TAX ALERT

Section 199A Qualified Business Income Deduction

IRS Notice 2019-07

Rental Real Estate Enterprise = "*Trade or Business*" Safe Harbor

The Internal Revenue Service ("IRS") has released significant guidance on the application of section 199A of the Internal Revenue Code ("Code") as to real estate ownership and income. IRS Notice 2019-07 describes a new IRS safe harbor procedure favorable to taxpayers who own rental real estate and want to claim the 20% qualified business income deduction allowed by section 199A. The IRS procedure will allow taxpayers who own rental real estate to treat it as a "trade or business" and claim the deduction if certain requirements are met. IRS Notice 2019-07, released January 18, 2019, is online at www.irs.gov/pub/irs-drop/n-19-07.pdf.

Introduction

Section 199A was enacted as a part of the Tax Cuts and Jobs Act, Pub. L. 115-97 ("TCJA"), on December 22, 2017. It provides a deduction to non-corporate taxpayers of up to 20% of qualified business income ("20% QBI deduction") from a taxpayer's qualified trade or business, including a trade for business operated through a relevant pass-through entity, such as a partnership, S corporation, or a sole proprietorship. (A pass-through entity, such as a partnership must file an annual information return with the IRS to report the income, deductions, etc., from its operations, but it does not pay income tax. Instead, it "passes through" any profits or losses to its partners. Each partner includes his or her share of the partnership's income or loss on his or her tax return.)

Section 199A(d) defines a "qualified trade or business" as any trade or business other than a specified service trade or business ("SSTB") or the trade or business of performing services as an employee. However, Section 199A does not specifically define the term "*trade or business*" which must exist to allow the deduction. That has resulted in uncertainty as to availability of the 20% QBI deduction to taxpayers for income from real estate owned individually or through a pass-through entity.

The IRS published proposed regulations under section 199A in August 2018 and released final regulations January 18, 2019. The regulations provide that a pass-through entity (*e.g.*

partnership, S corporation) must determine if it is engaged in a qualified trade or business under section 199A and report that determination to the owners and IRS. The pass-through entity must also separately identify and report on IRS Schedule K-1 issued to the owners any trade or business engaged in directly by the pass-through entity and each owner's allocable share of qualified business income

The IRS regulations define "trade or business" for section 199A as a trade or business under section 162 of the Code other than the trade or business of performing services as an employee. Section 162 generally allows deduction of the ordinary and necessary expenses incurred in the carrying on any trade or business. However, using the meaning of the term as stated in section 162 does not provide much help because trade or business is also not specifically defined in section 162; and engaging in a trade or business under section 162 is generally determined from the facts and circumstances of each case. That is usually done by applying broadly stated principles mentioned in previously decided court cases to the facts involved. The cases have held that for an activity to be a trade or business under section 162 the facts must show (1) the primary purpose for engaging in the activity is for income or profit and (2) the taxpayer is involved in the activity with continuity and regularity. The decided cases involving taxpayers claiming deduction under section 162 for expenses incurred in connection with real estate have had differing results. Some cases have held that the facts of a taxpayer's ownership of and activity involving real estate showed it was a trade or business under section 162, while other cases have held a taxpayer's real estate ownership and activity was not a trade or business within the meaning of section 162.

In IRS Notice 2019-07 the IRS states it is aware that whether a rental real estate enterprise is a trade or business is the subject of uncertainty for taxpayers, and to help mitigate this uncertainty, it is publishing in the notice a proposed IRS revenue procedure that provides for a "safe harbor" under which a rental real estate enterprise will be treated as a trade or business for purposes of the 20% QBI deduction under section 199A.

The rental real estate enterprise trade or business safe harbor proposed by the IRS appears to have limited application and contains specific requirements a taxpayer must meet to come within it so rental real estate activity will be treated as a trade or business for purposes of section 199A and claiming the 20% QBI deduction.

The proposed IRS revenue procedure provides that a rental real estate enterprise that fails to satisfy the safe harbor requirements may still be treated as a trade or business for purposes of section 199A if it meets the definition in IRS regulations under section 199A based on the facts and circumstances involved.

Rental Real Estate Enterprise Section 199A "*Trade or Business*" Safe Harbor

As indicated, IRS Notice 2019-07 includes a proposed IRS revenue procedure to provide a safe harbor under which what is defined in it as a rental real estate enterprise will be treated as a trade or business for purposes of section 199A. The following discussion summarizes the provisions of the proposed IRS revenue procedure and safe harbor.

Definition of "*Rental Real Estate Enterprise*" for Safe Harbor

The proposed IRS revenue procedure in IRS Notice 2019-07 states that for purposes of the section 199A trade or business safe harbor a "*rental real estate enterprise*" is defined as an

interest in real property held for the production of rents and may consist of an interest in multiple properties.

The individual or the relevant pass-through entity (*e.g.* partnership) must hold the interest directly or through an entity disregarded as an entity separate from its owner under section 301.7701-3 of the IRS income tax regulations.

Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rent as a single enterprise, with one exception.

Commercial and residential real estate may not be part of the same enterprise.

Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances.

Requirements of Rental Real Estate Enterprise "*Trade or Business*" Safe Harbor

IRS Notice 2019-07 and the proposed IRS revenue procedure provide that a rental real estate enterprise will be treated as a trade or business for purposes of section 199A if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

1. Separate books and records. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;

2. Performance of rental services. For taxable years beginning prior to January 1, 2023, 250 or more hours of *rental services* (defined below) are performed per year with respect to the rental real estate enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise; and

3. Contemporaneous records of rental services performed. The taxpayer maintains *contemporaneous* records, including time reports, logs, or similar documents, regarding the following:

    a. hours of all services performed;
    b. description of all services performed;
    c. dates on which such services were performed; and
    d. who performed the services.

Such records are to be made available for inspection at the request of the IRS.

The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

Definition of "*Rental Services*" for Safe Harbor Requirements

For purposes of the rental real estate enterprise trade or business safe harbor requirements the term "*rental services*" means and includes:

1. advertising to rent or lease the 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.

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

The term "rental services" does *not* include:

1. financial or investment management activities, such as arranging financing;
2. procuring property;
3. studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or
4. hours spent traveling to and from the real estate.

An example of apparent effect of the section 199A rental real estate enterprise trade or business safe harbor described in the proposed revenue procedure in IRS Notice 2019-07, based upon initial review of its provisions, is stated below after the conclusion of this summary.

Real Estate *Excluded* from "*Trade or Business*" Safe Harbor

The proposed IRS revenue procedure in IRS Notice 2019-07 provides that the following real estate arrangements are excluded from the rental real estate enterprise section 199A trade or business safe harbor:

1. Real estate used by the taxpayer (including an owner or beneficiary of a pass-through entity) as a residence for any part of the year under section 280A of the Code (governing deductions for a personal residence and home office) is *not eligible* for this safe harbor.

2. Real estate rented or leased under a *triple net lease* is also *not eligible* for the safe harbor. The term "*triple net lease*" is defined as 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 includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

Procedural Requirements for Using the Rental Real Estate Enterprise "*Trade or Business*" Safe Harbor

To use and take advantage of the rental real estate enterprise trade or business safe harbor a taxpayer or pass-through entity (e.g. partnership) must satisfy specified procedural requirements which are:

1. The taxpayer or pass-through entity must include a statement attached to its federal income tax return on which it claims the section 199A deduction or passes through section 199A information that the safe harbor requirements specified in the IRS revenue procedure for the safe harbor have been satisfied.

2. The statement attached to the return must be signed by the taxpayer, or an authorized representative of an eligible taxpayer or pass-through entity, which states:

   "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."

3. The individual or individuals who sign the statement must have personal knowledge of the facts and circumstances related to the statement.

Application and Effect of the Rental Real Estate Enterprise "*Trade or Business*" Safe Harbor

The guidance in IRS Notice 2019-07 and the proposed revenue procedure provide the following as to application and effect of the safe harbor treatment of rental real estate enterprises as a trade or business for purposes of section 199A:

1. The safe harbor for treatment of a rental real estate enterprise as a trade or business under section 199A is available to taxpayers who seek to claim the 20% QBI deduction with respect to the rental real estate enterprise.

2. If the safe harbor requirements are met, the rental real estate enterprise will be treated as a "trade or business" as referred to in section 199A(d) and for purposes of applying the IRS regulations under section 199A.

3. Pass-through entities may also use this safe harbor in order to determine whether a rental real estate enterprise is a trade or business as defined in section 199A(d).

4. Failure to satisfy the requirements of the safe harbor does not preclude a taxpayer from otherwise establishing that a rental real estate enterprise is a "trade or business" for purposes of section 199A.

5. The proposed IRS revenue procedure will apply to taxable years ending after December 31, 2017. Until such time that the proposed revenue procedure is published in final form, taxpayers may use the safe harbor described in Notice 2019-07 and the proposed revenue procedure therein for determining when a rental real estate enterprise may be treated as a trade or business for purposes of section 199A.

Conclusion

IRS Notice 2019-07 provides important guidance and greater certainty as to how the IRS will apply section 199A to real estate income of a taxpayer and pass-through entity.

The IRS safe harbor procedure under which a rental real estate enterprise will be treated as a trade or business under section 199A should be advantageous for taxpayers who can meet the safe harbor requirements. However, the scope, availability and effect of the safe harbor appears to be limited.

As indicated in IRS Notice 2019-07, and the IRS regulations under section 199A, taxpayers with real estate activities and income that do not meet the safe harbor requirements may still be able to qualify as a trade or business under section 199A based on all the facts involved and court decisions that have held real estate activity to be a trade or business under section 162. Meeting the safe harbor requirements stated in the proposed revenue procedure in IRS Notice 2019-07 with respect to maintaining separate books and records, and contemporaneous records of services performed, would be advisable to assure qualification for any 20% QBI deductions claimed by a taxpayer under section 199A for real estate activity and income, whether under the safe harbor, or otherwise based on the facts of the case.

If you would like to discuss section 199A, including the guidance released by the IRS on its application to rental real estate ownership and income, please contact your GableGotwals attorney or any member of our Tax Law Practice Group:

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Example: A is the sole owner and an officer of A Properties LLC, a limited liability company ("LLC"), that owns real property in Oklahoma that consists of two residential duplex properties located near a large university. LLC is disregarded as an entity separate from A as the single individual owner for federal income tax purposes under Treas. Reg. §301.7701-3. The units are rented by LLC to four other persons who are individuals, as tenants, pursuant to lease agreements for a one-year term, with provision for renewal. The tenants pay monthly rentals to LLC and the utility bills for their units. LLC pays all property taxes and insurance on the properties. LLC, as the lessor, is otherwise responsible for maintenance and repair of the properties and units during the lease term. A, and/or persons who through LLC he hires, directs and pays, do the following with respect to the properties and leases: (1) prepare the units for showing to prospective tenants, (2) repair and maintain the units in ordinary livable condition, and (3) repair, clean and restore the condition of the units after a lease termination. In 2019, all the units were under lease to tenants. In 2019, A directly performed 290 hours of services with respect to the properties and rental of them, which included (1) advertising to rent or lease the real estate, (2) negotiating and executing leases, (3) verifying information contained in prospective tenant applications, (4) collection of rent, (5) services related to the daily operation, maintenance, and repair of the properties, (6) management of the real estate, (7) purchase of materials, and (8) supervision of employees and independent contractors of A and LLC. In 2019, LLC maintained separate books and records for the rental real estate enterprise involved with the properties and units owned by LLC that reflect the income and expenses of LLC from it. A and LLC, in 2019, maintained detailed contemporaneous records, including time reports, logs and similar documents regarding (i) hours of all services performed, (ii) description of all services performed,

(iii) dates on which such services were performed, and (iv) who performed the services. The records are in an organized and complete form that can be made available for inspection at the request of the IRS. LLC should be able to determine, with respect to the properties in 2019, that LLC was engaged in a rental real estate enterprise and trade or business for purposes of section 199A by satisfying the safe harbor requirements in the proposed IRS revenue procedure in IRS Notice 2019-07.

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