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MORTGAGE BANKERS ASSOCIATION

June 4, 2018

The Honorable David J. Kautter
Acting Commissioner
Internal Revenue Service and
Assistant Secretary for Tax Policy of the
U.S. Department of the Treasury
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. William M. Paul
Acting Chief Counsel and
Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Request for Guidance Confirming Eligibility of the Deduction under Code Section 199A for Mortgage Banking Companies

Dear Acting Commissioner Kautter and Mr. Paul:

The Mortgage Bankers Association, the national association of the real estate finance industry, respectfully requests that the U.S. Department of the Treasury and the Internal Revenue Service issue guidance confirming that mortgage banking companies are eligible for the deduction of qualified business income under new Section 199A of the Internal Revenue Code, as established by the Tax Cuts and Jobs Act of 2017 (Pub. Law 115-97, Dec. 22, 2017). As we describe in the **attached memorandum**, we believe that the law, congressional intent, and sound tax policy strongly support that conclusion.

Thank you for your consideration. We would be pleased to meet with appropriate personnel to discuss any element of this necessary guidance. Please contact Fran Mordi, Associate Vice President, Financial Management, Tax & Accounting Policy at 202-557-2860 or Bruce Oliver, Associate Vice President, Commercial/Multifamily Policy at 202-557-2840 with any questions or to schedule the meeting.

Sincerely,

Thomas T. Kim
Senior Vice President
Commercial/Multifamily
Mortgage Bankers Association

Pete Mills
Senior Vice President
Residential Policy & Member Engagement
Mortgage Bankers Association

Attachment

cc: Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation

Tom West, Tax Legislative Counsel, U.S. Department of the Treasury

Michael Novey, Associate Tax Legislative Counsel, U.S. Department of the Treasury

Holly Porter, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service

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MORTGAGE BANKERS ASSOCIATION

# REQUEST FOR GUIDANCE CONFIRMING ELIGIBILITY OF THE DEDUCTION UNDER SECTION 199A FOR MORTGAGE BANKING COMPANIES

**June 2018**

## Introduction

The Mortgage Bankers Association urges the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) to issue guidance confirming that mortgage banking companies, including independent mortgage banking companies, are eligible for the deduction of qualified business income under new Section 199A of the Internal Revenue Code, as established by the Tax Cuts and Jobs Act of 2017.[1]

Mortgage banking companies are in the business of financing real estate, with a focus on financing real estate for borrowers in markets across the country – by connecting the real estate financing needs of local communities to global capital markets. As a type of mortgage banking company, independent mortgage banking companies tend to have a more regional business focus and are not affiliated with depository banking institutions. Notably, many independent mortgage banking companies are organized as pass-through entities and compete directly with mortgage banking companies with a national footprint, as well as banks and other lending institutions engaged in financing to provide real estate capital for multifamily rental housing, single-family homes, retail centers, office buildings, industrial facilities and other real estate in our economy.

As described below, we believe that the law, congressional intent, and sound tax policy strongly support the conclusion that mortgage banking companies are eligible for the deduction of qualified business income under Section 199A. Congress enacted this provision for this very reason – to support a competitive balance among businesses with different organizational structures.

## I. SECTION 199A

Section 199A allows a 20 percent deduction of qualified business income from entities organized as pass-through entities (e.g., a partnership, S corporation or sole proprietorship). The purpose of Section 199A was to maintain a competitive balance between C corporations (who benefit from a greatly reduced tax rate under the Tax Cuts and Jobs Act) and pass-through entities that

[1] Pub. Law 115-97 (Dec. 22, 2017).

compete with C corporations. The inclusion of Section 199A was critical to the passage of the Tax Cuts and Jobs Act.[2]

In crafting Section 199A, Congress intended the deduction to apply to actual business income of pass-through entities (i.e., income generated as a result of business activity) – not to wage income or its equivalent.[3] To prevent the pass-through deduction from applying to wage income recharacterized as business income, Section 199A carved out certain exclusions.

One such exclusion applies to pass-through entities that are a "specified service trade or business," defined as follows:

> SPECIFIED SERVICE TRADE OR BUSINESS.—The term "specified service trade or business" means any trade or business—
>
> (A) which is described in Section 1202(e)(3)(A) (applied without regard to the words "engineering, architecture,") or which would be so described if the term "employees or owners" were substituted for "employees" therein, or

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[2] See, e.g., U.S. Senator Ron Johnson (R-Wis.), *Statement on Current Tax Reform Proposals* (Nov. 15, 2017) ("We have an opportunity to enact paradigm-shifting tax reform that makes American businesses globally competitive, helps our economy reach its full potential, and creates greater opportunity and bigger paychecks for every American. In doing so, it is important to maintain the domestic competitive position and balance between large publicly traded C corporations and "pass-through entities" (subchapter S corporations, partnerships and sole proprietorships). These businesses truly are the engines of innovation and job creation throughout our economy, and they should not be left behind. Unfortunately, neither the House nor Senate bill provide fair treatment, so I do not support either in their current versions. I do, however, look forward to working with my colleagues to address the disparity so I can support the final version."), accessed at https://www.ronjohnson.senate.gov/public/index.cfm/2017/11/johnson-statement-on-current-tax-reform-proposals.

[3] See, e.g., the *Tax Cuts and Jobs Act, H.R. 1, Section-by-Section Summary,* released by the House Ways and Means Committee (indicating congressional intent to "prevent the recharacterization of actual wages paid as business income"); see also Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act,"* 18 (prepared for markup scheduled for Nov. 13, 2017) ("Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business, and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.").

> (B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Section 475(c)(2)), partnership interests, or commodities (as defined in Section 475(e)(2)).[4]

Section 1202(e)(3)(A), referenced in the definition of "specified service trade or business," and as modified in Section 199A, includes:

> any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners.[5]

The businesses selected for exclusion (by reference to Section 1202(e)(3)(A)) were identified for a clear reason. These are fields that present a heightened risk of recharacterization because the income of pass-through entities in those fields is likely the equivalent of wage income.

Significantly, the Section 199A definition of "specified service trade or business" does <u>not</u> reference the following business types listed under Section 1202(e)(3)(B) – (E):

> (B) any banking, insurance, *financing*, leasing, investing, or similar business,
>
> (C) any farming business (including the business of raising or harvesting trees),
>
> (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under Section 613 or 613A, and
>
> (E) any business of operating a hotel, motel, restaurant, or similar business.[6]

Unlike those fields of businesses listed in Section 1202(e)(3)(A), the income of businesses listed in (B) – (E) is not the equivalent of wage income and, therefore, is eligible for the deduction under Section 199A.

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[4] Section 199A(d)(2).

[5] As cited above, Section 199A(d)(2)(A) effectively modifies Section 1202(e)(3)(A) as it applies under Section 199A by (1) deleting the reference to the fields of engineering and architecture, and (2) replacing "employees" with "employees or owners."

[6] Section 1202(e)(3)(B) – (E) (emphasis added).

In addition to identifying specific fields of businesses, another significant element of Section 199A(d)(2) is the reference to the "performance of services."[7] Specifically, the "performance of services" within the fields listed in Section 199A(d)(2)(B) would make such trades or businesses ineligible for the deduction. IRS regulations, cited in the legislative history of the Tax Cuts and Jobs Act, provide clarification of what the "performance of services" means.[8] Specifically, 26 C.F.R. 1.448–1T(e)(4) and the examples provided therein discuss the performance of services to "clients," i.e., services to *third parties*.

## II. ANALYSIS

### *A. Mortgage banking companies are not excluded from the Section 199A deduction under Section 199A(d)(2)(A).*

As described above, Section 199A excludes from the 20 percent deduction entities engaged in a "specified trade or business," which it defines by reference to Section 1202(e)(3)(A). Mortgage banking companies do not, however, fall within the trades or businesses listed in Section 1202(e)(3)(A). For example, the typical mortgage banking company receives income from engaging in a variety of real estate financing activities, including:

- Delivering capital by originating, underwriting, processing mortgage loans and other financing activities;
- Delivering these loans to investors, government-sponsored enterprises, lenders or securitization vehicles;
- Performing a wide variety of mortgage servicing activities, including collection, foreclosure and collateral preservation, and collecting payments; and
- Securing mortgage insurance coverage or guarantees from FHA, VA, Rural Housing Service and/or private mortgage insurers.

These activities are part of the business of *financing* – which is *not* a specified trade or business identified in Section 1202(e)(3)(A). The income from these activities is also not akin to wages for services – in contrast to the nature of income in the fields of business listed in Section

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[7] Unlike the original House version, the Senate version of the bill, S.R. 1, did not contain "performance of services" in Section 199A(d)(2)(B) – but the Final Conference legislation ultimately added it. The original Senate version read: "(A) IN GENERAL.—The term 'specified service trade or business' means—(i) any trade or business involving the performance of services described in Section 1202(e)(3)(A), including investing and investment management, trading, or dealing in securities (as defined in Section 475(c)(2)), partnership interests, or commodities (as defined in Section 475(e)(2))."

[8] See Conference Report, 115 H. Rpt. 466, 216 nn. 44-46.

1202(e)(3)(A). As a result, in addition to not being specifically listed in Section 1202(e)(3)(A), mortgage banking companies do not create heightened recharacterization risk.

Moreover, mortgage banking companies cannot be considered a specified trade or business under the Section 1202(e)(3)(A) definition that includes "any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners." Rather, in performing these activities, the principal assets of mortgage banking companies include systems, processes and technology that support the origination, processing, sale and servicing business functions, as well as legal, contractual relationships with investors, issuers, lenders, insurers and/or federal housing agencies. Such business contracts are backed by written policies and procedures for the companies, which are audited by outside auditors and other parties.

The policies and procedures, along with the other assets of the company, support the mortgage banking company as an operating entity, not individual employees or owners. Mortgage banking companies also hold necessary entity-level licenses, registration and other business authorizations with state and/or federal government agencies in order to engage in the business of financing real estate.

Importantly, Section 199A(d)(2)(A) defines a "specified service trade or business" in part by reference to Section 1202(e)(3)(A) – and *not* Section 1202(e)(3)(B). This targeted drafting choice is objective evidence of Congress's intention not to exclude businesses described in Section 1202(e)(3)(B) from the pass-through deduction, including "banking, insurance, financing, leasing, investing, or similar business."

*Mortgage banking companies are unequivocally in the business of financing real estate* as described in Section 1202(e)(3)(B). If Congress had intended to include the business of financing within the definition of "specified service trade or service," it would have extended the scope of its cross reference to include Section 1202(e)(3)(B). But Congress did <u>not</u> do so.[9]

Finally, the appropriate lens for interpreting the application of new Section 199A is the congressional intent to maintain equal footing between C corporations and pass-through entities that compete with one another. Mortgage banking companies frequently are organized as pass-

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[9] Mortgage banking companies are not in the business of performing services included Section 199A(d)(2)(A) by reference to Section 1202(e)(3)(A). That is, they are not performing services in the field of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services. In particular, mortgage banking companies cannot be said to be performing services in the field of financial services, i.e., providing customers portfolio management services or otherwise investing, administering, or managing funds for customers.

through entities and they compete directly with national mortgage banking companies with offices across the United States as well as with banks and other lending institutions engaged in financing.

Therefore, interpreting Section 199A in a way that would have the effect of reducing tax rates for one group engaged in financing real estate (C corporations) while not reducing rates for another group engaged in similar financing activities (mortgage banking companies organized as pass-through entities) would be fundamentally inconsistent with the intent of Section 199A. Moreover, that outcome could detrimentally change the lending landscape, for example, by reducing access to capital outside of the nation's financial centers – which would be a result contrary to congressional intent.

### *B. Mortgage banking companies are not excluded from the Section 199A deduction under Section 199A(d)(2)(B).*

Section 199A(d)(2)(B) excludes any trade or business engaged in the "performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Section 475(c)(2))." The existence of the "performance of services" language in the provision is critical – this language was not included in the Senate bill, but was in the House bill during the legislative process – and was ultimately adopted in conference and passed by Congress.[10] The use of the term "performance of services" is intended to limit the application of Section 199A(d)(2)(B) to activities that are performed on behalf of third parties such as customers or borrowers. As noted above, IRS regulations cited in the legislative history of the Tax Cuts and Jobs Act clarify the meaning of "performance of services" in this manner.[11]

In effect, for a business to be excluded under Section 199A(d)(2)(B), it must engage in activities that <u>both</u> involve the "performance of services" on behalf of third parties, and "consist of investing and investment management, trading, or dealing in securities (as defined in Section 475(c)(2))."

As discussed above, mortgage banking companies perform a wide range of activities as part of the business of financing real estate, including working with borrowers to originate loans. Some mortgage banking companies may sell loans they originate into the secondary capital markets. For federal income tax purposes, mortgage loans held for sale to investors in the ordinary course of the mortgage banking company's trade or business are required to be marked-to-market under

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[10] As noted above, unlike the original House version, the Senate version of the bill, S.R. 1, did not contain "performance of services" in Section 199A(d)(2)(B) – but the Final Conference legislation ultimately included the language.

[11] See Conference Report, 115 H. Rpt. 466, 216 nn. 44-46.

Section 475. Thus, as required under tax laws, mortgage banking companies that have available-for-sale loans mark these loans to market.

While the marked-to-market loan portfolio sale activity of mortgage banking companies could be construed as "dealing in securities,"[12] this activity does not involve the "performance of services" for third parties, such as borrowers. In situations where mortgage banking companies sell mortgage loans into the secondary market, they already own the loans they sell and the transaction is executed as part of their business operations, rather than on behalf of, or for the benefit of, any third parties. These transactions are not structured to, and do not in fact, provide any type of service for borrowers. In addition, borrowers do not share in the upside or downside of the transaction.

Thus, even if the activity of selling loans that have been marked-to-market under Section 475 is viewed as "dealing in securities (as defined in Section 475(c)(2))," it does not involve the performance of services for third parties. Accordingly, the exclusion in Section 199A(d)(2)(B) is not triggered.

In sum, the exclusion in Section 199A(d)(2)(B) does not apply to mortgage banking companies, whether or not they sell originated loans in the secondary mortgage market.

## III. CONCLUSION

For the reasons stated above, Treasury and the IRS must issue guidance confirming that mortgage banking companies, including independent mortgage banking companies, are eligible for the Section 199A pass-through deduction. That conclusion is consistent with the law, congressional intent, and sound tax policy that supports maintaining a competitive balance and a level playing field among C corporations and businesses organized as pass-through entities.

Please contact Fran Mordi, Associate Vice President, Financial Management, Tax & Accounting Policy at 202-557-2860 or Bruce Oliver, Associate Vice President, Commercial/Multifamily Policy at 202-557-2840 with any questions regarding this memorandum or if you require any additional information.

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[12] In contrast, loan origination activities cannot be construed as "investing and investment management, trading, or dealing in securities (as defined in Section 475(c)(2))."