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Proposed Rental Business Safe Harbor under Section 199A

Tax Talks on **February 7, 2019**

On January 18, the Internal Revenue Service ("IRS") and the U.S. Department of the Treasury issued final regulations (the "Final Regulations") on the "pass through" deduction under section 199A[1] of the Internal Revenue Code (the "Code"). Very generally, section 199A provides individuals with a deduction of up to 20% of income from a domestic "trade or business" operated as a sole proprietorship or through a partnership, S corporation, trust, or estate. The Final Regulations define trade or business as "a trade or business under section 162, other than the trade or business of performing services as an employee."[2]

Prior to the issuance of the Final Regulations, taxpayer commenters expressed uncertainty as to whether a rental business qualified as a trade or business under section 199A—based on a long-standing uncertainty as to whether, and to what extent, a rental real estate business was a trade or business for purposes of section 162.

To provide some certainty for taxpayers potentially entitled to the pass-through deduction, the IRS released Notice 2019-07 (the "Notice") in conjunction with the Final Regulations. The Notice proposes a safe harbor under which taxpayers (including partnerships and S corporations owned by at least one individual, estate, or trust) may treat a "rental real estate enterprise" as a trade or business solely for the purposes of the section 199A deduction. Because the Notice would provide a safe harbor—and not a substantive rule—failure to meet the tests set forth in the Notice does not necessarily mean a rental real estate business is ineligible for the section 199A deduction. If the Notice standards are not met, then the general test under section 162 would need to be met for such a business.[3] However, in certain other contexts, tax professionals and the IRS have viewed safe harbors as establishing the bounds of the substantive law; it remains to be seen whether taxpayers will claim the pass-through deduction for real estate leasing activities that fail to satisfy the safe harbor.

Although any clarity provided by the IRS regarding section 199A and rental real estate businesses is helpful, the safe harbor itself is vague on multiple key points, and the safe harbor expressly does not apply to triple net leases. The utility of the safe harbor may, therefore, be exceedingly limited. Moreover, due to the uncertainty surrounding the definition of a “triple net lease” and the express *exclusion* of triple net leases from the scope of the safe harbor, as discussed below, the Notice may cause greater confusion in the section 199A context than it seeks to alleviate.

Basically, a rental real estate business can meet the safe harbor as long as “as least 250 hours of rental services” are performed with respect to the rental real estate enterprise either (i) each year (for tax years beginning on or before December 31, 2022), or (ii) in three of the prior five years (for later tax years) and certain recordkeeping requirements and other procedural requirements are met. The key term “rental services” is only defined by a list of services—a list introduced by the word “include,” which lacks clarity as to whether the list is inclusive or exclusive. The particular specified services on the list are:

- 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 rental property;
- Management of the real estate;
- Purchase of materials; and
- Supervision of employees and independent contractors.

However, the following financial or investment management activities are specifically excluded from classification as rental services: arranging financing; procuring property; studying financial statements or operations reports; planning, managing, or constructing long-term capital improvements; and traveling to and from the rental property.

The Notice makes it clear that rental services can be performed on behalf of the rental real estate business by any of a broad range of persons, including any property owner directly, or by employees, agents, or independent contractors of the owner. Thus, a property owner that hires a management company to perform rental services for the property should be able to include the time spent by the management company (and its employees) in determining whether the 250 hour requirement is met.

In addition, for the purposes of meeting the 250 hour requirement, taxpayers may group similar properties as one enterprise. However, commercial and residential rental properties may not be part of the same rental real estate enterprise, and taxpayers may not modify treatment year by year "unless there has been a significant change in facts and circumstances."

Additionally, there are two arrangements that are specifically excluded from the safe harbor. First, as mentioned above, any property rented under a "triple net lease" is excluded from being considered under the safe harbor. For purposes of the Notice, 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." The word "include" suggests that other leases may be treated as triple net leases; however, the Notice may simply contemplate that a lease arrangement under which the lessor pays some expenses may still qualify as a triple net lease. Second, any property used by the taxpayer as a residence for part of the year under section 280A is also excluded.[4]

The Notice also contains consistency rules and tax return reporting rules.

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[1] All references to "section" are to the Internal Revenue Code of 1986, as amended.

[2] Treas. Reg. § 1.199A-1(b)(14).

[3] While the Notice's safe harbor applies solely in the context of section 199A, the definition of trade or business under section 199A is coextensive with the definition under section 162.

[4] Under section 280A(d), a taxpayer uses a “dwelling unit” as a “residence” if the taxpayer “uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of (A) 14 days, or (B) 10 percent of the number of days during such year for which such unit is rented at a fair rental.” For the purposes of section 280A(d), a “dwelling unit” includes “a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit.” I.R.C. § 280A(f)(1)(A).

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