RENTAL REAL ESTATE: TRADE OR BUSINESS SAFE HARBOR UNDER IRC §199A

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Introduction

Section 199A, which was introduced as part of the Tax Cuts and Jobs Act ("TCJA") generally provides for a deduction of up to 20% of qualified business income. To be eligible for the qualified business income deduction under IRC §199A, an enterprise operated by an individual or relevant pass-through entity must first qualify as a trade or business under IRC §162. Amid the flurry of guidance on Section 199A issued in January 2019, which included both final and proposed regulations, was a safe harbor standard for rental real estate to be considered a trade or business. Notice 2019-7 includes a safe harbor *proposed* Revenue Procedure. Until it is published in final form, the proposed revenue procedure may be relied upon in determining when a rental enterprise may be treated as a trade or business, solely for purposes of IRC §199A.

Rental Real Estate Enterprise

A rental real estate enterprise is defined solely for purposes of the safe harbor as an interest in real property held for the production of rents and may include an interest in multiple properties. The individual or relevant pass-through entity (e.g., partnership (other than a PTP) and S-corporation owned by at least one individual, estate or trust) ***must hold the interest directly or through an entity disregarded as an entity for tax purposes.*** Commercial and residential real estate may not be combined in the same enterprise but a taxpayer may treat similar properties as a single enterprise for Section 199A. Treatment generally must be consistent year-to-year.

Safe Harbor Qualifications

A rental real estate enterprise will be treated as a trade or business solely for purposes of IRC §199A if:

1. Separate books and records are maintained for each rental enterprise;
2. 250 hours or more of "rental services" are performed per year for the enterprise; and
3. Taxpayer maintains contemporaneous records, including time reports or similar documents regarding:
    1. hours of services performed;
    2. description of all services performed;
    3. dates on which such services are performed; and
    4. who performed the services.
    5. This contemporaneous records requirement does not apply to the 2018 tax year.

Rental Services

Rental services, which may be performed by owners or by employees, agents, and/or independent contractors of the owners, include:

- 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;
- Purchase of materials; and
- Supervision of employees and independent contractors.

Rental services *do 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
- Hours spent traveling to and from the real estate.

Exclusions from Safe Harbor

1. *Triple Net Leases*. For purposes of the safe harbor, 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. This also includes a lease for a part of a property and the expenses allocable thereto.

Triple net leases traditionally refer to "turnkey" operations, where the lessor does not directly handle payment and maintenance obligations. To qualify under the safe harbor, such lessors may consider renegotiating the leases by simultaneously increasing rents and their service obligations toward the property.

Observation: In instances where a lessor handles payment and maintenance obligations and bills the lessee for these items, unless further clarification is provided, such an arrangement may not be a triple net lease for purposes of the safe harbor.

1. *Vacation Homes*. Property used as a personal residence for any part of the year is not eligible for the safe harbor.

If a rental enterprise does not meet the safe harbor thresholds, it may still be treated as a trade or business, if it otherwise qualifies as a trade or business pursuant to guidance under substantial case law under IRC §162 (e.g. considerable, continuous and regular participation in the enterprise). Additionally, under Treas. Reg. §1.199A-1(b)(14), a rental activity that does not rise to qualify as an IRC §162 trade or business is nonetheless treated as such for purposes of IRC §199A if the property is rented to a trade or business conducted by the individual or a relevant pass-through entity which is commonly controlled (e.g., 50% or more ownership) under Treas. Reg. §1.199A-4(b)(1)(i).

Statement under Penalties of Perjury

Note that taxpayers and relevant pass-through entities relying on the safe harbor are required to attach a signed statement to their return that the safe harbor requirements are met: "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 relevant facts relating to the revenue procedure, and such facts are true, correct, and complete." The signer must have personal knowledge of the facts and circumstances related to the statement.

Other Observations

Meeting the safe harbor to be considered a trade or business is only valid for Section 199A purposes and not any other provision of the Code. It should also be noted that the final regulations under IRC §199 require that the trade or business standard under IRC §162 must be met for each separate activity, or rental real estate enterprise, in the case of the safe harbor. Outside the safe harbor, an activity or rental real estate enterprise cannot be aggregated with another until it first meets the trade or business standard under IRC §162.

Although triple net lease arrangements are not eligible for the safe harbor of the Notice, the IRS did not preclude the possibility that triple net lease activity could rise to the level of a trade or business. Taxpayers should consider case law and the criteria of the Notice to evaluate their activities.

Next Steps

1. *2018 Tax Reporting* – Discuss with your tax advisor the facts and circumstances around each of your rental real estate enterprises and the manner in which each will be handled for IRC §199A tax reporting considering implications under the safe harbor.
2. *Contemporaneous Records* – If not already established, rental real estate owners and operators should put processes in place to capture time spent on rental services (e.g., time reports, logs, etc.) or request applicable details on invoices from their service providers. It is important to substantiate the level of rental services an owner performs personally or through delegation. The IRS has eased this requirement for the 2018 tax year only.
3. *Rental Arrangement Outside Safe Harbor – if the cash flow benefit of qualifying under IRC §199A is significant, a lessor and their tax advisor should ascertain whether the rental enterprise may otherwise qualify as a trade or business pursuant to case law under IRC §162. Alternatively, a lessor may consider renegotiating its lease and/or increasing its services toward the property so as to meet the safe harbor qualifications.*

To learn more about how the TCJA may impact you or your business, contact your HCVT tax professional.

About HCVT:

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