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Rental Real Estate and §199A

Planning Opportunities in Revenue Procedure 2019-38

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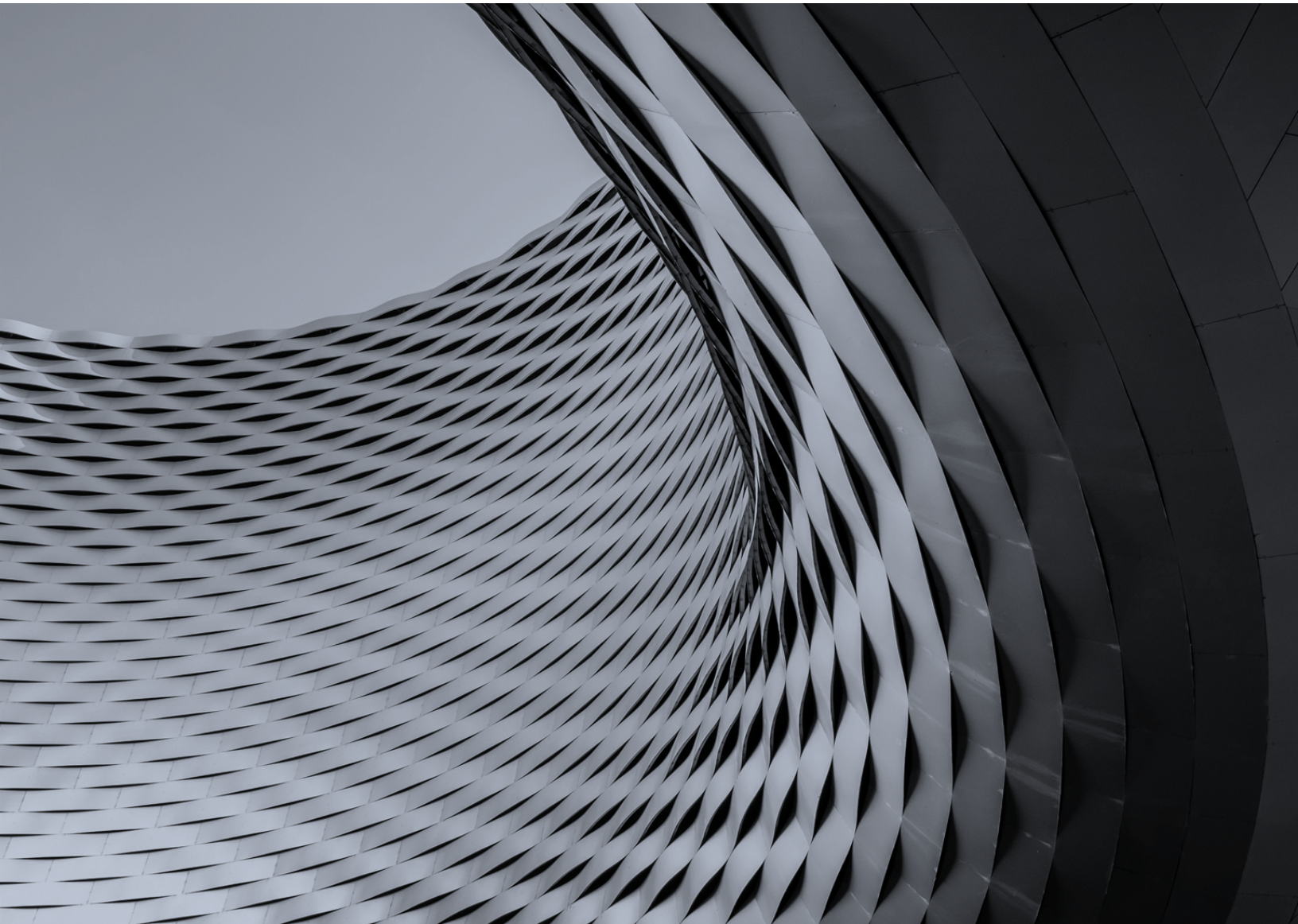
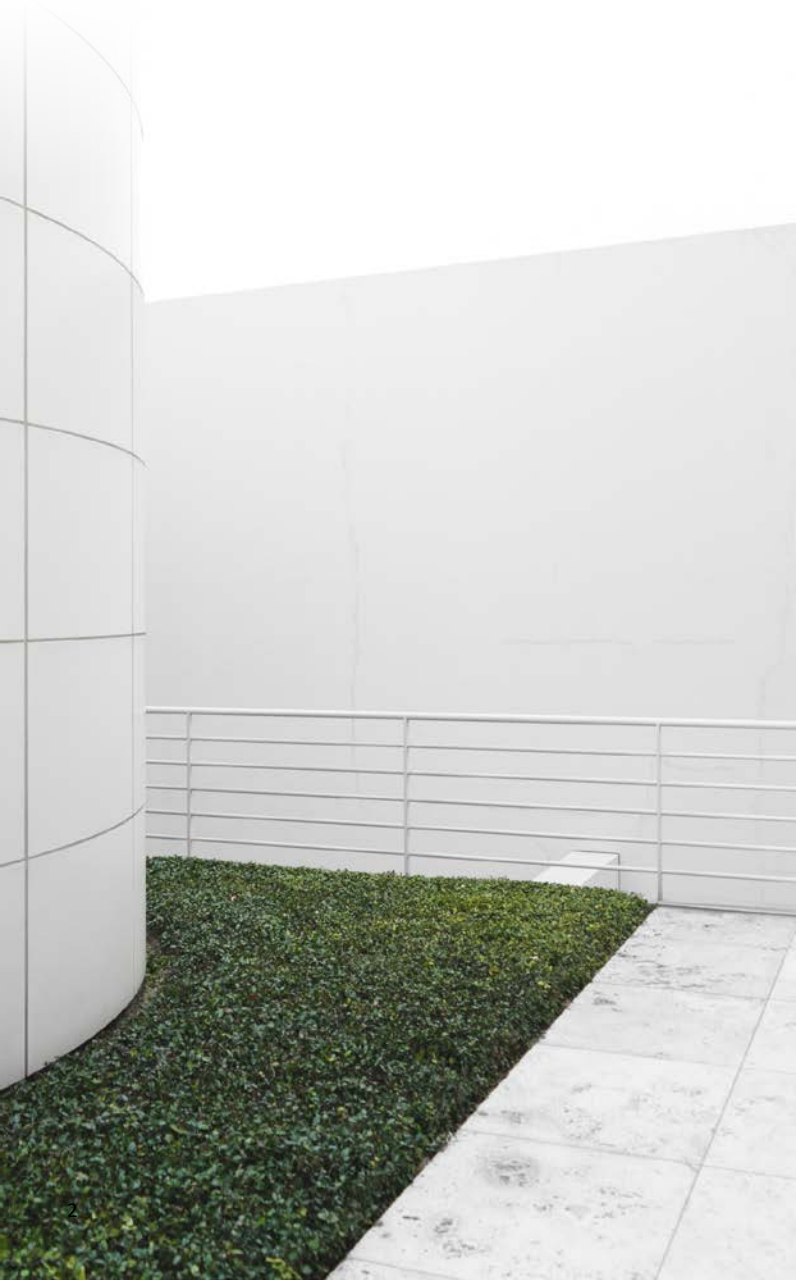


Purpose

To provide actionable opportunities for Advisors and Clients on the newly finalized (September 24, 2019) safe harbor guidance regarding rental real estate activity under Section 199A.



Introduction

The Tax Cuts & Jobs Act of 2017 (TCJA) brought about significant change to the U.S. income tax regime, particularly in the reduction of federal corporate tax rates from thirty-five percent to twenty-one percent. To equalize the effect of this significant reduction in corporate tax rates, Congress also enacted Internal Revenue Code Section 199A, providing up to a twenty percent exclusion of qualified business income to non-corporate taxpayers. To qualify for the Section 199A deduction, taxpayers must operate a "qualified trade or business." The definition of a "qualified trade or business" has caused undo confusion for taxpayers, particularly as it pertains to owners and operators of rental real estate. To clear some of this confusion, In September of 2019, the IRS issued Revenue Procedure 2019-38.

2

The Safe Harbor

In essence, Revenue Procedure 2019-38 provides a safe harbor for taxpayers with rental real estate activities. If the safe harbor rules are met, the taxpayer's rental activities will be treated as a qualified trade or business for Section 199A. The safe harbor requirements are as follows:

1. Rental activities must qualify as a "Rental Real Estate Enterprise." This is defined as "an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties….(taxpayer) must hold each interest directly or through an entity disregarded as an entity separate from its owner." The critical point in this first requirement is that the interest(s) must be held directly by the taxpayer or through an entity disregarded for tax purposes (eg. single-member LLC). Additionally, commercial and residential properties may not be combined into the same enterprise. Taxpayers may treat all rental properties as a single enterprise or each property as a separate enterprise. If a taxpayer elects to treat all of their properties as a single enterprise under the safe harbor, the taxpayer must continue to treat all enterprises, even ones that will be purchased in the future, in that same manner. The safe harbor does allow for an interest in a mixed-use property to be treated as two separate enterprises: one commercial and one residential. Generally, the provisions in the revenue procedure allow taxpayers some flexibility in ensuring that the first requirement of the safe harbor requirements is met.
2. Each enterprise must keep separate books and records to reflect income and expenses accurately. Taxpayers are allowed to consolidate separate accounting for each property together.
3. Hour requirement must be met. The IRS requires 250 hours of rental services to be performed for each enterprise that is less than four years old. Generally, if the taxpayer has separate enterprises for commercial and residential, the 250-hour requirement will have to be met for each enterprise. However, not all of these hours have to be performed by the taxpayer. To meet the 250-hour test, the taxpayer can also include hours spent by employees, agents, or independent contractors in meeting this threshold. If an enterprise has been in existence for more than four years, taxpayers must satisfy this 250 rental service hour requirement in only three of the last five years. The taxpayer must maintain time reports, logs, or documents including the date the services were performed, who performed the services, the hours of service performed, the amount paid for these services (if independent contractors), and a description of the services performed. For the reasons outlined above, the taxpayer's decision on how to treat their "enterprise" is critical. If taxpayers only have one enterprise, this next requirement will be easier to meet. If taxpayers have both commercial & residential properties and thus, have separate enterprises, the next requirement will be more challenging. It is worth noting, the IRS has specifically excluded the following activities from qualifying for the 250 rental service hour requirement: hours spent travelling to and from properties, and hours spent working on capital improvements. Generally, hours spent on "normal" activities such as advertising, negotiating leases, rent collection, maintenance, and management will qualify for the 250-hour threshold.

Specific Exclusions

There are a few types of property and activities that are specifically excluded from being eligible for Section 199A and would disqualify an enterprise from being eligible for the safe harbor.

- Real estate used personally. This provision is inclusive of the rules provided in IRC 280A which exclude the taxpayer from even using the property in question as an office or vacation home.

- Rental property subject to a triple net lease. Triple net leases are common in commercial real estate and require the tenant to pay for their pro-rata share of property taxes, insurance, utilities, and maintenance to the property. Commercial rentals subject to a triple net lease will exclude the property from being an eligible enterprise and thus, could exclude the taxpayer for qualifying for the 199A deduction.
- Real estate rented to a business conducted by a taxpayer which is under common control. An example would be a taxpayer who personally owns a building and leases it to his or her business. The final exclusion is very tedious but would apply if any portion of the interest is treated as a Specified Service Trade or Business which is a disqualified business activity for Section 199A.

Planning Opportunities

While the rules around 199A are complex and subject to many other limitations, including income thresholds, not discussed in this article, Revenue Procedure 2019-38 clarified most of the major questions for rental property owners and allows taxpayers to begin carefully planning their path to eligibility under 199A. While planning, taxpayers should keep the following items in mind:

- Segregate business activities between commercial and residential rental properties to ensure that the enterprise requirement is met.
- Create a log of all hours spent on each enterprise.
- Analyze the benefits of a triple net lease in comparison to the potential 199A deduction.
- Weigh the value of using a personal rental home (including a vacation home) for any part of the year (which would disqualify the taxpayer for the 199A deduction) compared to renting somewhere else.