Section 199A Final Regulations for Subchapter S Banks

WEBINAR CO-SPONSORED BY AMERICAN BANKERS ASSOCIATION, INDEPENDENT COMMUNITY BANKERS OF AMERICA AND SUBCHAPTER S BANK ASSOCIATION

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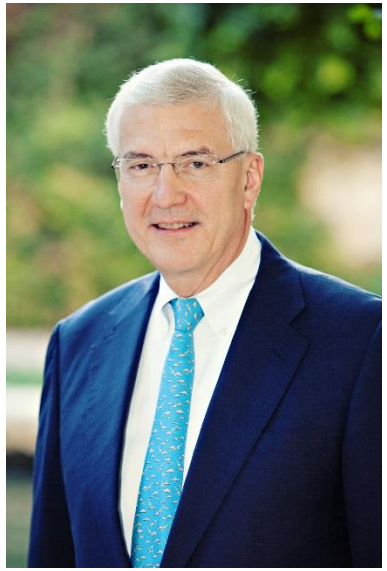

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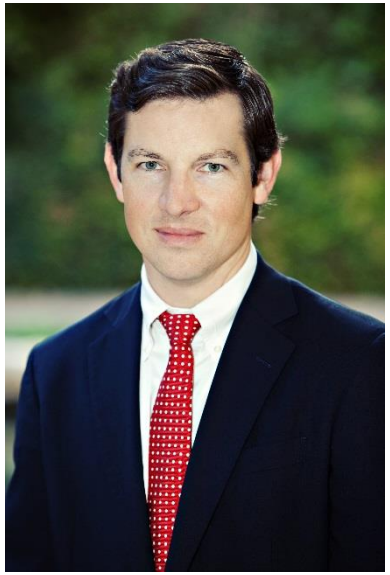

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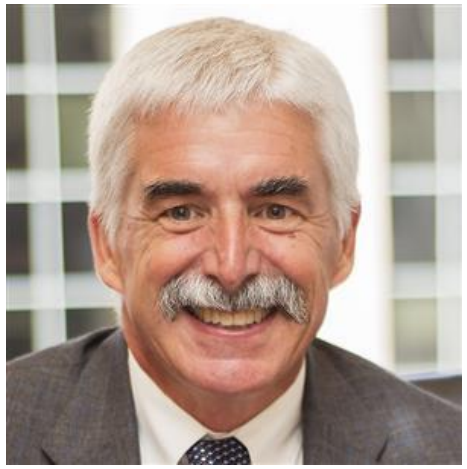

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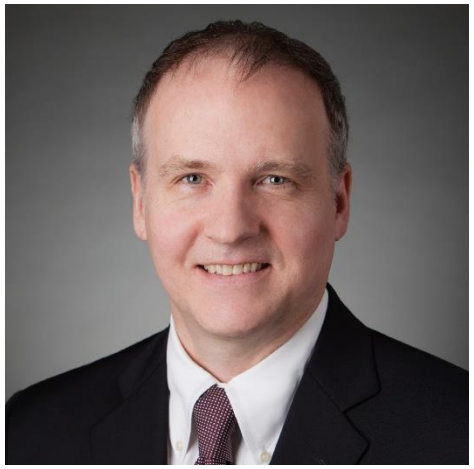

Today's Agenda

- High Level Review of Section 199A of the Internal Revenue Code
- Advocacy and Timeline of Guidance
- Key Issues and Technical Review
- Operational Requirements and Suggested Practices
- Examples
- Other Issues / Questions and Answers

Section 199A of the IRC - Highlights

- Deduction Allowed in an Amount Equal to 20% of Qualified Business Income (QBI) for Non-Corporate Taxpayers
- Sole Proprietors, Partnerships, S Corporations other Pass-Through Entities
- Evaluated at the Owner / Shareholder / Partner Level
- Generally 100% Available for Individual Taxpayers with Taxable Income of $157,500 and Joint Filers of $315,000
- Intended to Provide Reasonable Parity with Corporate Rate Reduction Providing a Top Individual Rate of 29.7%
- Expires in 2025
- After Considering the Level of Taxable Income, Limitations Can Also Apply Based on Wages and Tangible Property
- Key Issues (to be discussed in greater detail in this presentation)
  - Definition of Qualified Business Income (QBI)
    - What is a Trade or Business?
  - Definition of a Specified Service Trade or Business (SSTB's)
  - Aggregation
  - Recordkeeping and Reporting
- Ongoing Evaluation of S vs. C Status

How Did We Get Here?

- Section 199A of the Internal Revenue Code (the Statute)
  - Blueprint
  - House Version
  - Senate Version
  - Final Law Signed on December 22, 2017
  - Issues Identified
    - Is Banking Wholly Excepted from the Definition of Financial Services?
    - Application of SSTB's
      - Dealing in Securities (loan sales)
      - Investment Management and Other Selected Activities

- Proposed Regulations Issued on August 8, 2018
  - Clarification of Core Banking (taking deposits and making loans) as QBI
  - Introduction of De Minimis Tests
    - 5% and 10% of Gross Receipts
    - Potential "Cliff Effect"
  - Uncertainty in Definition of "Trade or Business"
  - Positive Guidance on Aggregation
  - Continued Uncertainty in SSTB's
    - Dealing in Securities (loan sales)
    - Investment Management and Other Selected Activities

How Did We Get Here?

- Final Regulations Issued on January 18, 2019
  - Finalization of core banking (taking deposits and making loans) as QBI
  - Finalization of De Minimis Tests and "Cliff Effect"
    - No Change in De Minimis Levels
    - Impact of SSTB's in Single Trade or Business
    - Recognition of Allowable Multiple Trades or Businesses in a Single Entity
  - No Firm Definition of Trade or Business
  - Very Important Exclusion for Originated Loans from Dealing in Securities Definition
  - Continued Uncertainty in Other Potential SSTB Activities
- Advocacy
  - Working with Members and Members' Staff in House and Senate Prior to Enactment
  - Formal Comment Letters Prior to and After Issuance of Proposed Regulations
  - Multiple Meetings with Congressional Staff During Process
  - Coordination of Letter from Senators to Treasury for Community Bank Application
  - "Grass Roots" Comment Letters
  - Meeting at OMB as Part of Regulation Process
  - Multiple Meetings and Discussions with Treasury Personnel
  - Discussions with Senior Administration Personnel

Key Issues & Technical Review

- **Banking Definition**
  - Final Regulations provide additional definitional guidance on “banking”
  - Treasury did not accept comments that would have provided a “blanket” exclusion for any services performed within the legal bank charter
  - Acknowledges that even if the bank is conducting SSTB activities above the applicable de minimis threshold (i.e., 5% or 10% of gross receipts), the bank can still segregate those SSTB activities so as not to disqualify all of the banking activity from the 20% PTE deduction
  - The Final Regulations also contain favorable changes to the definition of “dealing”
    - Performance of services to originate a loan is not treated as the purchase of a security from the borrower
    - Removes reference to negligible sales exception under Code Sec. 475 regulations
    - Thus, unless the bank is actually purchasing loans in the secondary market for resale, its normal lending activities will not result in an SSTB activity

Key Issues & Technical Review

- **De Minimis Threshold**
  - No change in 5% and 10% gross receipts levels; Final Regulations retain provisions of proposed regulations based on gross receipts being above or below $25 million
  - Computation of gross receipts:
    - Code Sec. 448 regulations appear to be the applicable source for defining gross receipts
    - Main issue is whether gross receipts from property sales (e.g., sales of loans or securities) are reduced by tax basis in those assets
    - In general, if not a capital asset – other than sales of depreciable property – gross receipts are not reduced by tax basis; although question remains as to interplay with Code Sec. 582 provisions
  - As discussed in the previous slide, the Final Regulations allow a bank to segregate their SSTB activities as a separate trade or business
    - **CAUTION:** This can be a trap for the unwary
    - See discussion of "trade or business" on next slide

Key Issues & Technical Review

- **What is a "Trade or Business"?**
  - Code Sec. 199A references Code Sec. 162(a) for purposes of defining a trade or business
  - Generally requires that the trade or business maintain (or can produce) a separate set of books and records
  - Final Regulations retain provisions in the proposed regulations that items of QBI properly attributable to more than one trade or business are to be allocated using a reasonable method based on all of the facts and circumstances
  - Final Regulations provide for elective aggregation of separate trades or businesses at the entity level (and elective aggregation also available at the individual level as well); cannot aggregate a separate trade or business that is an SSTB
  - If an SSTB activity falls below the applicable gross receipts de minimis threshold, and is not deemed to be a separate trade or business, the bank must take care to ensure the SSTB activity will not exceed the applicable de minimis threshold in a subsequent year, which could put the bank at risk of losing the 20% PTE deduction on 100% of the banking-related income

Key Issues & Technical Review

- **What is a "Trade or Business"?**

  Example of SSTB activity

  - S Corp bank with over $25MM in gross receipts is conducting wealth management services that make up 3% of its total gross receipts
  - Assume bank operates its wealth management services at that level for 3 years
  - In filing its S Corp return for those 3 years, the bank only reports one trade or business (i.e., banking), all taxable income from which is QBI, as its wealth management services fall below the applicable 5% gross receipts de minimis threshold
  - Assume in year 4 that the bank acquires another wealth management business, which increases its gross receipts from wealth management services to 8%
  - Because in its prior years' returns the bank only reported one trade or business, there is a risk that the bank may not be able to now argue that the wealth management services are a separate trade or business, which would jeopardize all of the bank's taxable income from qualifying as QBI in year 4 (and going forward)
  - The bank would want to consider reporting the wealth management services as an SSTB activity starting in Year 1 if the wealth management services are considered to be a separate trade or business under Code Sec. 162(a) and the applicable facts and circumstances

Key Issues & Technical Review

- **Specified Service Trade or Business ("SSTB")**
  - What activities are likely to be treated as SSTB's?
    - Wealth management and trust advisory services
    - Loan sales (if bank is both buying and selling loans in the secondary market)
    - Other services as determined to meet definition of an SSTB
  - What activities should be protected?
    - Loan sales (if bank only originating loans for resale)
    - Commission-based sales of insurance policies
    - "Low level" ancillary services provided to customers as a convenience – assuming they fall below the applicable gross receipts de minimis threshold

Key Issues & Technical Review

- **Rental Real Estate Activities**
  - IRS issued Notice 2019-07 in conjunction with issuing the Code Sec. 199A final regulations
  - Provides a safe harbor under which rental real estate activities will be treated as a trade or business solely for purposes of Code Sec. 199A if the following requirements met:
    - Separate books and records are maintained
    - 250 or more hours of rental services are performed per year with respect to each rental activity (although note that certain rental activities involving similar properties can be aggregated)
    - For tax years beginning after Dec. 31, 2018, taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding (1) hours and description of all services performed; (2) dates on which such services were performed; and (3) who performed the services
  - Taxpayer may treat all similar properties held for the production of rents as a single enterprise
  - Failure to satisfy the safe harbor requirements does not preclude a taxpayer from otherwise establishing that the real estate activities are a trade or business for purposes of Code Sec. 199A – it will be a facts and circumstances determination

Key Issues & Technical Review

- **Rental Real Estate Activities (cont'd)**
  - Rental real estate activities includes (1) advertising to rent or lease real estate; (2) negotiating and executing leases; (3) verifying information contained in prospective tenant applications; (4) collection of rent; (5) daily operation, maintenance and repair of the property; (6) management of the real estate; (7) purchase of materials; and (8) supervision of employees and independent contractors
  - Real estate rented or leased under a triple net lease is not eligible for the safe harbor – generally deemed to be an investment activity versus an active trade or business, and thus may not generate QBI eligible for the 20% PTE deduction
  - Banks will need to assess their rental real estate activities and assess if they rise to the level of a trade or business
  - The de minimis threshold rules do not directly apply to the rental real estate activities, so banks will have to assess their activities on a case-by-case basis

Key Issues & Technical Review

- **Other Issues**
  - QBI does not include capital gains or losses
  - Final Regulations reiterate that any item of capital gain or loss, such as gains or losses from Code Sec. 1231 assets which are treated as capital on an individual shareholder's tax return, are not taken into account as a qualified item of income, gain, deduction or loss in computing QBI
  - QBI also excludes portfolio interest and dividends from non-banking activities (e.g., dividends from equity investments held by holding company)
  - Negative QBI from one trade or business is allocated to other trades or businesses with positive QBI; a net negative QBI is carried forward to subsequent years

Operational Requirements & Suggested Practices

- **Schedule K-1 Disclosures**
  - Line 17, code “V” – Section 199A income
  - Line 17, code “W” – Section 199A W-2 wages
  - Line 17, code “X” – Section 199A unadjusted basis
  - Line 17, code “AA” – Excess taxable income
  - Line 17, code “AB” – Excess business interest income
  - Footnote: Election to aggregate trades or businesses
  - Footnote: Code Sec. 1231 gains / losses
  - Footnote: SSTB activities (QBI, W-2 wages and UBIA must be reported for each SSTB activity)

  - See sample Schedule K-1 included in presentation materials

Operational Requirements & Suggested Practices

- **New Form 8990**
  - Limitation on business interest expense under Code Sec. 163(j)
  - Only applies if average gross receipts for 3 prior tax years exceeds $25 million (see slide #12 for discussion of gross receipts)
  - Generally not a concern for banks, as business interest income will exceed business interest expense
  - However, shareholders may benefit from the excess business interest income generated by the bank to offset interest expense from other investments that may otherwise be limited
  - The instructions provide the following item:
    - "If you are subject to the section 163(j) limitation and are an owner of a pass-through entity that is not subject to the section 163(j) limitation, you must include your share of the pass-through business interest expense, adjusted taxable income, and business interest income on lines 1, 13, and 23, respectively. You must request the pass-through entity to separately state, in sufficient detail, the items necessary to figure these amounts."

Operational Requirements & Suggested Practices

- **New Form 8990 (cont'd)**
  - The instructions also provide the following item:
    - "For purposes of section 163(j), a taxpayer with an ownership interest in a partnership or S corporation, must include a share of the partnership's or S corporation's gross receipts, in proportion to the partner's distributive share or S corporation's pro rata share of gross income, unless the partner and partnership, or S corporation shareholder and S corporation, are treated as a single person."
  - S Corp banks will need to assess the need to provide this information to their shareholders on a case-by-case basis

Operational Requirements & Suggested Practices

- **Practical Considerations**
  - A plain-vanilla bank originating loans (even if selling some loans in the secondary market) and providing low levels of other ancillary services to customers (e.g., custodial trust services) should be able to treat 100% of its qualifying income as QBI eligible for the 20% PTE deduction
  - This does not, however, mean that all of the S Corp shareholders will get the full 20% PTE deduction on their individual returns; that will depend on each shareholder's specific tax situation
  - Keep in mind that we are only covering some of the key concepts pertaining to the 20% PTE deduction for banks, but there are numerous nuances in the Code Sec. 199A provisions – beyond the scope of this session – which will impact each individual shareholder differently
  - Banks should generally have adequate W-2 wages in order to avoid any limitation on the 20% PTE deduction; as such, the unadjusted basis immediately after acquisition of qualified property held for use in the trade or business ("UBIA") may likely not even come into play; however, you will want to assess the need to report the UBIA if needed by the shareholders (e.g., will the shareholders aggregate multiple PTE activities?)

26 U.S. Code § 581. Definition of bank

For purposes of sections 582 and 584, the **term "bank" means a bank or trust company** incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State, **a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers** similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

Trust Department Activities

- Custody agreements – contract to “hold assets” for clients as directed by the client;
- Investment management – providing discretionary investment advice or authority to direct investment;
- Administrative activities – administration of will and estates, serving as an executor, financial reporting, decision making regarding operating business assets;
- Family office activity – bill pay, financial and fiduciary reporting, travel arrangements, review and recommendation of third party investment managers.

Dividing the Trust Department

- Separate SSTBs or one SSTB
- Review and revise existing agreements to clarify the source of gross receipts
- Outsource investment management and advisory work
- C corp subsidiary or spin-off

Consulting - 199A(d)(2) – (b)(1)(vi)

The performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales (or economically similar services) or the provision of training and educational courses. For purposes of the preceding sentence, the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided.

Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services. Services within the fields of architecture and engineering are not treated as consulting services.

Financial Services – 199A(d)(2)-(b)(1)(viii)

The performance of services in the field of financial services means the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 of the Code or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services.

This includes services provided by financial advisors, investment bankers, wealth planners, retirement advisors, and other similar professionals performing services in their capacity as such. Solely for purposes of section 199A, the performance of services in the field of financial services does not include taking deposits or making loans, but does include arranging lending transactions between a lender and borrower.

Investing and Investment Management – 199A(d)(2) – (b)(1)(x)

The performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The performance of services of investing and investment management does not include directly managing real property.

26 CFR § 301.7701-4 - Trusts.

(a)Ordinary trusts. In general, the term “trust” as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

301.7701-4 - Trusts.

"…the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."

"…it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries…"

301.7701-6 Definitions; person, fiduciary.

(a)Person. The term person includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group. The term also includes a guardian, committee, trustee, executor, administrator, trustee in bankruptcy, receiver, assignee for the benefit of creditors, conservator, or any person acting in a fiduciary capacity.

(b)Fiduciary -

(1)In general. **Fiduciary is a term that applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another, as in the case of receivers.** A committee or guardian of the property of an incompetent person is a fiduciary.

(2)Fiduciary distinguished from agent. There may be a fiduciary relationship between an agent and a principal, but the word agent does not denote a fiduciary. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the Internal Revenue Code. In cases when no legal trust has been created in the estate controlled by the agent and attorney, the liability to make a return rests with the principal.

QBI Fee Schedule

TRUSTEE
Minimum Fee $3,000

1.10% on first	$1,000,000
.75% on next	$1,000,000
.60% on next	$3,000,000
.50% on next	$5,000,000
.40% above	$10,000,000

COURT RELATED ACCOUNTS
Minimum Fee $3,000

3% on first	$2,000,000
2.5% on next	$2,000,000
1.5% above	$4,000,000

CUSTODIAN
Minimum Fee $1,500

.25% Flat Fee

CUSTODIAN WITH BILL PAYMENT
Minimum Fee $3,000

.55% on first	$1,000,000
.40% on next	$1,000,000
.30% on next	$3,000,000
.25% on next	$5,000,000
.20% above	$10,000,000

Possible Legal Challenges or Fixes

- Declaratory judgment action
- Administrative appeal
- Clarifying legislation