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Section 1031 Exchanges and the 20 Percent Business Deduction under IRC Section 199A

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The enactment of section 199A as part of the Tax Cuts and Jobs Act of 2017 created a 20 percent deduction on qualified business income (QBI). The section 199A 20 percent deduction applies to income of a qualified trade or business and is subject to two limitations: one based upon the w-2 wages paid by the business (the "w-2 wage limit") and one based upon a combination of w-2 wages paid and the unadjusted basis of the qualifying property of the trade or business (the "unadjusted basis limit"). With the passage of the last several months, issues are emerging with respect to how these limitations apply to section 1031 exchanges. This article addresses three of those issues: (1) the effect year-straddling exchanges have on the unadjusted basis limit; (2) the section 199A unadjusted basis of replacement property; and (3) the extent to which real property ownership is a qualified trade or business under section 199A.

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Overview of the Section 199A Deduction

The w-2 wage limit disallows any portion of the section 199A deduction that exceeds 50 percent of a business's w-2 wages. The unadjusted basis limit disallows any part of the section 199A deduction that exceeds the sum of 25 percent of the business's w-2 wages and 2.5 percent of the unadjusted basis in the business's assets. Taxpayers can take the section 199A deduction to the extent of the greater of the w-2 wage limit and the unadjusted basis limit. An example illustrates the computation of the section 199A deduction and the calculation and application of the w-2 wage limit and the unadjusted basis limit.

> **Example:** Ezra owns an office building with an unadjusted basis of $20 million. The office building generates $2.5 million of QBI. Ezra pays $400,000 in wages. Ezra's section 199A deduction, before applying the w-2 wage limit and unadjusted basis limit, is $500,000 ($2,500,000 of QBI × 20%). The w-2 wage limit is $200,000 ($400,000 of w-2 wages × 50%) and the unadjusted basis

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limit is $600,000 ($400,000 of w-2 wages × 25% + $20,000,000 unadjusted basis × 2.5%). The greater of these two amounts, the $600,000 unadjusted basis limit, applies. Because the 20 percent deduction of $500,000 is less than the unadjusted basis limit of $600,000, Ezra may claim the entire $500,000 section 199A deduction.

The Unadjusted Basis Limit and Exchanges that Straddle Tax Years

Many property owners realize that if they sell a property towards the end of the year and structure that disposition as part of an intended section 1031 exchange, installment sale rules can postpone any gain that might be realized from the disposition of the property into the subsequent year. The example of Ezra helps illustrate this strategy. Assume that in October 2019 Ezra receives an offer to buy his property from a potential purchaser. Ezra may like the offer and wish to sell the property, but he may want to keep his options open to do a section 1031 exchange. Assume that Ezra enters into the contract and sells the property in October 2019. If Ezra closes on the sale in 2019 and does not structure the sale as part of a section 1031 exchange, he would recognize the gain in 2019. Alternatively, if Ezra closes on the sale in 2019 and structures the sale as part of an intended section 1031 exchange by hiring a section 1031 qualified intermediary (1031 QI) to receive the sale proceeds, he can defer any gain he recognizes until 2020, when he might receive boot—cash, benefits, or other non "like-kind" property in the exchange—from the 1031 QI. To delay the gain recognition until 2020 through this structure, Ezra must have a bona fide intent to make the exchange when he sells the office building and engages the 1031 QI.

If Ezra hires a 1031 QI, the 1031 QI must hold the exchange proceeds for at least 45 days, the period during which Ezra can identify his replacement property. If, at the end of that 45-day period, Ezra has not identified replacement property, the 1031 QI will return the exchange proceeds to Ezra. To ensure deferral of gain recognition until 2020, Ezra would want to close on the disposition of the office building in fewer than 45 days before the end of 2019, so sometime after about November 17, 2019. The 45-day period would then expire in early 2020, and if Ezra has not identified any replacement properties, he can receive the sale proceeds from the 1031 QI at that time and recognize gain upon receipt of the proceeds (assuming he can satisfy the bona fide intent requirement). By deferring receipt of the exchange proceeds by 45 days, Ezra could defer gain recognition by about one year. The benefit of deferring payment of tax for a year can provide time-value-of-money savings, and structuring transactions to delay the disposition of property until later in the year was a common strategy for many property owners.

The unadjusted basis limit in section 199A may cause some property owners to reconsider this strategy. That is because the limitation is based upon the qualified property that a taxpayer holds at the end of the taxable year to which the deduction applies. In Ezra's situation, the taxable year is 2019. If Ezra's exchange is pending at that point (i.e., Ezra has sold the office building and the 1031 QI holds the exchange proceeds), then Ezra would not hold the office building on the last day of 2019, so his unadjusted basis in the qualified property would be zero. The section 199A deduction would be subject to the w-2 wage limit of $200,000 instead of the $600,000 unadjusted basis limit. The absence of the office building on the last day of the year reduces Ezra's section 199A deduction from $500,000 to $200,000. If the 37 percent tax rate applies to that $300,000 difference, then not holding the property on the last day of 2019 costs Ezra $111,000 of taxes ($300,000 lost deduction × 37%). That cost may not offset the time-value-of-money benefit of deferring gain recognition until 2020, if that was Ezra's strategy. If Ezra can control the timing of the disposition of the office building, he should take into account the effect that the timing of the disposition has on the section 199A deduction for 2019, and he may decide to delay the sale of the office building until 2020.

The Section 199A Unadjusted Basis of Replacement Property

The US Treasury Department has issued regulations governing the amount of unadjusted basis an exchanger takes in replacement property. Those regulations adopt a "step-in-the-shoes" rule under which the unadjusted basis of the replacement property generally will be the unadjusted basis of the relinquished property. This is significant because the unadjusted basis typically reflects the cost of the property. For instance, Ezra's unadjusted basis in the office building is $20 million, indicating he paid that amount for the property. That amount will most likely be different from the office building's adjusted basis, which takes depreciation deductions into account. Ezra's adjusted basis in his replacement property would equal the adjusted basis he had in the relinquished office building. Nonetheless, if Ezra transfers the office building in exchange for other like-kind property, recognizes no gain from the exchange, and does not add additional funds to the replacement property, the unadjusted basis of the replacement property will be $20 million. Thus, Ezra will have an adjusted basis in the replacement property, which he will use for all purposes other than computing the section 199A deduction, and a different unadjusted basis, which he will use for section 199A purposes. By allowing Ezra to step into the shoes for section 199A purposes, the rule preserves Ezra's section 199A deduction by maximizing the unadjusted basis limit.

The tradeoff of the step-in-the-shoes rule is that the depreciable period of the replacement property may be limited to the depreciable period the exchanger had in the relinquished property. The depreciable period is the longer of the property's recovery period or 10 years. Because the office building has a 39-year recovery period, that would be its depreciable period. Ezra's replacement property, assuming he pays no additional consideration for the replacement property, will take the remaining depreciable period he had in the office building. The depreciable period of the replacement property does not reset with the exchange. Even if the remaining depreciable period is less than 10 years, Ezra will be stuck with the remaining depreciable period he had in the office building.

Trade or Business of Rental Real Estate

After a career of managing rental properties, property owners often use section 1031 to exchange out of management-intensive property into something that requires little or no management by the property owner. Typical replacement property for property owners with such a goal is triple-net lease property with a credit tenant, an interest in a Delaware statutory trust (DST) that qualifies as real property, or syndicated tenancy-in-common interest (TIC) in real property managed by an institutional manager.

Ezra, for example, may have managed the office building for 20 years and may be ready to sell it, exchange into triple-net property or a DST interest, and significantly reduce his activity managing property. The section 199A question related to such decisions in the section 1031 context is whether such replacement property can satisfy the section 199A trade or business requirement. The section 199A regulations provide that the general section 162 definition of trade or business applies to section 199A. Under section 162, a trade or business is "[t]hat which occupies the time, attention, and labor . . . for the purpose of a livelihood or profit." *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911). This general definition does not provide clarity or certainty as to whether owning rental real estate is a trade or business.

Multiple cases have considered whether owning rental property is a trade or business. The results of those cases do not appear to be consistent or provide a basis for definitively concluding that the ownership is a trade or business. For instance, in *Hazard v. Commissioner*, 7 T.C. 372 (1946), the Tax Court ruled that property held for rental is a trade or business, and the owner recognized ordinary loss on the sale of the property. Based on very similar facts, a few years later, the district court in Connecticut ruled that property held for rental is not a trade or business and the owner recognized capital loss on the sale of the property. See *Grier v. United States*, 120 F.Supp. 395 (D. Conn. 1954) (discussing several cases that ruled on whether owning rental property was a trade or business). In both cases, the taxpayers owned and rented property and provided few or no rental services. The facts of the two cases do not warrant the different tax treatment. Consequently, they do not provide guidance for determining the extent to which a property owner must provide services to owned rental property for the ownership to be a trade or business under section 162 and to qualify the income from such property for the section 199A deduction.

In light of the uncertainty in the common law regarding whether owning and renting property is a trade or business, the IRS has published a proposed safe harbor in Notice 2019-07 (to be effective for taxable years ending after December 31, 2017) that applies to rental real estate enterprises (RREEs). Under the proposed safe harbor, if an RREE satisfies several requirements, it will be treated as a trade or business for purposes of the section 199A deduction. Under the proposed safe harbor, an RREE is "an interest in real property held for the production of rents and may consist of an interest in multiple properties." The safe harbor provides that taxpayers may treat each property as separate enterprise or treat multiple similar properties as a single enterprise. Regarding the similar-properties rule, the notice provides that commercial and residential properties cannot be part of the same enterprise. The notice expects taxpayers with multiple rental properties to stick with their designation of single-property RREEs or a multiple-property RREE, requiring a significant change in facts to alter the separate/single enterprise decision.

An RREE will qualify for the safe harbor treatment as a trade or business for section 199A purposes only if it satisfies three general requirements. First, separate books and records must reflect the income and expenses of each RREE. Second, the RREE must satisfy the following 250-hour rental services requirement. For taxable years beginning before January 1, 2023, the 250-hour rental services requirement mandates at least 250 hours of rental services be performed with respect to an RREE each year. For taxable years beginning after December 31, 2022, at least 250 hours of rental services must be performed with respect to an RREE in any three of the five preceding taxable years (or in each taxable year, for an RREE held less than five years). Third, the taxpayer must maintain time reports, logs, or similar documents regarding (1) hours of all services performed, (2) description of services performed, (3) dates on which services were performed, and (4) who performed the services.

The RREE safe harbor in Notice 2019-07 recognizes the following services performed by the owners or by employees, agents, and independent contractors for purposes of applying the 250-hour rental services requirement:

- 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;
- Management of the real estate;
- Purchasing materials; and
- Supervision of employees and independent contractors.

Only time spent on permitted services counts toward the 250-hour rental services requirement. The proposed safe harbor specifically excludes several types of services from the definition of rental services. The following services are excluded from the definition of rental services, so time spent on them will not count toward the 250-hour rental services requirement:

- Financial or investment management activities;
- Arranging financing;
- Procuring property;
- Studying and reviewing financial information;
- Planning, managing, or constructing long-term capital improvements; and
- Traveling to and from the real estate.

Perhaps the most interesting exclusion is the time spent traveling to and from rental real estate. For property owners with properties spread over a broad area, and possibly scattered throughout the country, the exclusion of travel time can be significant. That is time that the property owner must devote to the management of the property but cannot count toward the 250-hour rental service requirement.

Many property owners who are doing section 1031 exchanges will be disheartened by the exclusion of certain arrangements from the safe harbor. The notice excludes real estate used as the taxpayer's residence, which property owners realize does not qualify for section 1031 treatment. This exclusion, therefore, should not affect section 1031 exchanges. More importantly for many property owners considering a section 1031 exchange, the notice also excludes triple-net property from the safe harbor. The notice defines triple-net property as property subject to a lease agreement that requires the tenant or lessee to (1) pay taxes, (2) pay fees, (3) pay insurance, and (4) be responsible for maintenance activities for a property in addition to rent and utilities.

When Ezra learns that he could lose the section 199A deduction if he acquires triple-net replacement property, he may be less inclined to pursue that alternative. Ezra should consider, however, whether the definition of triple-net lease leaves room for him to structure the arrangement to come within the safe harbor or whether he could get comfortable taking the section 199A deduction despite not coming within the safe harbor.

Although the RREE safe harbor precludes triple-net properties from the definition of RREE, there is a potential workaround. The ability to provide services through an agent raises the question of whether a landlord can contract with a tenant to have the tenant provide the services as the landlord's agent. Such an arrangement would be operationally equivalent to a triple-net lease but would be legally different. If the tenant, as agent of the landlord, failed to provide rental services as an agent of the landlord, the failure would be a breach of the services agreement and a violation of the rental agreement by the landlord. Those breaches would appear to offset each

other, so the damages for breach of the service agreement owed to the landlord should offset the damages for breach of the rental agreement owed to the tenant. By contrast, a tenant in a triple-net lease must cover its responsibilities under the terms of the rental agreement. A breach of the rental agreement would subject the tenant to the damages available concerning the lease agreement.

To avoid triple-net status to come within the RREE safe harbor, some property owners may negotiate with the tenant to provide some rental services sufficient to satisfy the 250-hour rental services requirement. Thus, property owners might be able to devise various types of arrangements to structure leases to avoid triple-net status while relieving the landlord of most management responsibilities. In many triple-net situations, which resemble financing arrangements, the tenant controls the arrangement and will not be interested in ceding any control or responsibilities to the landlord. As a result, modifying the triple-net arrangement may not be available to Ezra, even if he would be willing to provide some management services.

Exchangers who are unable to come within the RREE safe harbor may nonetheless consider relying upon *Hazard* and other cases that held that owning rental property is a trade or business and claim the section 199A 20 percent deduction with respect to the triple-net properties. In doing so, property owners should first become comfortable that, despite the uncertainty in this area, they have sufficient authority to support their reporting position and avoid penalties. Taxpayers would be well advised to read *Grier* and the cases it cites before taking such a reporting position. Despite ambiguity in this area, ownership of a triple-net property is the easiest type of situation in the rental property area in which for the IRS to argue that no trade or business exists. Ezra may not want to run that risk in his retirement. He could be left to invest in triple-net properties and lose the 199A deduction or to look for non-triple-net properties, which often will mean settling for a tenant that is not as creditworthy as many who provide typical triple-net properties.

To satisfy the final requirement of the RREE safe harbor, property owners must disclose information about their rental-service activity in a statement attached to the return claiming the section 199A deduction. The statement must be signed by the taxpayer or an authorized representative with personal knowledge of the facts and circumstances of the statement and include the following statement: "Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete." Because failing to qualify for the safe harbor does not indicate that ownership of the property is not a trade or business, some owners of rental properties may believe that their activities are sufficient to establish that their ownership is a trade or business. Such owners may opt not to meet this requirement for qualifying for the safe harbor to avoid being subject to penalties of perjury for any potential misstatement of a fact.

Conclusion

Major changes to the tax law affect the application of the law in some unanticipated ways, which in turn can affect taxpayer behavior. This article shows how the enactment of section 199A can affect decisions that taxpayers make with respect to the timing of an exchange, the type of replacement property to be acquired, and any agreements that govern the replacement property. Taxpayers and their advisors continue to study the effects section 199A might have on taxpayer decisions in the context of section 1031. As time passes, structures and arrangements will emerge that help address those concerns, lead taxpayers in a different direction, or prove that tax law does not always drive behavior. ■