CORDASCO
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2019

THE "20% 199A DEDUCTION" AND "QUALIFIED OPPORTUNITY FUNDS"

Detailed Overview

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RECENT DEVELOPMENTS INVOLVING THE "20% 199A DEDUCTION" AND "QUALIFIED OPPORTUNITY FUNDS"

INTRODUCTION

The **"Tax Cuts and Jobs Act" (TCJA)** signed into law in late 2017 represented the most substantial tax reform legislation since 1986. This legislation contained two brand new provisions that are attracting tremendous attention: the new 20% deduction under section 199A **(*"20% 199A Deduction"*)** available to owners of a broad range of businesses and other investors, and a new set of potential tax benefits for taxpayers who invest their capital gains in ***"Qualified Opportunity Funds."*** Although both provisions were first effective in 2018, there are still unsettled issues regarding these new provisions. Therefore, over the last 12 months, the IRS has been busy releasing significant guidance addressing many of these issues.

We are sending you this letter to give you an overview and provide you with the latest guidance on these two critically important provisions: **1)** The ***20% 199A Deduction*,** and **2)** The ***Tax Benefits of Investing in "Qualified Opportunity Funds."***

Caution! Even though the IRS has released guidance on both provisions, we are still waiting for further IRS clarifications. For example, in late 2018 the IRS issued lengthy "proposed regulations" on *Qualified Opportunity Funds* (which we highlight in this letter). However, these proposed regulations could be replaced with "final regulations" soon which could provide additional guidance. We closely monitor these IRS releases on an ongoing basis, so please feel free to call our firm for the latest IRS notifications, announcements, and regulations regarding the *20% 199A Deduction* and *Qualified Opportunity Funds*.

Also, ***we suggest you call our firm before implementing any tax planning technique discussed in this letter.*** You cannot properly evaluate a planning strategy without calculating your overall tax liability with and without that strategy. This letter contains ideas for Federal income tax planning only. ***State income tax issues are not addressed.***

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THE 20% 199A DEDUCTION (INCLUDING THE LATEST IRS GUIDANCE)

First effective in 2018, the new 20% 199A Deduction is one of the most significant and far-reaching provisions of the **"Tax Cuts And Jobs Act" (TCJA).** The IRS has estimated that over 20 million taxpayers took this deduction on their 2018 tax returns. As with most major new tax provisions, the actual statutory provisions of section 199A left many unanswered questions and gray areas. In response to that uncertainty, the IRS has recently provided important guidance by: **1)** Issuing lengthy and detailed Final 199A Regulations ("Final 199A Regs"), and **2)** Releasing other miscellaneous section 199A guidance (including a new Revenue Procedure that helps determine whether net income from a rental real estate activity qualifies for the 20% 199A Deduction). This segment highlights key provisions from this IRS guidance.

OVERVIEW - BASICS OF THE 20% 199A DEDUCTION

Before discussing the new 199A guidance, let's first review the basics of the 20% 199A Deduction:

Types Of Income That May Generate The 20% 199A Deduction. There are three types of income that may generate the 20% 199A Deduction: **1) Qualified Business Income, 2) Qualified REIT Dividends, and 3) Publicly Traded Partnership Income.** Of these three types of qualifying income, **"Qualified Business Income" (QBI)** is having the most significant impact on the broadest range of taxpayers. Consequently, the remainder of this discussion of the 20% 199A Deduction focuses on **"Qualified Business Income" (QBI). Please Note!** Generally, *the 20% 199A Deduction for Qualified REIT Dividends* and/or *Publicly-Traded Partnership Income* (before applying the taxable income limitation) is simply 20% of the Qualified REIT Dividends and Publicly Traded Partnership Income.

Who Qualifies For The 20% 199A Deduction With Respect To "Qualified Business Income" (QBI)? Taxpayers who may qualify for this 20% 199A Deduction are generally taxpayers that report "Qualified Business Income" (QBI) as: Individual owners of S corporations or partnerships; Sole Proprietors; Trusts and Estates; and Certain beneficiaries of trusts and estates. **Planning Alert!** The 20% 199A Deduction is available **for tax years beginning after 2017 through 2025 and** is generally taken on the owner's individual income tax return. The 20% 199A Deduction does not reduce the individual owner's "Adjusted Gross Income" (AGI) or impact the calculation of the owner's Self-Employment Tax. Instead, the deduction simply reduces the individual owner's Taxable Income (regardless of whether the owner itemizes deductions or claims the standard deduction). In other words, the 20% 199A Deduction is allowed **in addition to** an individual's itemized deductions or standard deduction.

Rules For 20% 199A Deduction For QBI Are Much Simpler For Taxpayers With 2019 "Taxable Income" Of $160,700 Or Below ($321,400 Or Below If Filing Joint Return). Computing the 20% 199A Deduction for QBI for some taxpayers can be extremely tricky. However, as you read the following discussion, you will discover that certain provisions that could otherwise limit the amount of the 20% 199A Deduction, **do not apply** to taxpayers with 2019 "Taxable Income" (excluding the 20% 199A Deduction) of **$160,700 or below** (**$321,400** or below if married filing jointly). **Caution!** For married individuals filing separately, this Taxable Income threshold is $160,725 or below.

"Qualified Business Income." **"Qualified Business Income" (QBI) -** that is generally eligible for the 20% 199A Deduction - is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to **"any"** trade or business **other than: 1)** Certain **personal service** businesses known as **"Specified Service Trades**

Or Businesses" (described in more detail below), and **2)** The **Trade or Business** of performing services **"as an employee."** **Caution!** W-2 wages you receive as an employee do not qualify for the 20% 199A Deduction. Moreover, the IRS says that income you earn as an independent contractor (e.g., sole proprietor) will not qualify if it is ultimately determined that you should have been classified as a *"common law"* employee. Determining whether a person should be classified as a "common law" employee requires the weighing of multiple factors and is exceedingly fact specific. If you are operating as an independent contractor and would like us to assist you in determining whether you could possibly be re-classified by the IRS as a "common law" employee, please call our Firm.

- **QBI Generally Does Not Include:** **1)** Dividends (although Qualified REIT Dividends separately qualify for the 20% 199A Deduction), investment interest income, short-term capital gains, long-term capital gains, income from annuities, commodities gains, foreign currency gains, etc.; **2) Reasonable compensation** paid **by an S corporation to a shareholder; 3)** Any **"guaranteed payment"** paid to a partner by the partnership; or **4)** Any amount allocated or distributed by a partnership **to a partner** for services rendered to a partnership where it is ultimately determined that the partner was **acting other than in** his or her capacity as a partner.

W-2 Wage And Capital Limitation On The Amount Of The 20% Of QBI Deduction. Generally, the amount of your 20% of QBI Deduction with respect to each Qualified Trade or Business may not exceed **the greater of: 1)** 50% of your allocable share of W-2 wages allocated to the QBI of each "Qualified Trade or Business," or **2)** The sum of 25% of your allocable share of W-2 wages with respect to each "Qualified Trade or Business" plus 2.5% of your allocable share of unadjusted basis of tangible depreciable property held by the business at the close of the taxable year. **Observation.** This limitation, to the extent it applies to a taxpayer, is generally designed to ensure that the full 20% of QBI Deduction is available only from qualified businesses that have enough W-2 wages, enough tangible depreciable business property, or both.

- **Owners With Taxable Income Below Specified Thresholds Are Exempt From The W-2 Wage And Capital Limitation!** For 2019, an otherwise qualifying taxpayer is **entirely exempt** from the **W-2 Wage and Capital Limitation** if "**Taxable Income"** (computed without regard to the 20% 199A Deduction) is **$160,700 or below** (**$321,400** or below if married filing jointly). **Caution!** For 2019, the Wage and Capital Limitation phases in ratably as a taxpayer's Taxable Income **goes from more than $160,700 to $210,700, or from more than $321,400 to $421,400** (if filing jointly).

Business Income From "Specified Service Trade Or Businesses" (SSTBs) Generally Does Not Qualify For The 20% 199A Deduction For Owners Who Have "Taxable Income" Above Specified Thresholds. Based on your "Taxable Income" (before the 20% 199A Deduction), all or a portion of your business income from a so-called *"Specified Service Trade or Business"* (i.e., certain service-type operations discussed in more detail below) **may not qualify** for the 20% 199A Deduction. More specifically, if your **"Taxable Income"** for 2019 (before the 20% 199A Deduction) is **$160,700 or below ($321,400 or below** if married **filing jointly), "all"** of the business income from your **"Specified Service Trade or Business" (SSTB)** is eligible for the 20% 199A deduction. However, if for 2019, your **"Taxable Income"** is **$210,700 or more ($421,400 or more** if married **filing jointly), "none"** of your SSTB income qualifies for the 20% 199A Deduction. **Caution!** If for 2019, your **"Taxable Income"** is **between $160,700 and $210,700** (between **$321,400 and $421,400** if married **filing jointly**), only **"a prorated portion"** of your SSTB income will be eligible for the 20% 199A Deduction.

- **Planning Alert!** If your Taxable Income for 2019 is **$160,700 or less ($321,400 or less** if married **filing**

jointly), you are provided two major benefits with respect to the 20% 199A Deduction for Qualified Business Income (QBI): **1)** Your SSTB income (if any) is fully eligible for the 20% 199A deduction, ***and*** **2)** You are completely exempt from the W-2 Wage and Capital Limitation.

HIGHLIGHTS OF FINAL 199A REGS AND OTHER RECENT IRS GUIDANCE

With this overview in mind, the following is a survey of key highlights from the Final 199A Regs and other recent IRS guidance regarding the 20% 199A Deduction:

IRS Provides 250-Hour Safe Harbor For Rental Real Estate. For any business activity to generate "Qualified Business Income" (QBI), it first must be determined that the activity constitutes a *"trade or business."* For Federal income tax purposes, there has always been uncertainty whether and when a specific *"real estate rental"* activity would be considered a "trade of business." In response to that uncertainty, the IRS released guidance that presumes a rental real estate activity is a "trade or business" ***for purposes of the 20% 199A Deduction*** if the owner, employees, and independent contractors provide 250 or more hours of qualifying services with respect to the rental property during the tax year. **Planning Alert!** Failing to satisfy this 250-hour safe harbor only means the rental real estate activity will not be *"presumed"* to be a *"trade or business"* for purposes of the 20% 199A Deduction. For those who fail to satisfy this safe harbor, depending on the facts, it would still be possible that the owner could successfully argue that the rental real estate activity constitutes a "trade or business" under general common law principles or using another safe harbor (i.e., the self-rental safe harbor). **Caution!** This 250-hour safe harbor contains several rules and requirements, including:

- **Hours-Of-Services Included In The 250-Hour Test.** Generally, the safe harbor is satisfied if the taxpayer can properly document that at least 250 hours of services were provided to the rental real estate activity during the current tax year. **Hours that will count toward the 250-hour test** include rental services performed by: owners of the rental real estate (including owners of a partnership or S corporation that owns the rental real estate), employees, agents, and/or independent contractors of the owners. For example, if the owner of the rental real estate hires a management company to manage the property, the hours spent by the management company should count toward the 250-hour test since the management company would most likely be an "agent" and/or "independent contractor" of the owner. Moreover, the types of qualifying rental services include: Advertising to rent or lease the real estate; Negotiating and executing leases; Verifying information contained in prospective tenant applications; Collection of rent; Daily operation, maintenance and repair of the property (including the purchase of materials and supplies); Management of the real estate; Supervision of employees and independent contractors. **Caution!** Not all services can be included in the 250-hour test. For instance, the following services ***will not count:*** Financial or investment management activities (such as arranging financing); procuring property); Studying and reviewing financial statements or reports on operations; Time spent on improvements to the rental property that generally must be capitalized; or, Hours spent traveling to and from the real estate.

- **Alternate 3-Out-Of-5 Year Test.** If the 250-hour test is not actually satisfied for the current year, the 250-hour test will be "deemed" met for the current year if: **1)** The rental real estate activity has been in existence ***for at least 4 prior years***, and **2)** At least 250 hours of qualifying services were provided to the rental real estate activity for ***any 3 of the 5 consecutive years*** ending with the current tax year.

- **Documenting Hours Of Service.** For tax years ***beginning after 2019,*** taxpayers relying on the 250-hour safe

harbor must keep ***contemporaneous records*** (e.g., time reports, logs, or similar documents) of the following: **1)** Hours of all services performed; **2)** Description of all services performed; **3)** Dates on which such services were performed; and **4)** Who performed the services. These records must be available for inspection by the IRS upon request. **Planning Alert!** Even though this *"contemporaneous record"* requirement does not technically apply until the 2020 tax year, for 2019 - taxpayers presumably will need some form of reasonable support that documents the hours of service they are claiming. Regardless, 2020 is rapidly approaching! It is not too early to begin implementing procedures that ensure owners, employees and independent contractors will be able to produce contemporaneous logs and/or time reports for hours spent if requested by the IRS. For example, owners might consider encouraging agents or independent contractors to include in their invoices the hours worked, and a description of the work performed with respect to the rental real estate enterprise.

- **Hours Of Service Provided To Multiple Rental Real Estate Activities May Be Combined In Certain Situations.** For purposes of the 250-hour test, owners may generally combine two or more rental real estate activities into a single rental real estate "enterprise." This could prove particularly beneficial where an owner needs to aggregate the hours of service for multiple real estate activities in order to satisfy the 250-hour requirement. **Caution!** "Residential Rental" and "Commercial Rental" real estate may not be aggregated for purposes of the 250-hour test. Moreover, multiple rental real estate activities owned by separate pass-through entities (e.g., partnership, S Corporation) generally may not be aggregated by the owners of the pass-through entities.

- **Certain Rental Real Estate Is Not Eligible For The 250-Hour Safe Harbor.** The 250-hour safe harbor ***is not available*** for a rental real estate activity, if: **1)** The rental real estate is used by the taxpayer during the year as a residence for more than the greater of 14 days **or** 10% of the days the property was rented to others; **or** **2)** The real estate is rented or leased under a "triple net lease" (i.e., a lease that requires the lessee to pay property taxes, fees, insurance, and maintenance for the leased real estate). **Planning Alert!** As mentioned previously, for those who fail to qualify for this 250-hour safe harbor, depending on the facts, it would still be possible that the owner could successfully argue that the rental real estate activity constitutes a "trade or business" under general common law principles or using another safe harbor (i.e., the self-rental safe harbor). The self-rental safe harbor presumes that rental real estate is a trade or business for purposes of the 20% 199A Deduction if the property is leased between certain commonly controlled parties.

- **Filing 1099s Is Generally Advisable.** Generally, any "trade or business" that pays a service provider $600 or more for the year is required to report the payments to the IRS and to the recipient by filing Form 1099. For 2019, Form 1099 must be filed with the recipient of the payment by **January 31, 2020,** and a copy is generally required to be filed with the IRS by February 28, 2020 (March 31, 2020 if filed electronically). Penalties for failing to file a Form 1099 can be significant. **Caution!** It is generally advisable for owners treating rental real estate as a trade or business to file all otherwise required Form 1099s with respect to their real estate rental properties. **Planning Alert!** Even if Form 1099 would otherwise be required for a payment, any trade or business (including a rental real estate trade or business) that makes a payment using a credit card, a debit card, or a qualified third party payment network, ***is not required*** to report that payment on Form 1099.

Guidance On The Determination Of "Qualified Business Income" (QBI). As previously discussed, "Qualified Business Income" (QBI) - that is eligible for the 20% 199A Deduction - is generally defined as the net amount of

qualified items of income, gain, deduction, and loss with respect to **"any"** trade or business **other than: 1)** Certain **personal service** businesses known as **"Specified Service Trades Or Businesses," 2)** The **Trade or Business** of performing services **"as an employee," 3) Reasonable compensation** paid **by an S corporation to a shareholder,** or **4)** Any **"guaranteed payment"** paid to a partner by the partnership. QBI is commonly generated as pass-through income to an S corporation shareholder or a partner in a partnership, or as self-employed business income of a sole proprietor. The Final 199A Regs and other recent IRS guidance have provided additional information regarding the impact of the following selected items on the computation of QBI:

- **"For AGI" Deduction Of One-Half Of The Self-Employment Tax By A Self-Employed Taxpayer.** Generally, a self-employed individual is allowed a "For AGI" (i.e., above-the-line) deduction for one half of the self-employment tax (S/E Tax) paid with respect to self-employed income. The Final 199A Regs clarify that this deduction for one half of the S/E Tax reduces QBI to the extent the S/E Tax was attributable to S/E income included in the individual's QBI.

- **"For AGI" Deduction For Health Insurance Premiums By Self-Employed Taxpayers.** If you are a self-employed individual, you are generally allowed a "For AGI" deduction for health insurance premiums you paid for yourself, your spouse, and your dependents (the insurance can also cover your child who was under age 27 at the end of 2019, even if not your dependent). The Final 199A Regs generally clarify that this deduction for health insurance premiums reduces QBI to the extent this deduction was attributable to S/E income included in your QBI.

- **"For AGI" Deduction For Retirement Plan Contributions By Self-Employed Taxpayers And Partners.** If you are a self-employed individual or a partner in a partnership, you are generally allowed a "For AGI" deduction for contributions made on your behalf to a qualified retirement plan (e.g., SEP Plan, SIMPLE Plan, Other Qualified Retirement Plan). The Final 199A Regs generally clarify that this deduction for contributions to a retirement plan reduces QBI to the extent the retirement plan contribution was attributable to income included in your QBI.

- **"For AGI" Deduction By A Partner Who Is Not Reimbursed For The Payment Of Partnership Expenses.** Generally, a partner is entitled to a "For AGI" deduction for out of pocket business expenses the partner pays on behalf of the partnership. Historically, the IRS has generally taken the position that a partner may deduct business expenses paid on behalf of the partnership only if there is an agreement (preferably in writing) between the partner and the partnership providing that those expenses are to be paid by the partner, and that the expenses will not be reimbursed by the partnership. The Final 199A Regs expressly declined to address to what extent (if any) *"deductions for unreimbursed partnership expenses*" impact the determination of a partner's QBI. However, on its website, the IRS posted a *"Q&A"* that stated: "*To determine the total amount of QBI, the taxpayer must consider deductions not reported on Schedule K-1 that are related to the trade or business. This* ***could include unreimbursed partnership expenses*** *...."* [Emphasis added]. **Planning Alert!** The "Draft" Instructions to the "2019" Form 8995 (*"Qualified Business Income Deduction Simplified Computation"*) also states: "*To figure the total amount of QBI, the taxpayer must consider all items that are related to the trade or business.* ***This includes ... unreimbursed partnership expenses*** *....*" [Emphasis added].

- **"For AGI" Deduction For Interest Paid On Debt Incurred To Purchase S Corporation Stock Or A Partnership Interest.** If an individual borrows funds in order to purchase a partnership interest or S corporation stock,

the interest the borrower pays on that loan will generally be deductible. If and to the extent the partnership or S corporation operates a trade or business, the borrower will generally be able to deduct the interest as a "For AGI" deduction. As was the case regarding unreimbursed partnership expenses (discussed above), the Final 199A Regs expressly declined to address to what extent (if any) "*the interest expense to acquire partnership and S corporation interests"* impacted the determination of a partner's or S corporation's shareholder's QBI. However, on its website, the IRS posted a *"Q &A"* that stated: "*To determine the total amount of QBI, the taxpayer must consider deductions not reported on Schedule K-1 that are related to the trade or business. This* ***could include*** .... ***business interest expense*** *...."* [Emphasis added]. **Planning Alert!** The Draft Instructions to the 2019 Draft Form 8995 ("Qualified Business Income Deduction Simplified Computation") contain a *"QBI Flow Chart."* The second box of that flow chart includes *"interest expenses for purchase of the partnership/S corporation interest/stock"* in the list of items that are included in calculating QBI.

- **Impact Of The "For AGI" 179 Deduction Taken By A Partnership Or S Corporation On The Owner's QBI.** Subject to certain limitations (e.g., dollar caps, taxable income limitation), a taxpayer may elect to take an immediate deduction for the cost of 179 property (e.g., business equipment, furniture and fixtures, certain business vehicles, etc.). If an S corporation or partnership elects to take the 179 deduction with respect to the purchase of qualifying business property, the potential limitations that could cap the amount of the 179 deduction for that year must be applied twice (i.e., once at the pass-through entity level, and a second time at the owner level). Since this double application of the 179 deduction limitations could result in a pass-through entity's 179 deduction not being limited at the entity level, but being capped at the pass-through owner's level, some asked whether the 179 deduction taken by a pass-through entity reduced the QBI generated by that entity. The Final 199A Regs do not address this issue. However, on its website, the IRS posted a *"Q&A"* that appears to confirm that a 179 deduction from a pass-through entity (that is attributable to pass-through QBI from that entity) reduces the QBI only to the extent the 179 deduction is not limited on the owner's return (e.g., the 179 deduction would presumably not offset the pass-through QBI for that tax year if and to the extent the 179 deduction was limited by the owner's dollar caps or the owner's taxable income limitation).

- **Impact Of Depreciation Recapture On QBI.** A capital gain or loss (long-term or short-term) is excluded from the determination of QBI. However, on the sale of depreciable "personal" business property, the gain is generally treated as *"ordinary"* gain (not "capital" gain) to the extent the selling taxpayer previously took either depreciation or the 179 Deduction with respect to that property. This is commonly referred to as *"Depreciation Recapture Gain."* The Final 199A Regs indicate that *Depreciation Recapture Gain* (i.e., treated as "ordinary" gain) with respect to a qualifying business is included in the calculation of QBI. **Planning Alert!** *Depreciation Recapture Gain* most commonly occurs when a taxpayer sells depreciable "personal" property (e.g., business equipment, furniture and fixtures, certain business vehicles, etc.). However, in certain situations, the sale of depreciable "real" property (e.g., depreciable buildings used in a commercial business) could generate *Depreciation Recapture Gain*. For example, TCJA allows taxpayers to "elect" to take the 179 Deduction for certain capitalized expenditures related to the roof or interior of an *existing commercial* building. If an owner elects to take the 179 Deduction with respect to a commercial building, and the owner later sells that building, the sale can trigger *Depreciation Recapture Gain* to the extent of the previous 179 Deduction.

- **Impact Of §751 On QBI When Selling A Partnership Interest.** Generally, the gain on the sale of a partnership

interest is classified as a "capital" gain which is excluded from the computation of QBI. However, §751 requires a partner to treat income from the sale of the partner's partnership interest as "ordinary" gain (not "capital" gain) to the extent of the partner's share of the partnership's *"Unrealized Receivables"* (e.g., zero-basis receivables held by a cash-basis partnership and *Depreciation Recapture Gain* reflected in the partnership's depreciable property), and substantially appreciated inventory. The Final 199A Regs say that any gain on the sale of a partnership interest to the extent it is treated as *"ordinary"* gain under §751(a) is considered attributable to the trades or businesses conducted by the partnership. Therefore, if the partnership is generating QBI at the date of the sale of the partnership interest, the *"ordinary"* gain triggered to the selling partner under §751 should also be included in the partner's QBI. **Caution!** Since no counterpart to §751 applies to S corporation shareholders, no portion of the gain or loss on the sale of S corporation stock will be included in the determination of QBI.

Clarification Of Selected SSTB Issues. As discussed previously, based on your "Taxable Income" (before the 20% 199A Deduction), all or a portion of your business income from a so-called ***"Specified Service Trade or Business" (SSTB)*** **may not qualify** for the 20% 199A Deduction. An SSTB is generally defined as a trade or business activity involved in the performance of services in the fields of: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, or any trade or business involving the services of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. An "SSTB" **does not include** the performance of **architectural** or **engineering** services. **Caution!** The Final 199A Regs provide significant guidance on SSTBs, including many examples of the types of businesses that **would** or **would not be classified as SSTBs.** This IRS guidance is far too lengthy to cover in detail in this letter. However, the following are selected SSTB anti-abuse rules that the Final 199A Regs clarified:

- **Not All SSTB Income Is Excluded From QBI!** Based on your "Taxable Income" (before the 20% 199A Deduction), all or a portion of your qualified business income from an SSTB **may qualify** for the 20% 199A Deduction. More specifically, if your **"Taxable Income"** for 2019 (before the 20% 199A Deduction) is **$160,700 or below ($321,400 or below** if married **filing jointly), "all"** of the qualified business income from your SSTB is eligible for the 20% 199A deduction. However, if for 2019 your **"Taxable Income"** is **$210,700 or more ($421,400 or more** if married **filing jointly), "none"** of your SSTB income qualifies for the 20% 199A Deduction. **Caution!** If for 2019, your **"Taxable Income"** is **between $160,700 and $210,700** (between **$321,400 and $421,400** if married **filing jointly**), only **"a prorated portion"** of your SSTB income will be eligible for the 20% 199A Deduction.

- **5%/10% De Minimis Rule Is All Or Nothing.** Before the Final 199A Regs, the IRS had proposed a de minis safe harbor for a trade or business that generated both SSTB income and non-SSTB income. This proposed safe harbor basically provided that a trade or business would not be treated as an SSTB if less than 10% of its overall gross receipts was generated by an SSTB activity. For trades or businesses with overall gross receipts exceeding $25 million, the 10% de minimis safe harbor is reduced to 5% of overall gross receipts. Until the Final 199A Regs were released, the IRS had not specifically addressed how a trade or business with SSTB income exceeding the 10%/5% threshold would be classified. **Planning Alert!** Unfortunately, the Final 199A Regs make it clear that, if a taxpayer's SSTB gross receipts **exceed the 10%/5% de minimis threshold,** the **entire trade or business** is treated as **an SSTB!**

- **Guidance For Outside Owners Of Rental Property Leased To A 50%-Commonly-Controlled SSTB.** Before the

Final 199A Regs, the IRS had proposed an SSTB anti-abuse rule that generally provided that a business is treated as generating SSTB income if the business provides services or property to another 50%-Commonly-Controlled SSTB. For example, assume that Partner "A" and Partner "B" are the sole owners of AB Law Firm (an SSTB), and are also the two sole owners of a separate LLC (AB LLC) that leased the office building to the AB Law Firm. In that situation, the rental income generated by the 50%-commonly-controlled AB LLC would also be treated as SSTB income. However, this proposed anti-abuse rule did not specifically address the treatment of an owner who was not included in the 50%-commonly-controlled test. For example, assume in the previous hypothetical that the LLC that owned the office building was owned equally by A, B, and C (ABC LLC) which, in turn, leased the office building to the AB Law Firm (owned equally by A and B). Assuming C is not an attorney and is unrelated to A and B, the Final 199A Regs appear to provide that, since A and B are both a member of the 50%-Commonly-Controlled group, their respective shares of ABC LLC's rental income would be treated as SSTB income. However, C's share of ABC LLC's rental income would not be treated as SSTB income because C was not a member of the 50%-commonly-controlled group.

- **Guidance For Owners Of Rental Property That Is Only Partially Leased To A 50%-Commonly-Controlled SSTB.** As in the immediately preceding example, let's again assume that A and B are the sole owners of AB Law Firm (an SSTB), and are also the two sole owners of a separate LLC (AB LLC) that owns an office building (Office Building). However, unlike the previous example, now assume that AB LLC leases only 80% of the Office Building to AB Law Firm and leases the remaining 20% to D (an unrelated third party). The Final 199A Regs say that only 80% of the rental income generated by AB LLC is treated as SSTB income. The remaining 20% of the rent would not be treated by AB LLC as SSTB income because that 20% portion of the Office Building was not leased to a 50%-Commonly-Controlled SSTB.

THE NEW "QUALIFIED OPPORTUNITY FUNDS" PROVISIONS AND TAX BENEFITS

BACKGROUND

The Tax Cuts and Jobs Act ("TCJA") enacted §1400Z creating a brand new set of tax incentives for taxpayers who invest in Qualified Opportunity Funds which own qualified property in certain financially-distressed geographical areas (designated as "Qualified Opportunity Zones" or "QOZs"). The new tax incentives offer an opportunity for taxpayers to invest in these "Qualified Opportunity Funds" ("QOFs") which, in turn, will allow them to defer otherwise taxable gain they have previously generated. The Treasury Department has designated over 8,700 census tracts as QOZs. There are designated QOZs in all 50 states, the District of Columbia, and several U.S. territories. In October 2018, the IRS released its first set of Proposed Regulations under §1400Z, and released a second set of Proposed Regulations in April 2019. This segment provides an overview of **1)** The general tax benefits of investing in a QOF, **and 2)** Taxable gains eligible for the tax benefits of investing in a QOF.

GENERAL TAX BENEFITS OF INVESTING IN "QUALIFIED OPPORTUNITY FUNDS"

Generally, new section 1400Z allows taxpayers to defer capital gains (long-term or short-term) to the extent the gains are invested in a QOF ***within 180 days*** of realizing the capital gain. In addition, if the investment in the QOF is held for at least 5 years - then 10% of the original deferred capital gain is essentially eliminated. If the QOF investment is held at least 7 years - then 15% of the original deferred capital gain is eliminated. Moreover, for qualified investments in a QOF held for at least 10 years, the taxpayer may elect to exclude any gain that arose after the taxpayer initially purchased the QOF investment. **Observation!** All remaining deferred gain reflected in

the investment in a QOF must be fully recognized on the **earlier of 1)** The date the taxpayer sells the QOF investment, or **2)** December 31, 2026. Thus, the **remaining deferred gain must be fully recognized** no **later than December 31, 2026,** even if the taxpayer still holds the QOF investment on December 31, 2026. **Planning Alert!** Even in the best-case scenario, 85% of the original deferred capital gain will be taxed ***no later than December 31, 2026*** at whatever capital gains rates exist in 2026. If the current effective *maximum* long-term capital gain rate of 23.8% (including the 3.8% net investment tax) is increased between now and 2026, the increase in the capital gains rates would dilute the tax benefit of the tax deferral.

- **Example.** Assume that a taxpayer sold a capital asset on July 1, 2019 for $110 with a basis of $10 (realizing a $100 qualifying capital gain). The taxpayer could defer 100% of the $100 capital gain by investing $100 (i.e., the *"amount"* of the gain) in a QOF **within 180 days** of the sale that triggered the $100 gain. If the QOF investment is held at least 5 years and then sold, the taxpayer could exclude $10 of the deferred gain (i.e., 10% x deferred gain of $100). If instead, the QOF investment is held at least 7 years, the taxpayer could exclude $15 of the deferred gain (i.e., 15% x deferred gain of $100). If the taxpayer still owns the QOF investment on December 31, 2026, on that date the taxpayer will have to recognize $85 of deferred gain (the original deferred gain of $100 less 15% of the $100 gain as a result of holding the investment for at least 7 years). Further assume in this example that the taxpayer held the QOF investment (originally purchased for $100) for 10 years, and then sold it for $140 generating a $40 gain. The taxpayer could exclude the entire $40 gain. **Practice Alert!** As mentioned above, if the taxpayers hold the QOF investment for at least 7 years, at a minimum 85% of the original deferred capital gain will be taxed ***no later than December 31, 2026*** (which is the date that all of the then outstanding deferred gains must be recognized). Thus, it appears that a taxpayer would have to purchase the interest in the QOF ***before the end of 2019*** in order to ***meet the 7-year holding period by December 31, 2026.***

- **Transfers Of QOF Investment By "Gift" Trigger The Deferred Gain To The Donor.** If a taxpayer owns a QOF investment (that reflects a deferred gain) and *"gives"* the QOF interest to another (e.g., to a family member) before December 31, 2026, the gift will trigger all remaining deferred gain to the donor. Don't forget, if the taxpayer still owns the QOF investment ***on December 31, 2026,*** all the remaining deferred gain is automatically triggered.

- **Transfers Of QOF Investment Due To An Owner's "Death" Do Not Trigger The Deferred Gain.** Generally, the transfer of a QOF investment upon the death of the owner does not trigger the deferred gain reflected in the QOF investment. Instead, the recipient of the QOF investment generally inherits the decedent's deferred gain and holding period of the QOF investment.

TAXABLE GAINS ELIGIBLE FOR THE TAX BENEFITS OF INVESTING IN A QOF

Generally, a gain on the sale of an asset is "eligible" for the tax benefits of section 1400Z ***only if*** the gain: **1)** Is ***"treated as a capital gain"*** for federal income tax purposes; **2)** Would otherwise have been recognized (except for qualifying for the tax benefits under §1400Z) for federal income tax purposes ***before January 1, 2027, AND* 3)** Does not arise from a sale or exchange ***with a related party*. Caution!** Although "short-term" capital gains may qualify for these tax benefits, if a "short-term" capital gain is deferred by making a qualifying investment in a QOF, the deferred gain will also be a "short-term capital gain" when it is ultimately recognized. **Planning Alert!** A capital gain that results from a taxpayer selling "goodwill" as part of the sale of an operating business could qualify for the tax benefits of §1400Z.

- **Capital Gains Under §1231 May Also Qualify.** According to "proposed" regulations issued by the IRS in October, 2018, a ***"net"*** capital gain arising from the sale of §1231 property for the tax year qualifies for the tax benefits of §1400Z. Section 1231 property is generally defined as property held in a **"*trade or business"*** for ***"more than one year"*** that is either: **1)** Subject to the allowance for depreciation under §167 (e.g., depreciable business equipment, buildings, vehicles); or **2)** Non-depreciable real property (e.g., the real estate lot on which a building used in a business stands). A *"net"* §1231 gain (qualifying for the tax benefits of §1400Z) occurs if the taxpayer's total *"gains"* recognized by taxpayer from the sale of §1231 property for the taxable year exceeds the taxpayer's total *"losses"* from §1231 property. **Planning Alert!** Generally, when a capital asset is sold, the 180-day re-investment period under §1400Z begins on the date the asset is sold. However, according to the proposed regulations: "*[T]he 180-day [Re-Investment] Period .... with respect to any **capital gain net income from section 1231 property** for a taxable year **begins on the last day of the taxable year.***" [Emphasis added].

- **Example Of "Net" §1231 Gain.** Assume that for the tax year a taxpayer had a **single §1231 gain of $100** (from the sale of Office Building) and a **single §1231 loss of <$80>** (from the sale of a Residential Apartment Building). In this situation, the taxpayer would have a **"net" §1231 gain** of **$20** ($100 less $80). According to the proposed regulations, only the **"net" §1231 gain** of **$20** would be eligible for deferral by investing in a QOF. In addition, the 180-day re-investment period would begin on the last day of the taxable year during which the sales of §1231 property occurred.

- **Impact Of The Depreciation Recapture Gain.** Any gain on the sale of depreciable property that is classified as an "ordinary" gain under the depreciation recapture provisions ***does not*** qualify for the tax benefits of §1400Z. For example (as discussed previously in this letter with respect to the 20% 199A Deduction), on the sale of depreciable "personal" business property, the gain is generally treated as "ordinary" gain (not "capital" gain) to the extent the selling taxpayer previously took either depreciation deductions or the 179 deduction with respect to that property. This so-called *Depreciation Recapture Gain* may not be deferred by investing in a QOF.

FINAL COMMENTS

The requirements that must be satisfied in order to qualify for the 20% 199A Deduction or the tax benefits of investing in a Qualified Opportunity Fund are extensive and extremely technical. The information contained in this material represents only a general overview of selected aspects of those two provisions, and should not be relied upon without an independent, professional analysis of how any of the matters discussed may apply to a specific situation. If you need additional information on either of these provisions that we did not address in this letter, please contact us. In addition, please call us before implementing any planning ideas discussed in this letter, or if you need additional information.

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