STRADLEY RONON

Tax Insights

A Publication of the Stradley Ronon
Tax Practice Group

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JANUARY 23, 2019

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RICs Permitted to Pass Through Qualified REIT Dividends – IRS Issues Proposed Regulations on QBI

The Treasury Department and the Internal Revenue Service (IRS) issued proposed regulations (REG-134652-18) (https://www.irs.gov/pub/irs-drop/reg-134652-18.pdf) concerning the deduction for qualified business income (QBI) under Section 199A. The proposed regulations provide guidance on the treatment of previously suspended losses that constitute QBI. The proposed regulations also provide guidance on the determination of the Section 199A deduction for taxpayers that hold interests in regulated investment companies (RICs), charitable remainder trusts and split-interest trusts. Section 199A was enacted as part of the 2017 Tax Cuts and Jobs Act (TCJA). It provides a deduction of up to 20 percent of QBI from a U.S. trade or business operated as a sole proprietorship or through a partnership, S corporation, trust or estate. (Section references are to the Internal Revenue Code of 1986, as amended (the Code).)

Section 199A also allows individuals and some trusts and estates (but not corporations) a deduction of up to 20 percent of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, including qualified REIT dividends and qualified PTP income earned through pass-through entities. This component of the Section 199A deduction is not limited by Form W-2 wages or the unadjusted basis immediately after acquisition (UBIA) of qualified property. Although the Treasury Department and the IRS published proposed regulations interpreting Section 199A on Aug. 16, 2018 (the August Proposed Regulations) (see our prior coverage here (https://www.stradley.com/insights/publications/2018/08/tax-insights-august-15-2018)), those proposed regulations did not address the issues covered by the proposed regulations issued now.

Subchapter M of the Code also provides rules under which a RIC may pay dividends that a shareholder in the RIC may treat in the same manner (or a similar manner) as the shareholder would treat the underlying item of income or gain if the shareholder realized it directly (e.g., capital gain dividends, exempt-interest dividends, dividends eligible for the dividends received deduction, etc.). The proposed regulations provide guidance on conduit treatment of qualified REIT dividends; however, the Treasury Department and the IRS continue to consider whether it is appropriate to provide for conduit treatment of qualified PTP income. Issues arise with qualified PTP income in part from the fact that income attributable to a specified service trade or business within the meaning of Section 199A(d)(2) of a PTP may be qualified PTP income for taxpayers with taxable income below a threshold amount, but not for taxpayers with taxable income above the top of the phaseout range. Additional novel issues are presented by the rules relating to the treatment of losses for purposes of Section 199A and potentially for shareholders that are foreign persons, tax-exempt organizations, and trusts underlying individual retirement accounts and qualified retirement plans.

The proposed regulations provide rules under which a RIC that receives qualified REIT dividends may pay Section 199A dividends. A noncorporate shareholder receiving Section 199A dividends would treat them as qualified REIT dividends under Section 199A(e)(3), provided the shareholder meets the holding period requirements for its shares in the RIC (i.e., RIC shares must be held by the shareholder for more than 45 days during the 91-day period beginning on the date that is 45 days before the date on which the shares becomes ex-

dividend with respect to such dividend). The rules under which a RIC would compute and report Section 199A dividends are based on the rules for capital gain dividends in Section 852(b)(3) and exempt interest dividends in Section 852(b)(5). The amount of a RIC's Section 199A dividends for a taxable year is limited to the excess of the RIC's qualified REIT dividends for the taxable year over allocable expenses. Section 199A dividends generally are also subject to the principles that apply to other RIC dividends. See, e.g., Rev. Rul. 2005-31, 2005-1 C.B. 1084 (RICs may designate amounts allocated to capital gain dividends, exempt interest-related dividends and short-term capital gain dividends, even if the aggregate total amount exceeds the total amount of the RIC's dividend distributions; additionally, individual shareholders of RICs who are U.S. persons may apply designations that differ from those applied by shareholders who are nonresident alien individuals) and Rev. Rul. 89-81, 1989-1 C.B. 226 (if a RIC has two or more classes of stock and designates the dividends that it pays on one class as consisting of more than that class's proportionate share of a particular type of income, the designations are not effective for federal tax purposes to the extent that they exceed the class's proportionate share of that type of income).

Although the regulations are proposed, taxpayers may rely on the rules in the amendments to Treasury Regulation Sections 1.199A-3 and 1.199A-6 set forth in the proposed regulations in their entirety until the date a Treasury decision adopting the proposed regulations as final regulations is published in the Federal Register. This includes the rules relating to the payment of qualified REIT dividends by a RIC and means that RICs can rely on these rules for purposes of preparing their 2018 Forms 1099-DIV.

IRS Issues Final Regulations on QBI

On Aug. 16, 2018, the Treasury Department and the IRS published proposed regulations interpreting Section 199A (the August Proposed Regulations) (see our prior coverage here (https://www.stradley.com/insights/publications/2018/08/tax-insights-august-15-2018)). The August Proposed Regulations contain six substantive sections, each of which provides rules relevant to the calculation of the Section 199A deduction. The August Proposed Regulations, with modifications in response to comments and testimony received, were adopted as final regulations (https://www.irs.gov/pub/irs-drop/td-reg-107892-18.pdf), which were issued concurrently with the issuance of the proposed regulations discussed above.

IRS Issues Safe Harbor for Rental Real Estate Enterprise as Section 199A Trade or Business

The IRS issued Notice 2019-7 (https://www.irs.gov/pub/irs-drop/n-19-07.pdf), which contains a proposed revenue procedure, and which provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for the purposes of the QBI deduction under Section 199A.

The proposed revenue procedure provides a safe harbor for treating a rental real estate enterprise as a trade or business solely for purposes of the Section 199A deduction. If an enterprise fails to satisfy the requirements in the safe harbor, the rental real estate enterprise may still be treated as a trade or business for purposes of Section 199A if the enterprise otherwise meets the definition of a trade or business in Treasury Regulation Section 1.199A-1(b)(14). Relevant pass-through entities (RPEs), as defined in Treasury Regulation Section 1.199A-1(b)(10), may use the safe harbor in order to determine whether a rental real estate enterprise is a trade or business.

Solely for purposes of the safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties. The individual or RPE relying on the revenue procedure must hold the interest directly or through an entity disregarded as an entity separate from its owner under Treasury Regulation Section 301.7701-3. Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with the exception of those described in the paragraph below that begins "Real estate used by the taxpayer…") as a single enterprise. Commercial and residential real estate may not be part of the same enterprise. Taxpayers may not vary this treatment from year to year unless there has been a significant change in facts and circumstances.

Under the safe harbor, solely for the purposes of Section 199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are all satisfied during the tax year with respect to the rental real estate enterprise:

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

B. For tax years beginning prior to Jan. 1, 2023, 250 or more hours of rental services are performed (as described below) per year with respect to the rental enterprise. For tax years beginning after Dec. 1, 2022, in any three of the five consecutive tax years that end with the tax year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described below) per year with respect to the rental real estate enterprise; and

C. The taxpayer maintains contemporaneous records, including time reports, logs or similar documents, regarding the following: (i) hours of all services performed, (ii) description of all services performed, (iii) dates on which such services were performed and (iv) who performed the services. Such records are to

be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to tax years beginning prior to Jan. 1, 2019.

Rental services for purposes of the proposed revenue procedure include (a) advertising to rent or lease the real estate; (b) negotiating and executing leases; (c) verifying information contained in prospective tenant applications; (d) collection of rent; (e) daily operation, maintenance and repair of the property; (f) management of the real estate; (g) purchase of materials; and (h) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents and/or independent contractors of the owners. The term "rental services" does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing or constructing long-term capital improvements; and hours spent traveling to and from the real estate.

Real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on this safe harbor) as a residence for any part of the year under Section 280A is not eligible for this safe harbor. Real estate rented or leased under a triple net lease is also not eligible for this safe harbor. For purposes of the revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities.

The proposed revenue procedure is to apply to tax years ending after Dec. 1, 2017. Until such time that the proposed revenue procedure is published in final form, taxpayers may use the safe harbor described in the proposed revenue procedure for purposes of determining when a rental real estate enterprise may be treated as a trade or business solely for purposes of Section 199A.

IRS Issues Final Regulations on Section 965 Deemed Repatriation Tax

The IRS has issued final regulations (https://www.irs.gov/pub/irs-drop/td%20%28reg-104226-18%29.pdf) under Section 965 (the transition tax provision added to the Code by the TCJA). The proposed regulations, issued in August 2018 (see our prior coverage here (https://www.stradley.com/insights/publications/2018/08/tax-insights-august-8-2018)), mirror rules that were previewed by the IRS in a series of Notices issued after Section 965 became effective (see our prior coverage of the Notices here (https://www.stradley.com/insights/publications/2018/01/tax-insights-january-10-2018), here (https://www.stradley.com/insights/publications/2018/01/tax_insights_january_24_2018) and here (https://www.stradley.com/insights/publications/2018/04/tax-insights-april-11-2018)). Section 965 generally requires U.S. shareholders to pay a "transition tax" on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the U.S. The TCJA provides for a shift from the pre-2018 "worldwide" tax system to a "participation exemption" system. Under the old rules, U.S. taxpayers were generally taxed on all income, whether earned in the U.S. or abroad, but foreign income earned by a foreign subsidiary of a U.S. corporation would not be subject to U.S. tax until that income was "repatriated" to the U.S. via dividends. The transition tax effectively bridges the old rules with the new by taxing certain previously untaxed foreign income. The final regulations retain the basic approach and structure of the proposed regulations with certain revisions. The final regulations retain the applicability dates that were in the proposed regulations and, consistent with the applicability date of Section 965, generally apply beginning the last tax year of a foreign corporation that begins before Jan. 1, 2018; with respect to a U.S. person, the final regulations generally apply beginning the tax year in which or with which such tax year of the foreign corporation ends.

Pennsylvania Issues Employer Withholding Guide

The Pennsylvania Department of Revenue has issued a publication, Employer Withholding Information Guide (REV-415 (https://www.revenue.pa.gov/FormsandPublications/FormsforBusinesses/EmployerWithholding/Documents/rev-415.pdf)), providing guidance on various aspects of employer withholding. Information on the following is included in the guide: employer withholding requirements, taxable compensation that is not subject to withholding, taxable and nontaxable benefits and business expenses, calculation of withholding and payment, electronic filing and payment requirements, requirements for W-2s, acceptable filing methods based on number of employees, general information and specifications for Forms 1099, amended returns and annual withholding reconciliation statements, Amended PA W-3s and W-2Cs, interest and penalties, refunds of overpayments, data exchanges, and a list of brochures and forms.

New Jersey Explains Taxation of Deemed Repatriation Dividends and GILTI for Individuals and Pass-Through Entities

The New Jersey Division of Taxation has published a list of answers to questions (https://www.state.nj.us/treasury/taxation/TCJA.shtml) about the taxation of Section 965 deemed repatriation income and Section 951A Global Intangible Low-Taxed Income (GILTI) for individuals and pass-through entities.

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