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Code § 199A Final Safe Harbor for Rental Real Estate; Recent Developments in Partnership Structural Issues; Taxing Sale of Intangible Assets

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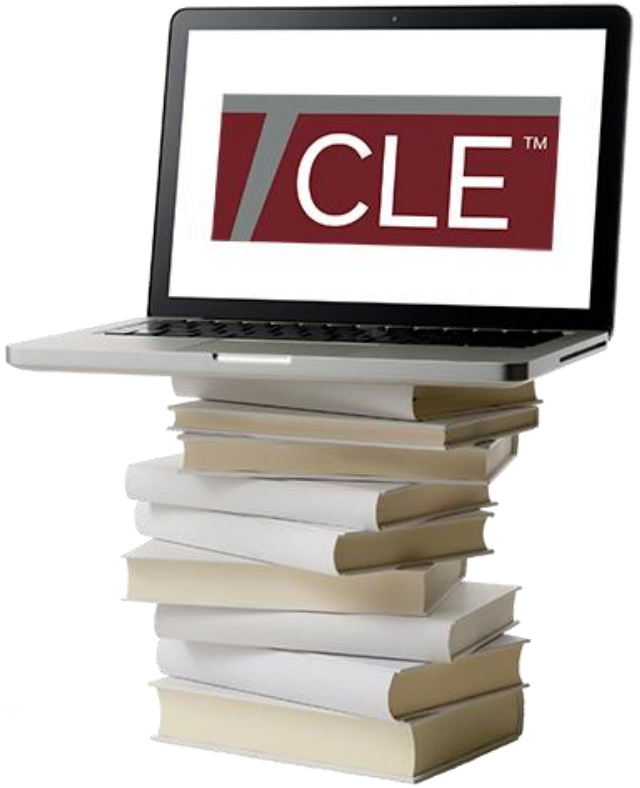

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Overview

- Final “safe harbor” for rental real estate as qualified business income under Code § 199A; planning tips for real estate
- Recent developments in partnership tax structuring
- Income Taxation of Intellectual Property and Other Intangibles in Light of 2017 Tax Reform

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- How the new safe harbor for real estate changed from its proposed terms and the extent to which the safe harbor helps
- Strategy for qualifying real estate rental as a trade or business under IRC § 199A independent of the safe harbor

Real Estate as QBI (II.E.1.e.)

Rental is deemed to be a trade or business if:

- It is rented or licensed to a trade or business which is commonly controlled under Reg. § 1.199A-4(b)(1)(i), whether or not it is aggregated. That control means that the same person or group of persons, directly or through Code § 267(b) or 707(b) attribution, owns 50% percent or more of each trade or business to be aggregated, including 50% or more of the issued and outstanding shares of an S corporation or 50% or more of the capital or profits in a partnership.
- Rental to a C corporation does not qualify, because a C corporation cannot be aggregated

But, treated as SSTB if and to the extent leased to commonly controlled SSTB (II.E.1.c.iv.(o))

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

Preamble to final regs, T.D. 9847 (2/8/2019):

> In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

Rev. Proc. 2019-38 "provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business" solely for purposes of Code § 199A and the regulations thereunder, then says, "If an enterprise fails to satisfy the requirements of this safe harbor, it may be treated as a trade or business for purposes of section 199A if the enterprise otherwise meets the definition of trade or business in § 1.199A-1(b)(14)."

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Safe harbor available with respect to a "rental real estate enterprise" (defined below)
- If safe harbor requirements are met, the rental real estate enterprise will be treated as a single trade or business when applying the regulations, including aggregation rules

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Safe harbor available with respect to a “rental real estate enterprise” (defined below)
- If safe harbor requirements are met, the rental real estate enterprise will be treated as a single trade or business when applying the regulations, including aggregation rules
- RPEs, as defined in § 1.199A-1(b)(10), may also use this safe harbor

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Rental real estate enterprise is an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties
- Taxpayer or RPE must hold each interest directly or through an entity disregarded as an entity separate from its owner

Rental Real Estate & Code § 199A (II.E.1.e.i.(a).)

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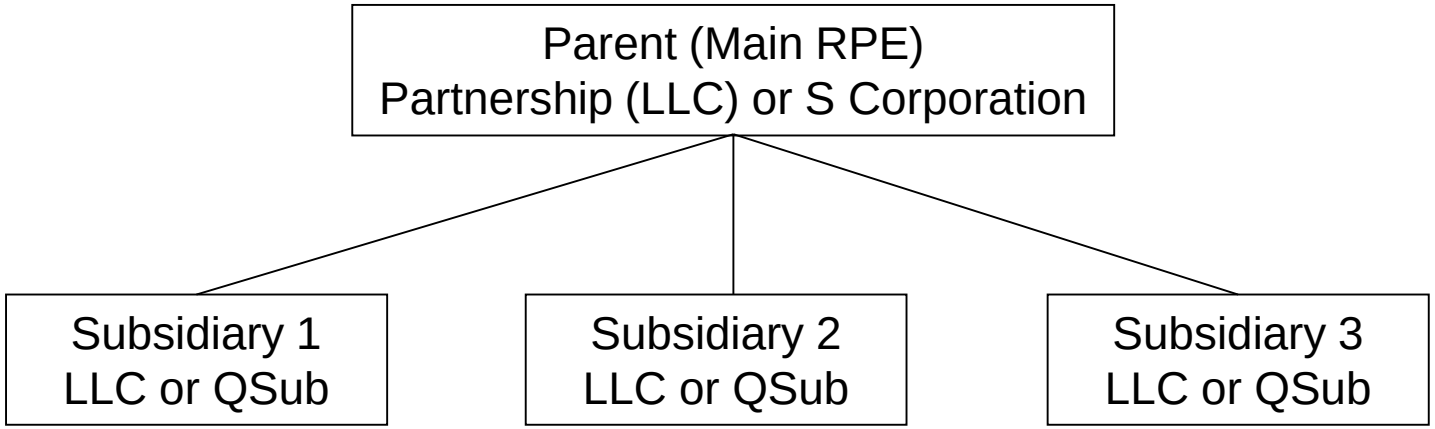
May need to restructure to have single member LLCs under the main RPE (if main RPE is an S corporation, also might use QSub) so that all real estate interests are one RPE and qualify as a single rental real estate enterprise:



Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Generally, taxpayers and RPEs may either treat each interest in similar rental property as a separate rental real estate enterprise or treat interests in all similar rental properties as a single rental real estate enterprise
- Thus, commercial rental may only be part of the same enterprise with other commercial rental(s), and residential rental may only be part of the same enterprise with other residential rental(s)

Rental Real Estate & Code § 199A

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Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Once taxpayer or RPE treats interests in similar properties as a single rental real estate enterprise under safe harbor, must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when rely on the safe harbor
- However, if treat each residential or commercial property interest separately, may later elect to combine all of them within applicable category

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

New rules/clarification in safe harbor:

- A single building with residential and commercial (mixed-use) may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests
- Each rental real estate enterprise that satisfies the requirements of the safe harbor is treated as a separate trade or business for purposes of applying Code § 199A and regs

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Annually decide whether to use the safe harbor
- Each rental real estate enterprise will be treated as a single trade or business if meet all of: (A) separate books and records for each rental real estate enterprise, (B) 250 or more hours of rental services each year (or three out of past five if exist four years), and (C) contemporaneous records – stricter than the passive loss rules. Changes in (A) & (C) from before – see materials

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Attach statement to timely filed original return
- Dropped requirement that statement signed under penalties of perjury
- List of what qualifies and what does not qualify as rental services essentially the same as before
- So is list of rental real estate arrangements excluded from safe harbor, other than expanding the reach of the triple net lease and anti-SSTB exclusions (both in following slides)

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Triple net lease "includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and ***to pay for maintenance activities for a property in addition to rent and utilities***" (emphasis added)
- Used to be "… to be responsible for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or 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."

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- "To be responsible for maintenance activities" indicated to me that, for the lease be a disfavored "triple net lease" under Notice 2019-7, the tenant had to not only pay for maintenance but also arrange the maintenance
- Rev Proc. 2019-38 eliminates the responsibility requirement by providing that mere payment of maintenance is enough connection to maintenance activity that, when combined with other factors in both tests, would make the lease a disfavored triple net lease

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- This change will knock most large shopping centers and large office buildings out of the safe harbor
- However, those activities do not appear to need a safe harbor anyway, given the level of service typically provided (see slides after safe harbor)
- I am more concerned about real estate with only one or a very few tenants, where the IRS seems to want the landlord to take more financial risk

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Safe harbor also excludes the entire rental real estate interest if any portion of the interest is treated as an SSTB under § 1.199A-5(c)(2) (which provides special rules where property or services are provided to an SSTB)
- In contrast to this complete knockout when an SSTB is involved, SSTB rules knock out only that portion of the rental leased to the SSTB
- Rely on general rules instead of safe harbor

Trade or Business

- Best discussion - part II.I.8.c.iii Rental as a Trade or Business
- Part II.G.4.I.i.(a) “Trade or Business” Under Code § 162
- Part II.G.27.b Real Estate as a Trade or Business
- One rental to one tenant can qualify if the landlord does enough activity
- Safe harbor is much more stringent than case law
- However, consider keeping records that safe harbor would require

Real Estate as QBI (II.E.1.e.)

Should expenditures and employees move to landlord, with tenant reimbursing landlord for costs?

- Tenant may have plenty of wages and not need them for W-2 wage limitation; employees would help landlord with W-2 wage limitation calculation
- Are landlord's owners different from tenant's owners?
- Does landlord want to devote time to this active role?
- Landlord entity becomes liable for employees' action or inaction; whoever controls landlord may be personally liable for negligent hiring
- Consider perceived adequacy of liability insurance

Partnership Structuring

- Final regulations discussing employee vs. partner in tiered structures
- Nature of interest expense when a partnership interest changes hands
- Effect of changes on inside basis when an interest in a tiered structure changes hands

Employee vs. Partner in Tiered Structures

- How recently finalized regulations treat compensatory payments from disregarded entities to partners in the parent partnership
- What those regulations intentionally did not address that provide opportunities for tiered partnership structures

Compensatory Payments from Disregarded Entities to Partners

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- All of a partnership's or sole proprietorship's operating income is subject to income tax and self-employment (SE) tax (II.L.3.)
- Rul. 69-184: payments from a partnership to a partner never reported on Form W-2 and instead must be reported on a K-1 (II.C.8.)

Compensatory Payments from Disregarded Entities to Partners
(II.C.8.)

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- An entity that is disregarded for income tax purposes is also disregarded for SE tax purposes, even though separate entity for payroll tax purposes
- Thus, a partner in a partnership that owns a disregarded entity is treated as a partner with respect to the disregarded entity and cannot receive a Form W-2 (the "DRE Rule")

Compensatory Payments from Disregarded Entities to Partners
(II.C.8.)

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T.D. 9869 (7/2/2019) commented, "As noted in the preamble to TD 9766, these regulations do not address the application of Rev. Rul. 69-184 in tiered partnership situations, but rather clarify that a disregarded entity owned by a partnership is not treated as a corporation for purposes of employing any partner of the partnership…. However, the Treasury Department and the IRS will continue to consider the application of Rev. Rul. 69-184, including the specific issue noted by the commenter [regarding publicly traded partnerships], and welcome further comments."

Compensatory Payments from Disregarded Entities to Partners
(II.C.8.)

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- Suppose that Partnership P owns 95% of Partnership S, and A is an individual who owns the other 5% of Partnership S
- A cannot be an employee of Partnership S, because A is a partner in Partnership S
- However, A can be an employee of Partnership P

Compensatory Payments from Disregarded Entities to Partners
(II.C.8.)

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- However, if A worked exclusively for Partnership S and Partnership P merely acted as a conduit through which Partnership S compensated A, then IRS might argue that Partnership S is considered the true payor of compensation, recharacterizing payments to A as those to a partner
- The IRS took a similar position in CCA 201916004, which asserted that running a partner's compensation through a Certified Professional Employer Organization (CPEO) does not convert the compensation to wages; rather, the CPEO needs to use Form 1099-MISC to report that compensation

Nature of Interest Expense

- How to determine the deductibility of interest expense incurred by a partnership
- How distributions from a partnership affect that determination
- Taxpayer victory regarding how that determination changes when a partnership interest changes hands

Nature of Interest Expense
(II.G.21.a.)

- Generally interest is classified as business, investment, or personal
- How the borrowed funds were used determines the nature of the expense
- If the loan proceeds went directly to the borrower, trace the flow of funds to see what borrower did with them

Nature of Interest Expense
(II.G.21.a.)

- If lender disburses to person other than the borrower for the sale or use of property, services, or any other purpose, treat debt as if borrower used proceeds for that expenditure
- If a taxpayer incurs or assumes a debt for the sale or use of property, services, or any other purpose, or takes property subject to a debt, debt is treated as if the taxpayer paid for such property, services, or other purpose.

Nature of Interest Expense
(II.C.3.d)

Notices 88-37 and 89-35:

- Debt-financed distributions to partners look to the partners' use of the loan proceeds
- Separately trace each partner's use, and allocate interest expense to each partner, with the nature of that expense dependent on that use

Nature of Interest Expense
(II.C.3.d)

Lipnick v. Commissioner, 153 T.C. No. 1 (2019):

- Dad used debt-financed distribution to buy investments, so the interest expense was investment interest
- Dad gave and bequeathed partnership interest to son while debt was outstanding
- IRS argued the debt retained its nature forever

Nature of Interest Expense
(II.C.3.d)

Lipnick v. Commissioner, 153 T.C. No. 1 (2019):

- Instead, court held that the son's deemed assumption of debt made the transfer a deemed bargain sale
- Therefore, the debt was allocated among the partnership's assets

Tiered Structures: Inside Basis (II.Q.8.e.iii.)

- How inside basis adjustments flow inside tiered partnerships
- A new TAM may expand the types of transfers that can trigger inside basis adjustments

Tiered Structures: Inside Basis (II.Q.8.e.iii.(b))

- If partnership UTP has Code § 754 election in place, a qualifying transfer would cause a basis increase in UTP's basis in partnership LTP that UTP owns
- However, LTP would need to have a Code § 754 election in place for UTP to receive a basis increase in LTP's assets

Tiered Structures: Inside Basis (II.Q.8.e.iii.(b))

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Tiered Structures: Inside Basis (II.Q.8.e.iii.(b))

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Letter Ruling 201906002:

With respect to any increase in the basis of partnership property under Code § 743, a partnership is treated as an aggregate of its owners under the anti-churning rules (see later) that apply to the transfer of intangibles in determining whether amortized

Tiered Structures: Inside Basis

- When partnership has a net unrealized loss that exceeds $250,000, qualified transfer triggers decrease in the basis of that partner's share of the partnership's assets, even if Code § 754 election not in effect (II.Q.8.e.iii.(c))
- Qualified transfer includes "exchange," whether or not exchange is taxable (II.Q.8.e.i)

Tiered Structures: Inside Basis

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TAM 201929019: (II.Q.8.e.i)

- Such a transfer includes a deemed distribution of a partnership interest in an assets-over merger of two partnerships (II.Q.8.e.v.)
- Partnership X is deemed to contribute all of its assets and liabilities to Partnership Y in exchange for an interest in Y
- Immediately thereafter, X is deemed to distribute interests in Y to X's owners in liquidation of X

Tiered Structures: Inside Basis (II.Q.8.e.iii.(c))

- Thus, a qualified transfer includes an actual or a deemed distribution of a partnership interest
- TAM 201929019 used this to argue a mandatory basis step-down occurred
- Triggering basis adjustments can be favorable or unfavorable to taxpayers and should be considered when planning a nontaxable transfer

Intellectual Property

- How 2017 tax law changes curtailed favorable treatment on the sale of intellectual property
- How the treatment of goodwill, etc. differs from the above treatment, which may inform strategies for allocating purchase price or structuring a purchase

Intellectual Property (III.G.6.a)

- Property used in a business is not a "capital asset," even if it requires a lot of capital investment (such as a building)
- Code § 1231 treats as capital gain any gain from the sale of business assets, except to the extent of depreciation recapture on personal property
- Code § 1231 treats as ordinary loss any loss from the sale of business assets
- Any ordinary losses deducted in this way are later recaptured by taxing Code § 1231 gain as ordinary income

Intellectual Property (III.G.6.a)

Ineligible for Code § 1231:

- inventory
- property held primarily for sale to customers in the ordinary course of trade or business
- copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in Code § 1221(a)(3)
- certain U.S. Government publications

Intellectual Property (II.G.19.b.)

Code § 1221(a)(3) excludes from capital gain and Code § 1231 treatment a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by:

- a taxpayer whose personal efforts created such property,
- in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
- a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described above

Intellectual Property (II.Q.8.b.i.(f))

However, the sale of an interest in a partnership that holds the above-mentioned property may receive capital gain treatment with respect to the value attributable to that property if:

- the property is not being amortized, or
- the sale is a Code § 736 redemption (II.Q.8.b.ii.)

Goodwill (II.Q.1.c)

Purchased goodwill and other intangibles may be amortized unless goodwill anti-churning rules (II.Q.1.c.iv.) apply:

- The intangible was held or used at any time on or after 7/25/1991, and on or before such date of enactment by the taxpayer or a related person,
- The intangible was acquired from a person who held such intangible at any time on or after 7/25/1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or
- The taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after 7/25/1991, and on or before such date of enactment

Goodwill (II.Q.1.c)

- Letter Ruling 201906002 allowed a tiered partnership to get a Code § 743 basis adjustment. The ruling also described how the IRS would treat various transactions under the goodwill anti-churning rules.
- Goodwill amortization provides current deduction (over 15 years) but also may cause goodwill to be subjected to ordinary income tax instead of capital gain

Goodwill (II.Q.1.c)

- Consider what happens if one amortizes $X and it grows in value to $10X
- Compare self-created intellectual property (ordinary income) to self-created goodwill and other intangibles (capital gain)
- However, a sale of intangibles between related parties may be ordinary income:
  - sale between a partnership and its controlling owner or sale between two partnerships controlled by the same persons (II.Q.8.c)
  - sale between a controlled corporation and related party or liquidation (II.Q.7.g.)

Conclusion

- February 12, 2019 webinar Fiduciary Income Tax Refresher and Update 2019
- Blog: Business Succession Solutions
- Reports on Heckerling: http://www.thompsoncoburn.com/forms/gorin-heckerling
- Gorin's Business Succession Solutions
- January 28 webinar for Fourth Quarter Newsletter
- Leimberg – October 31 – see newsletter