qualified business income. For a REIT, any dividend distribution that represents a capital gain or an ordinary dividend (not business income) will not qualify. The new Section 199A continues to retain provisions allowing a deduction for agricultural and horticultural cooperatives. [↑](#footnote-ref-9)
10. The taxpayer in Herbert did not prevail where the taxpayer owned a single building, holding a single tenant. This could be extended to a rental of a simple ground lease. On the other hand, cases where taxpayer prevailed involved ownership of several rental properties. The argument may be made whether based on the number of properties being subject to preparation, marketing and ease, that the entirety of the activities should be treated as a trade or business. As to further guidance, presently the IRS’s Chief’s Counsel Office has not assigned staff to review this issue, and is seeking commentary and questions. [↑](#footnote-ref-10)
11. See Advo, Inc. v. Com’r, 141 T.C. No. 9 (2013), where the Tax Court disallowed a Section 199 deduction for work entirely subcontracted out, but required Section 263A capitalization, finding based on an evaluation of factors that taxpayer did not take on the benefits and burdens of manufacturing. Not at issue were wages, but simply the taxpayer’s claim that it was the producer; to which the court disagreed. Interestingly, two years later, in the 2015-year, the Service issued Treas. Reg. 1.199-3, wherein under subparagraph (f)(2), it listed by example the exact same circumstances, but made a favorable conclusion. [↑](#footnote-ref-11)
12. While Section 199A should not be limited by Section 263A capitalization, limited wages present a significant possible limit to home builders. [↑](#footnote-ref-12)