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Guidance Regarding Trade or Business Determination for Section 199A

The Department of the Treasury and Internal Revenue Service have issued Notice 2019-07, providing guidance regarding the determination of when a rental real estate activity may rise to the level of a trade or business for purposes of Section 199A.

BACKGROUND

On January 18, 2019, the Internal Revenue Service (IRS) published Notice 2019-07 concerning the determination of whether a rental real estate enterprise will be treated as a trade or business for purposes of Section 199A. Notice 2019-07 was published contemporaneously with final regulations under Sections 1.199A-1 through 1.199A-6. If a taxpayer satisfies requirements described in the proposed revenue procedure included within Notice 2019-07, the rental real estate enterprise will be treated as a trade or business for purposes of Section 199A. If the requirements are not satisfied, the rental real estate enterprise may still be considered a trade or business for purposes of Section 199A if it is otherwise treated as a trade or business under Section 162.

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DETAILS

Overview of the QBI Deduction

Eligible taxpayers may be entitled to a deduction of up to 20 percent of the qualified business income (QBI) earned from each qualified trade or business. QBI with respect to each qualified trade or business is generally defined to mean any item of domestic income, gain, loss, and deduction attributable to a qualified trade or business (QTB). A QTB is further defined to include any trade or business except for a specified service trade or business (SSTB).

In general, a rental real estate trade or business will be considered a QTB and will not be treated as an SSTB. Consequently, QBI generated from a rental real estate trade or business is eligible for the Section 199A deduction, subject to other relevant limitations. However, whether a rental real estate activity rises to the level of a trade or business is uncertain. To provide clarity around this determination, the IRS published Notice 2019-07.

Notice 2019-07

Notice 2019-07 includes a proposed revenue procedure that provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business for purposes of Section 199A. Where a taxpayer fails to qualify for the safe harbor, determination of the rental real estate enterprise as a trade or business will be determined under the general principles of Section 162.

Pursuant to the proposed revenue procedure, 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 proposed revenue procedure applies to individual taxpayers or relevant passthrough entities (RPE)[1] holding interests in rental real estate either directly or through a disregarded entity (as defined in Section 301.7701-3). Further, while taxpayers may choose to treat each real estate property as a separate enterprise or combine them into a single enterprise, two important limitations exist: (1) commercial and residential real estate may not be part of the same enterprise and (2) taxpayers may not vary treatment from year-to-year unless there has been a significant change in the relevant facts and circumstances.

To meet the requirements of the safe harbor, the rental real estate enterprise must:

1. Maintain separate books and records reflecting the income and expenses for each rental real estate enterprise.
2. For taxable years beginning before January 1, 2023, spend at least 250 hours in connection with the performance of rental services. For taxable years beginning after December 31, 2022, in any three of five consecutive taxable years that end with the taxable year (or in each year for an enterprise held less than five years), spend at least 250 hours in connection with the performance of rental services.
3. For taxable years beginning after December 31, 2018, maintain contemporaneous documentation, including time reports, logs, or similar documents regarding the following: (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.

For purposes of the safe harbor, the term "rental services" is defined to include: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) 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 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; or hours spent traveling to and from the real estate.

Reporting Requirements

To take advantage of the safe harbor described in the proposed revenue procedure, a taxpayer or RPE must include a statement attached to the return on which it claims the Section 199A deduction or passes through the information needed for the owners to claim the Section 199A deduction. The statement, which certifies that the three aforementioned safe harbor requirements have been met, must be signed by the taxpayer, or an authorized representative of an eligible taxpayer or RPE, 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."

Exceptions to the Safe Harbor

Importantly, the proposed revenue does not apply to real estate rented or leased under a triple net lease whereby the tenant or lessee is required to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities.

1 Section 1.199A-1(b)(10) defines an RPE to mean a partnership (other than a publicly traded partnership) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. Other passthrough entities including common trust funds are treated as RPEs if they file Form 1065 and are owned, directly, or indirectly, by at least one individual, estate, or trust.

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BDO INSIGHTS

Notice 2019-07 provides a useful safe harbor for determining when certain rental real estate property will be viewed as rising to the level of a trade or business. However, failure to meet the safe harbor, or a decision to not apply the proposed revenue procedure, does not necessarily mean a rental real estate activity will fail to be considered a trade or business. In those situations, further analysis will be needed to determine whether the activity rises to the level of a trade or business under Section 162.

- When evaluating application of Notice 2019-07, taxpayers should carefully consider whether they fully meet the requirements of the safe harbor. For example, the prohibition against combining commercial and residential rental properties may make satisfying the requirements difficult. However, the activities, in totality, may still rise to the level of a trade or business under Section 162. Consequently, analysis and documentation of a trade or business outside of the safe harbor may still be possible.
- The proposed revenue procedure contains very specific and detailed recordkeeping requirements. Taxpayers who intend to rely on this safe harbor should ensure processes and procedures are in place to capture this information on a contemporaneous basis.
- Properties leased on a triple net basis are not eligible for the safe harbor. However, the definition of triple net leased property for purposes of the revenue procedure is not entirely clear. In particular, the proposed revenue procedure doesn't describe the meaning of the requirement that the tenant "be responsible for maintenance activities." Does this mean that provision of some maintenance service by the property owner may cause the rental real estate to fail to be considered a triple net lease and therefore eligible to apply the proposed revenue procedure?
- When evaluating whether a rental real estate activity rises to the level of a trade or business, the analysis requires determining whether the taxpayer (1) is involved in the activity with continuity and regularity and (2) the taxpayer's primary purpose for engaging in the activity is for income or profit.[2] Although this analysis is highly factual, extensive judicial guidance exists to aid taxpayers in their evaluations.[3] Additionally, the preamble to the regulations published under Section 199A notes that in determining whether a rental real estate activity is a Section 162 trade or business, relevant factors might include (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).
- When leased on a triple net basis, taxpayers are likely to find that establishing a trade or business is more difficult. While the Tax Court's decision in Curphey[4] is favorable, a number of cases reached a contrary conclusion holding that rental real estate leased on triple net basis where the owner spends nominal time operating the property is likely held for investment rather than trade or business purposes.[5] Ultimately, a taxpayer's operating rental real estate that is leased on a triple net basis will need to carefully consider their specific facts in light of existing law.

2 The Supreme Court held in *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), that a taxpayer's activities rose to the level of a trade or business where the taxpayer (1) is involved in the activity with continuity and regularity and (2) the taxpayer's primary purpose for engaging in the activity is for income or profit.

3 See, for example, *John D. Fackler*, 45 BTA 708, *Hazard v. Commissioner*, 7 TC 372 *Hendrickson v. Commissioner*, 78 TCM 322, and *Schwarcz v. Commissioner*, 24 TC 733

4 In *Curphey v. Commissioner*, 73 TC 766, the taxpayer owned several residential rental properties which he directly managed. The IRS argued that Section 1.212-1(b) would treat rental real estate expenses as generated from an investment activity. The Tax Court rejected this theory and concluded that the taxpayer's efforts to seek new tenants, supply furnishings, and in otherwise preparing the units for new tenants was "sufficiently systematic and continuous" to rise to the level of a trade or business.

5 For example, in *Neill v. Commissioner*, 46 BTA 197, the taxpayer rented land on a triple net basis. The taxpayer hired a law firm to which the tenant paid the rent. The law firm also paid her mortgage interest on the property and any incidental expenses. The court viewed ownership of the rental property as an investment activity analogous to the holding of stocks or bonds, and not a trade or business concluding: "[w]e think the rule is settled that the mere ownership of property from which income is drawn does not constitute the carrying on of business within the purview of the cited section."

Additionally, in *Union National Bank of Troy*, 8 AFTR 2d 5133 the taxpayer attempted to claim a capital loss on the sale of an interest in a commercial building that was rented on a triple net basis whereas the IRS sought to treat the loss as ordinary. A critical question, then, was whether the taxpayer's activities with respect to the property rose to the level of a trade or business. The taxpayer's only interaction with the rental property was to collect his share of rents. The court, applying Second Circuit precedent, concluded that the rental real estate did not rise to the level of a trade or business.

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