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Rental Real Estate and the Code Sec. 199A Deduction

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On January 18, 2019, Treasury issued final regulations (the "Final Regulations") under Code Sec. 199A (which were published in the Federal Register on February 8, 2019), and also issued proposed regulations addressing some ancillary Code Sec. 199A issues not addressed by the original Code Sec. 199A proposed regulations that had been issued in August 2018 (the "Proposed Regulations"). In addition, on the same date the IRS issued (1) Notice 2019-07 (the "2019 Notice"), which contains a proposed revenue procedure that provides for a safe harbor as to when a rental real estate enterprise will be treated as a trade or business for purposes of Code Sec. 199A, and (2) Rev. Proc. 2019-11, which provides methods for calculating W-2 wages for purposes of the limitations contained in Code Sec. 199A.

A Code Sec. 199A deduction is available only with respect to qualifying income from a qualified trade or business, and one of the major issues that has led to substantial rhetoric, as well as numerous submissions to Treasury both before and after the issuance of the Proposed Regulations, is when the rental of real estate is considered to be a trade or business. Treasury and the IRS expanded their guidance on this issue with (1) Treasury's explanation in the Preamble to the Final Regulations, (2) Treasury's clarification of the application of the aggregation rules contained in Reg. §1.199A-4 to multiple parcels of real estate, and (3) the IRS's issuance of the 2019 Notice. However, many questions still linger, as will be discussed in this month's Partner's Perspective.

The Trade or Business Requirement and the Proposed Regulations

Code Sec. 199A(a) provides that, subject to certain limitations, a 20% deduction is available for qualified business income ("QBI"), which is defined in Code Sec. 199A(c) as qualified items with respect to any qualified trade or business of the taxpayer. In turn, qualified trade or business is defined in Code Sec. 199A(d) as a "trade or business," other than a specified service trade or business ("SSTB") or the trade or business of performing services as an employee. So, what is a "trade or business"?

The Proposed Regulations addressed this concept in Prop. Reg. §1.199A-1(b)(13), wherein Treasury defined a trade or business as "a section 162 trade or business other than the trade or business of performing services as an employee." The Preamble to the Proposed Regulations makes the following statements:

> Proposed §1.199A-1(b) also defines trade or business for purposes of section 199A and proposed §§1.199A-1 through 1.199A-6. Neither the statutory text of section 199A nor the legislative history provides a definition of trade or business for purposes of section 199A. Multiple commenters stated that section 162 is the most appropriate definition for purposes of section 199A. Although the term trade or business is defined in more than one provision of the Code, the Department of the Treasury (Treasury Department) and the IRS agree with commenters that for purposes of section 199A, section 162(a)

> provides the most appropriate definition of a trade or business. This is based on the fact that the definition of trade or business under section 162 is derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries. Thus, the definition of a trade or business under section 162 provides for administrable rules that are appropriate for the purposes of section 199A and which taxpayers have experience applying and therefore defining trade or business as a section 162 trade or business will reduce compliance costs, burden, and administrative complexity.

A special carve-out from the trade or business requirement for "self-rented property" (the "Self-Rented Property Trade or Business Carve-Out Rule") was inserted into the Proposed Regulations as the second sentence of Prop. Reg. §1.199A-1(b)(13) (with the first sentence being the reference to Code Sec. 162 stated above). The rule provided:

> In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under §1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under §1.199A-4(b)(1)).

However, the definition of common control for purposes of the above rule was somewhat limited, as attribution was limited to one's spouse, children, grandchildren and parents (i.e., no grandparents or siblings, and no entity look-through rules such as those contained in Code Secs. 267(b) or 707(b)).

Lastly, to round out some of the uncertainty regarding the treatment of rental real estate under Code Sec. 199A, there was some question as to how the aggregation rules of Prop. Reg. §1.199A-4 were to be applied. Clearly, only non-SSTB commonly-controlled trades or businesses (under the restrictive definition noted above) could be aggregated. However, assuming each of two or more parcels of real estate was operated in a manner so that each parcel met the trade or business definition (so that they were eligible to be aggregated), the question was whether factor (A) of the Prop. Reg. §1.199A-4(b)(1)(v) requirement that two of the following three factors must be satisfied could be met for separate parcels of real estate:

> (A) <u>The trades or businesses provide products and services that are the same or customarily offered together</u>.
>
> (B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
>
> (C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies). (Emphasis added.)

In other words, could the separate parcels be considered to "provide products or services that are the same or customarily offered together"?

The January 18, 2019 Developments

Treasury and the IRS declined to change the Code Sec. 162 standard for determining when rental real estate constitutes a trade or business, with Treasury explaining its position at pages 15-18 of the Preamble to the Final Regulations and the IRS issuing the 2019 Notice, which Notice also is discussed in that Preamble. There is a lot of language in the Preamble that requires careful attention in order to understand the lay of the land and the uncertainty that remains. Let's start with a pertinent portion of the opening paragraph of the Preamble discussing rental real estate activities as a trade or business:

> A majority of the comments received on the meaning of a trade or business focus on the treatment of rental real estate activities. Commenters noted inconsistency in the case law in determining whether a taxpayer renting real estate is engaged in a trade or business. Some commenters suggested including safe harbors, tests, or a variety of factors, which if satisfied, would qualify a rental real estate activity as a trade or business. A number of commenters suggested that all rental real estate activity should qualify as a trade or business. Further, one commenter suggested that rental income from real property held for the production of rents within the meaning of section 62(a)(4) should be considered a trade or business for purposes of section 199A…. (Emphasis added.)

One paragraph later in the Preamble, Treasury explains its position in not backing off the Code Sec. 162 approach to determine whether a rental real estate activity constitutes a trade or business:

> Providing bright line rules on whether a rental real estate activity is a section 162 trade or business for purposes of section 199A is beyond the scope of these regulations. Additionally, the Treasury Department and the IRS decline to adopt a position deeming all rental real estate activity to be a trade or business for purposes of section 199A. However, the Treasury Department and IRS recognize the difficulties taxpayers and practitioners may have in determining whether a taxpayer's rental real estate activity is sufficiently regular, continuous, and considerable for the activity to constitute a section 162 trade or business. Accordingly, Notice 2019-07, 2019-XXX IRB XXX released concurrently with these final regulations, provides notice of a proposed revenue procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A.

The Preamble then goes on to explain what the 2019 Notice is intended to do. Rather than paraphrase it, the following is the Preamble's summary of the 2019 Notice:

> Under the proposed safe harbor, a rental real estate enterprise may be treated as a trade or business for purposes of section 199A if at least 250 hours of services are performed each taxable year with respect to the enterprise. This includes services performed by owners,

> employees, and independent contractors and time spent on maintenance, repairs, collection of rent, payment of expenses, provision of services to tenants, and efforts to rent the property. Hours spent by any person with respect to the owner's capacity as an investor, such as arranging financing, procuring property, reviewing financial statements or reports on operations, planning, managing, or constructing long-term capital improvements, and traveling to and from the real estate are not considered to be hours of service with respect to the enterprise. The proposed safe harbor also would require that separate books and records and separate bank accounts be maintained for the rental real estate enterprise. Property leased under a triple net lease or used by the taxpayer (including an owner or beneficiary of an RPE) as a residence for any part of the year under section 280A would not be eligible under the proposed safe harbor. A rental real estate enterprise that satisfies the proposed safe harbor may be treated as a trade or business solely for purposes of section 199A and such satisfaction does not necessarily determine whether the rental real estate activity is a section 162 trade or business. Likewise, failure to meet the proposed safe harbor would not necessarily preclude rental real estate activities from being a section 162 trade or business. (Emphasis added.)

Before commenting on (1) the 2019 Notice and the uncertainties that remain for rental real estate, and (2) the two highlighted items in the above paragraph, we note that, in addition to the 2019 Notice, the Final Regulations made a couple of other changes to the concepts that were contained in the Proposed Regulations that affect rental real estate. First, the Final Regulations changed factor (A) in the two-out-of-three factor aggregation requirement contained in Reg. §1.199A-4(b)(1)(v) to allow multiple parcels of real estate to meet factor (A) by adding the word "property" to factor (A): "The trades or businesses provide products, property, or services that are the same or customarily offered together." (Emphasis added.) Note that the Preamble indicates that "the final regulations add examples clarifying when a real estate business satisfies the aggregation rules" and that "the final regulations retain the factors provided in the proposed regulations, modified to take real estate into account."

Examples 16 through 18 of Reg. §1.199A-4(d) illustrate the operation of the aggregation rule in the case of real estate activities. Of note is Example 17, which states that a residential condominium building and a commercial rental office building are not the same type of property (Factor A), and although both businesses share significant centralized business elements (Factor B), they are not operated in coordination with, or reliance upon, each other (Factor C), and, therefore, can not be aggregated. (This example is consistent with the 2019 Notice, which provides that "[c]ommercial and residential real estate may not be part of the same enterprise.") However, what is not discussed in this Example is whether, under appropriate circumstances, the renting of commercial real estate and residential real estate could be considered as being one trade or business, so the three-factor aggregation standard would not be relevant.

The Uncertainty and Some Observations

One has to wonder what the 2019 Notice adds to the mix, with particular focus on the critical second paragraph appearing on page 16 of the Preamble, which discusses rental real estate activities as a trade or business:

> In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (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). (Emphasis added.)

More on the highlighted clause shortly, but it seems clear that multiple properties can constitute a trade or business. And if significant hours (e.g., clearly 250, as contained in the 2019 Notice, and probably less than that) are spent in providing services to those multiple properties, wouldn't it be reasonable to conclude that a trade or business exists without resorting to the safe harbor in the 2019 Notice? And while the Preambles to the Proposed Regulations and the Final Regulations make it clear that Code Sec. 469 concepts generally are not being imported into Code Sec. 199A, one can hardly ignore the Reg. §1.469-2T(f)(2) significant participation rule, whereby income from an activity with more than 100 hours of participation is considered "active" income.

Also note that the utility of the 2019 Notice is somewhat limited from the perspective of the manner in which the 250-hour requirement operates. Section 3.02 of the 2019 Notice requires that an individual or RPE must hold its interests in the property directly or through a disregarded entity. This means that if multiple properties are held through a holding structure, the hours can be aggregated for purposes of the 250-hour test, but if held through brother-sister entities, each entity apparently would have to satisfy the 250-hour requirement separately.

Understand that deciding to come under the safe harbor in the 2019 Notice is not a benign decision, as a taxpayer must attach the following statement to the taxpayer's tax return: "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." In this regard, note the following requirement in Section 3.03(C) of the Notice:

> (C) The taxpayer maintains contemporaneous records, 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. 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.

How many taxpayers want to be subject to making a representation under penalties of perjury about contemporaneous records being maintained by their employees? And, if agents are being used to perform the services, which would not be unusual, how is the foregoing requirement practically going to be satisfied? The initial reaction of tax professionals is one of concern about the above safe harbor requirement.

More importantly, let's shift from the 2019 Notice back to the factors set forth on page 16 of the Preamble regarding how to determine "whether a rental real estate activity is a section 162 trade or business." Specifically, let's focus on clause (ii) about the number of properties rented. This language strongly suggests that a taxpayer who owns, for example, multiple triple-net-lease properties and spends the requisite amount of time in negotiating leases, meeting with tenants, inspecting the properties, etc. is engaged in a "section 162 trade or business."

Keep in mind that aggregation for real estate is an important concept, as the ability to aggregate multiple properties enables a taxpayer having insufficient W-2 wages/UBIA from one property to use excess W-2 wages/UBIA from another property that is part of the aggregated group to support a full Code Sec. 199A deduction. However, in order to aggregate, remember that each of the activities for which aggregation is desired must be a separate trade or business. This means that a triple-net-lease property, standing alone, is not eligible for aggregation. Moreover, recall that under the 2019 Notice a triple-net-lease property is not eligible to be considered part of the a "real estate enterprise" for purposes of the safe harbor. It sure seems that the concepts on page 16 of the Preamble provide an avenue for a taxpayer to qualify triple-net-lease property, or property for which insignificant services are being rendered, as a trade or business, if the taxpayer provides "enough" services to "enough" properties. Is this an "end run" around the aggregation rules? Only time will tell.

As a final observation about rental real estate under the January 18th guidance listed on page one of the column, note that the Self-Rented Property Trade or Business Carve-Out Rule contained in Reg. §1.199A-1(b)(14) (which was 1(b)(13) in the Proposed Regulations) has been modified to provide that the property must be rented to a trade or business conducted by an individual or a commonly controlled RPE, thereby preventing a lease to a commonly controlled C corporation from being eligible for the rule (which was an open question under the Proposed Regulations).

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