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Proposed Regulations Provide Further Guidance to Taxpayers to Qualify for the §199A Deduction for Qualified Business Income

By Robert E. Ward, J.D., LL.M.
WardChisholm, P.C.
Vancouver, British Columbia and Bethesda, Maryland

On August 16, 2018, the Internal Revenue Service published Proposed Treasury Regulations (the ''Proposed Regulations'')[1] under §199A as enacted by the 2017 tax act.[2] The preamble to the Proposed Regulations confirms the 20% deduction for qualified business income under §199A is available to both foreign and domestic taxpayers. Foreign individuals and entities conducting business in the United States will often prefer to do so through a U.S. corporation because of the reduction in the corporate tax rate from 35% to 21% and the opportunity to defer home country recognition of the income realized by the U.S. corporation. However, investments in U.S. real property may favor use of passthrough entities in order to take advantage of preferential capital gain rates on dispositions of U.S. real property interests. While capital gains are excluded from qualified business income for purposes of the deduction offered by §199A, rental income satisfies the requirements for qualified business income and can be partially sheltered by the 20% deduction available when the requirements of the statute are met.

For foreign investors whose U.S. taxable income does not exceed the threshold amount of $157,500[3] (the ''Threshold Amount''), the only limitation on the taxpayer's ability to claim the 20% deduction for qualified business income is that the amount deductible not exceed 20% of the amount by which the taxable income of the taxpayer exceeds the sum of net capital gain and the aggregate amount of qualified cooperative dividends).[4] However, in the case of taxpayers whose taxable income exceeds the Threshold Amount, W-2 wages incurred with respect to the qualified trade or business and the basis of qualified property used in the trade or business will determine how much a taxpayer will benefit from the 20% deduction provided by §199A.

If taxable income exceeds the Threshold Amount, §199A(b)(2) imposes two alternative limitations on the taxpayer's ability to claim the 20% deduction for qualified business income. The first is that the deduction may not exceed 50% of W-2 wages paid with respect to the qualified trade or business. The second limitation is the sum of (a) 25% of the W-2 wages paid with respect to the qualified trade or business plus (b) 2.5% of the ''unadjusted basis immediately after acquisition of all qualified property'' (the ''UBIA Amount''). The taxpayer is allowed to use the limitation which allows the largest deduction. With the assumption that the amount of W-2 wages paid in connection with most real estate investments will not generate sufficient W-2 wages to allow the full amount of the §199A deduction, this article focuses on the guidance provided by the Proposed Regulations regarding qualified property for purposes of the UBIA Amount.

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[1] REG-107892-18.

[2] Pub. L. No. 115-97 (Dec. 22, 2017).

All section references are to the Internal Revenue Code of 1986, as amended (''the Code''), or the Treasury regulations thereunder, unless otherwise indicated.

[3] Taxpayers filing joint returns are eligible for 200% of the Threshold Amount, $315,000. However, to file a joint return at least one spouse must be a U.S. citizen. *See* §6013(g).

[4] §199A(a)(1).

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Qualified property is defined by §199A(b)(6) as tangible property used in the qualified trade or business which is eligible for depreciation under §167 and

(i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

(ii) which is used at any point during the taxable year in the production of qualified business income, and

(iii) the depreciable period for which has not ended before the close of the taxable year.

The Proposed Regulations explain that the term ''unadjusted basis immediately after acquisition'' (''UBIA'') means the basis on the date the property was placed in service as determined under §1012 or other applicable sections of chapter 1 of the Code.[5] Basis adjustments due to regular, accelerated, or bonus depreciation, expensing under §179, and tax credits do not reduce UBIA.[6] Somewhat similarly, basis adjustments under §734(b) and §743(b) are also ignored in determining UBIA.

Example: A, B, and C are equal partners in ABC Partnership. The UBIA Amount of the partnership assets is $300; fair market value, $1,200. The partnership has made an election under §754. D buys A's interest in ABC Partnership for $400. Because of the §754 election, D's basis in the assets of ABC Partnership is $400. However, the UBIA Amount of the assets used in ABC Partnership's qualified trade or business remains $300.

While the result in the example makes sense for B and C, one may question whether the result was intended by the Proposed Regulations to apply to D.[7] The preamble states ''[t]reating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property (if, for example, the fair market value of the property has not increased and its depreciable period has not ended).'' If, instead of purchasing A's partnership interest, D had purchased one-third of the assets owned by ABC Partnership for $400 and used those assets in a qualified trade or business, including the qualified trade or business conducted by ABC Partnership, D would have a UBIA Amount basis of $400 immediately after acquisition. The form of the purchase should not require a different result, as long as D, A, and ABC Partnership are unrelated.

The term ''depreciable period'' is defined by §199A(b)(6)(B) as the period beginning with the date the property is first placed in service and ending on the later of

- 10 years after the date the property was first placed in service or
- the last day of the last full year in the applicable recovery period determined without regard to the alternative depreciation system of §168(g).

Additions or improvements to qualified property already placed in service will be treated as separate qualified property on the date first placed in service.[8] An anti-churning rule applies to exclude property acquired within 60 days of the end of taxable year and disposed of within 120 days without having been used in the trade or business for at least 45 days prior to disposition from qualified property taken into account for purposes of the UBIA Amount ''unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the section 199A deduction.''[9]

The treatment afforded tax-free exchanges under §1031 and §1033 by the Proposed Regulations may prove to be either a trap for the unwary or a planning opportunity. First, the depreciable period with respect to the exchanged basis as defined in Reg. §1.168(i)-6(b)(7) for the replacement MACRS property is determined by the date on which the relinquished property was first placed in service. Second, the UBIA Amount for the replacement MACRS property is determined by the adjusted basis in the relinquished property.[10] In contrast, if gain were recognized on the exchange such that basis in the replacement property is greater than the exchanged basis, the excess basis as defined in Reg. §1.168(i)-6(b)(8) is included in the UBIA Amount and the depreciable period runs from when the replacement property was first placed in service.[11]

Based on the text and the examples in the Proposed Regulations, it appears possible to extend the depreciable period by exchanging property which has a shorter recovery period for property which has a longer recovery period. The cost of such a strategy is use of the adjusted basis in the relinquished property to determine the UBIA Amount going forward.

Example: The taxpayer purchases residential real property in January 2019 for $10 million, which is

[5] Prop. Reg. §1.199A-2(c)(3).

[6] *Id.*

[7] The Proposed Regulations are not explicit in this regard. The entire discussion in the Proposed Regulations is contained in a single sentence. ''Basis adjustments under sections 734(b) and 743(b) are not treated as qualified property.'' Prop. Reg. §1.199A-2(b)(1)(iii).

[8] Prop. Reg. §1.199A-2(c)(1)(i).

[9] Prop. Reg. §1.199A-2(c)(1)(iv).

[10] Prop. Reg. §1.199A-2(c)(4) *Ex.* 2.

[11] Prop. Reg. §1.199A-2(c)(2)(iii)(B).

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allocated $2 million to the land on which the building is situated and $8 million to the improvements, which are depreciated over a 27.5-year recovery period on a straight-line basis using the mid-month convention. Annual depreciation deductions are $290,909. After five years, when the property has an adjusted basis of $6,545,455, the property is exchanged with an unrelated party for an office building worth $10 million. No gain or loss is recognized on the exchange. Under Prop. Reg. §1.199A-2(c)(2)(iii) and Reg. §1.168(i)-6(c)(4)(i), the recovery period for the replacement property is extended by 11.5 years (39 years – 27.5 years). Consequently, the depreciable period for the replacement property will run from January 2019. However, the adjusted basis will be available to determine the UBIA Amount for an additional 11.5 years. The benefit of the extended depreciable period offsets the use of the adjusted (reduced) basis: a longer depreciable period for a smaller UBIA Amount. If the exchange had not occurred, the remaining 23 years for which the unadjusted basis of the relinquished property was taken into account would allow total deductions of $4.6 million ($8 million × 2.5% × 23 years). With the exchange, the extended depreciable period allows additional deductions of $963,637 [($6,545,455 × 2.5% × 34 years) − $4,600,000].

If gain were recognized in the exchange, the increased basis is treated as separate qualified property first placed in service by the transferee on the date of the exchange.[12]

Under Reg. §1.168(i)-6(c)(4), if the recovery period for the replacement MACRS property is longer than the recovery period for the relinquished MACRS property, the depreciable period for the exchanged basis runs from the year in which the relinquished property was first placed in service but the longer recovery period for the replacement property applies. In contrast, if the recovery period for the replacement MACRS property is shorter than the recovery period for the relinquished MACRS property, the depreciable period for the exchanged basis runs from the year in which the replacement property is placed in service but the recovery period used is that applicable to the relinquished property.

Interestingly, neither the statute nor the Proposed Regulations require an exchange to be between unrelated parties in order to get the benefit of the extended recovery period illustrated by the example above. Section 199A(h)(1) directs the Secretary of the Treasury to issue anti-abuse rules similar to those found in §179(d)(2) in order to prevent manipulation of the recovery period for qualified property using transactions between related parties. Section 179(d)(2) addresses purchases. Section 199A(h)(2) directs issuance of anti-abuse rules related to exchanges, but omits any reference to related parties.

[12] Prop. Reg. §1.199A-2(b)(iv)(B).

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