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In this article, Stone discusses the condominium dealer's practical eligibility to benefit from the section 199A deduction.

I. Final Regs Appear Friendly to Condo Dealers

On January 18 Treasury issued final regulations, effective February 8, under section 199A. The statute was enacted under the Tax Cuts and Jobs Act and provides up to a 20 percent reduction in the noncorporate tax rate from 37 percent to 29.6 percent for a limited period. It essentially applies to the noncapital gain income of many business operations in noncorporate form, but with strict wage and property limitations, as well as other restrictions that have drawn into question whether it can be of use to condominium dealers. By including examples involving condominiums under the aggregation rules, the final regulations come close to specifically answering the question in the affirmative but, as we will see, they did not make it a certainty.[1] First, a little background on condominium dealer tax treatment.

II. Rental and Condo Risks and Rewards

For years, residential condominium developers have watched in envy as their residential rental developer counterparts have enjoyed federal income tax benefits that are unavailable to condominium developers.[2] In a typical ground-up deal, both undertake the financial risk of assembling a site and constructing a building that typically takes almost two years. In many ways, condominium developers take greater financial risks because their return is subject to market vagaries typically over a short three- or four-year period, whereas a rental building may generate income over many more years and a sale can be made, if at all, when the market seems right to the developer.[3] But both produce the same property: a residential building offering apartment units either for sale or lease.[4]

Nonetheless, the income taxation of both rental and condominium developers and

[1]Section 199A benefits expire for tax years beginning after December 31, 2025, so given the lead time to construct or convert a building, the regulations are timely.

[2]To be accurate, the condominium apartment building developer and the residential apartment building developer are often the same in that they may build or buy a portfolio of both. It is not unusual, for example, for a builder to put in construction plans for one type of development project and change them before completion based on market conditions.

[3]Moreover, rental owners could and still can sell their building and reinvest in other real estate (that does not even have to be an apartment building) tax free under section 1031, and the sale is also eligible for the new section 1400Z-2 Opportunity Zone deferral and exemption tax scheme, neither of which are available to the condominium developer (unless the developer successfully contests ineligibility under the recently proposed Opportunity Zone regulations).

[4]The same tax disparity arises between owners who do not construct the buildings but rather acquire an existing building and either rent the apartments or convert the apartment building to condominium status generally for sale of the apartment units to the public. In some circumstances, market conditions at the time of approval by the state attorney general may effectively prevent the condominium converter or developer from obtaining a profitable sale of some or all the units at such time and they will be rented, or in other more limited circumstances, rental may have always been the goal to avoid local law restrictions on residential rental payments. I assume for purposes of this discussion that the commonly understood meaning of the term "condominium developer or converter" is a person or entity that is offering the units for sale to the public.

converters was markedly different. Before 2018 the condominium developer was subject to an income tax rate of 39.6 percent, exclusive of state and local income taxes, on the sale of apartment units, constituting the full return on the investment. In contrast, the residential rental developer was subject to the same 39.6 percent rate on rental income but was and still is eligible for a 20 percent capital gain rate on gain from the sale of the building. Because rental income often is a small component of overall return, the residential owner was generally in a much better tax position.

Along came the TCJA, generally effective starting in January 2018 and expiring on December 31, 2025, for purposes of the individual tax rates described in this article.[5] In short, the residential rental developer continues to enjoy a 20 percent capital gain rate on the sale of the building (and the other benefits described in footnote 3) and a new 37 percent tax rate on rental income with a further 20 percent deduction likely under new section 199A, taking the rental tax rate to 29.6 percent. The condominium developer or converter, on the other hand, remains ineligible for the capital gains rate on the sale of the units because the property is held for sale to customers. Before some clarity was provided in the recent regulations, it was unclear whether the condominium developer or converter would also be effectively ineligible for the reduced 29.6 percent rate under section 199A and relegated, therefore, to a 37 percent rate on gains from sale of the units.

Accordingly, the residential rental owner would enjoy two rates (29.6 percent rental and 20 percent on sale) that are both less than the 37 percent rate that the condominium developer may have to pay. But the aggregation rules in the final regs appear to provide some reassurance that condominium developers can avail themselves of the 29.6 percent rate if they own other comparable residential rental buildings with sufficient tax basis to ensure full use of the 20 percent deduction.[6] Although the 29.6 percent rate would not put the condominium developer in the same overall beneficial tax position as the rental developer, it would greatly limit the disparity under the new law and would also be significantly less than the previous rate of 39.6 percent.[7] So let's take a look at new section 199A.

III. The Section 199A Limit Issue

A. In General

Section 199A provides a noncorporate taxpayer a deduction of up to 20 percent of the combined income earned from each of its qualified trades or businesses. Both condominium sales and apartment building rentals should be treated as qualified trades or businesses. When income exceeds specified thresholds (generally, $415,000), one of two alternative tests must also be met, and it is those two restrictions that are the focus of this discussion.[8]

B. Condo Dealers' Wages and Property

The first alternative test limits the 20 percent deduction, on a business-by-business basis, to 50 percent of W-2 wages/salary paid by the business. Thus, assume a condominium owner with no partners and only one condominium business sells out all units from an offering in one year and has $10 million in taxable income before the section 199A deduction. In the absence of the deduction, the owner's federal income tax is $3.7 million. If the full amount of the deduction applies, taxable income is reduced 20 percent to $8 million, and the tax is $2.96 million for an after-tax savings of $740,000. However, if the condominium owner employs and pays independent management companies or other contractors (Form 1099 recipients) for required business operations rather than relying heavily on employees (Form W-2 recipients) to conduct those

[5] Sections 1(j) and 199A(i).

[6] The rates listed are top or headline rates in each category and assume maximum amounts of income earned. To the extent the income is less, the rates are proportionately less.

[7] Under prior law, the condominium developer was subject to a 39.6 percent rate, and the residential rental developer was eligible for the 20 percent capital gain rate on sale. Given that the 20 percent capital gain rate is unchanged, that disparity is cut in half if the condominium developer is eligible for and can take advantage of the reduced rate of 29.6 percent.

[8] Further complications that must be navigated to achieve full eligibility, such as those arising from tiers of partnership ownership, ineligible specified service business taint, and amounts less than $415,000, are not discussed in this article. However, there is nothing unique to condominium owners about the additional complexity.

operations, the owner may not be entitled to any or only a limited amount of the section 199A deduction. For example, if the owner makes $1 million in W-2 payments, all is not lost, but the deduction is limited to 50 percent of that amount ($500,000) rather than $2 million if there had been $4 million or more in W-2 wages. In the scenario with the $500,000 deduction, the tax would be $3.515 million, which is better than no extra deduction, but not nearly as good as the full deduction.

As the TCJA was nearing completion, Congress recognized that taxpayers in the real estate industry generally do not pay as much compensation in the form of W-2 wages relative to their total compensation payments as other industries. Therefore, an alternative, more favorable test was added to the law. The alternative test limits the 20 percent deduction to 25 percent of W-2 wages plus 2.5 percent of the unadjusted tax basis (basically undepreciated original cost) of depreciable property held at year-end. To obtain the full 20 percent deduction in the previous example, the condominium developer would need to have $80 million in depreciable property (2.5 percent x $80 million = $2 million) in the absence of any W-2 wage payments. Although the new test is helpful to the rental owners and developers because their buildings may have cost them that much or more, it is of no use to condominium developers because condominium units are not depreciable property. Rather, they are more akin to inventory.

Can condominium owners treat other apartment buildings they may own as being in the same trade or business as their condominium buildings so they can "borrow" the tax basis in those apartment buildings? The law is not clear on what constitutes a single trade or business, but the fact that each building is likely part of a separate limited liability company or partnership makes this a difficult case to argue.[9]

If the same group of people owns separate businesses that are essentially alike but operate in different locations, with different management, or are otherwise treated as separate, the final regs permit aggregation of the commonly controlled similar businesses. Thus, if condominium developers can aggregate their condominium activities with their apartment rental activities, the activities can be treated as a single business. The developer in our example would be permitted to use any $80 million rental apartment building or buildings he may own to obtain the full $2 million deduction.

C. Aggregation Regs — Good News?

So what do the new regulations say about aggregating condominiums? To this reader, the regulations provide an unqualified approval through two examples. Reg. section 1.199A-4 permits aggregation of commonly owned (50 percent or more) qualified businesses if they meet two of three factors:

A. They provide products, *property*,[10] or services that are the same or customarily offered together.
B. They share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or other information technology resources.
C. They are operated in coordination with, or reliance on, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).[11]

D. Reg Examples — Condo Aggregation

To clarify the aggregation rules, the regulations provide a list of 18 examples. Example 17 takes the position that an owner of a residential condominium building[12] and a commercial rental building may not aggregate because a commercial building and a residential building are not the

[9]For a brief discussion of "a single trade or business," see Joint Committee on Taxation, "General Explanation of Public Law No. 115-97," JCS-1-18, at 14-15 (Dec. 2018). A detailed analysis is beyond the scope of this article.

[10]Proposed REG-107892-18 did not include the word "property." Emphasis added.

[11]Reg. section 1.199A-4(b)(1).

[12]The condominium building is presumably held for sale to the public rather than rented, but the example does not specify.

same type of property and, in the example, did not meet either of the other two factors. They are presumably not the same type of property because a building configured into offices is quite different from one configured into residential quarters.[13]

Example 18, on the other hand, describes an individual who owns a residential apartment building and a majority interest in a partnership that owns a residential condominium building and a residential apartment building. Although they all share centralized back-office functions and management, it appears that the condominium is renting rather than selling its units because the example states that the residential condominium and apartment building operate in "coordination with each other in renting apartments to tenants." The analysis assumes without explanation that they are the same type of property, but apparently no distinction is made regarding whether the condominium units are sold or rented. The example concludes that because the businesses are the same type of property (factor A) and share functions (factor B), they can be aggregated. Because they also coordinate rentals, the regulations state that they separately satisfy — but are not in this example required to meet — the joint operating requirement (factor C).

It would have been more advantageous if Example 18 made clear that the regs permit aggregation of an apartment rental building and a typical residential condominium building having apartment units that are offered for sale. In this attempt to show eligibility of all these factors by employing a rental condominium, the regulations have created some confusion about eligibility for garden variety condominium developers and converter dealer sales use of the building. Nonetheless, taxpayers can take further comfort that the regulations do not preclude aggregation of a rental building with a condominium dealer building. Had they intended to disallow aggregation of apartment rental buildings with condominium dealer buildings, we would have expected to see that expressly stated in the regs because dealer buildings are what generally come to mind when the term "condominium" is used. In Example 17, the regulations explicitly say that aggregation of a commercial building with a condominium building is not permitted. Both examples 17 and 18 were included in the final regulations, having been omitted from earlier proposed regs on aggregation. Thus, we can infer that the examples were meant to answer all questions on aggregation premised on the common understanding that the condominium apartment business is the business of dealer property. Accordingly, if dealer use was prohibited from aggregation, we would expect the same clarity as provided in Example 17.

Examples 17 and 18, like all the examples, are meant to clarify the general three-factor aggregation requirements. Review of the three factors themselves leads to the same conclusion: that condominium dealer apartment building businesses can be aggregated with residential rental apartment businesses even in the absence of any clarifying examples. The first requirement (factor A) is met if the same property is provided in the businesses. Residential apartment buildings and residential condominium apartment buildings are the same type of property. The residential condominium apartment building does not change form depending on whether the units are sold or rented. Thus, as long as the rental and condominium businesses have some form of centralized personnel or technology (factor B), aggregation should be permitted so that condominium owners also owning rental apartments will be eligible for the new 20 percent deduction, in whole or in part. It is just a shame that the regulatory examples did not state that proposition with absolute certainty.

IV. Planning Note

The 20 percent deduction expires January 1, 2026, for calendar-year taxpayers so unless Congress extends it, condominium developers and converters should consider planning to complete sales by the close of 2025, after which the old 39.6 percent rate returns. ■

[13]Given that aggregation is not a right granted by the statute but rather authorized by Treasury under its general statutory authority, we can assume that making a counterargument that commercial buildings should be eligible for aggregation with residential buildings will be quite challenging.