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Is Your Rental a Business? IRS Proposed Revenue Procedure Providing Safe Harbor Election for Rental Real Estate Enterprises

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On January 18, 2019, the IRS issued notice 2019-07 outlining a proposed revenue procedure, whose purpose was to address the uncertainty over whether a rental real estate enterprise is a “trade or business” under Section 199A of the Internal Revenue Code. To mitigate this uncertainty, the proposed revenue procedure provides for a safe harbor election under which a rental real estate enterprise will be treated as a “trade or business” solely for purposes of the Section 199A qualified business income deduction.

Article By Davis Kuelthau
Mark G. KmiecikPublications: Real Estate

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To qualify for treatment as a “trade or business” under this safe harbor election, the rental real estate enterprise must satisfy the requirements set forth in the proposed revenue procedure. If a rental real estate enterprise fails to satisfy these requirements, however, the rental real estate enterprise may still be treated as a “trade or business” for purposes of Section 199A if the rental real estate enterprise otherwise meets the definition of “trade or business” under Treas. Reg. §1.199A-1(b)(14). This would be the case for a rental real estate enterprise with property subject to a triple net lease, for example, because the proposed revenue procedure expressly disqualifies rental real estate enterprises with property subject to a triple net lease from making the safe harbor election.

Facts

On January 18, 2019, the IRS issued notice 2019-07. The notice contains a proposed revenue procedure that provides a safe harbor election under which rental real estate enterprises will be treated as a “trade or business” solely for purposes of Section 199A.

The issue addressed in this notice is whether a set of real estate investments rises to the level of a “trade or business” and by allowing trade or business aggregation the entire issue is overcome. To aggregate for purposes of the “trade or business” rule, the taxpayer must do the following:

1. Maintain separate books or records to reflect income and expenses for each rental real estate enterprise;
2. Engage in 250 or more hours of rental services per year with respect to the rental real estate enterprise; and
3. Maintain contemporaneous records, including time reports, logs, or similar documents, of the rental services performed.

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

For purposes of this revenue procedure, 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. If a property is subject to a triple net lease, the rental real estate enterprise is not

eligible to make the safe harbor election. That disqualification, however, does not mean that any rental real estate enterprise with property that is subject to a triple net lease cannot qualify as a "trade or business" under Section 199A. It only means that a rental real estate enterprise with property that is subject to a triple net lease is not eligible to make the safe harbor election under this proposed revenue procedure.

Conclusion

Instead of supplying taxpayers with a clear definition of a "trade or business" for purposes of the Section 199A deduction, the IRS addressed taxpayers' uncertainty as to whether a rental real estate enterprise is a "trade or business" by issuing a proposed revenue procedure providing for a safe harbor election to be treated as a "trade or business" under Section 199A. If a rental real estate enterprise doesn't meet the requirements under the proposed revenue procedure, it may still be treated as a "trade or business" for purposes of Section 199A if the rental real estate enterprise otherwise meets the definition of "trade or business" under Treas. Reg. § 1.199A-1(b)(14).

Treas. Reg. § 1.199A-1(b)(14) defines a "trade or business" as a "trade or business" as defined under Section 162. Unfortunately, Section 162 does not provide a clear definition in that it only states that expenses can be deducted when they are incurred for a legitimate and active trade or business. Hence, the proposed revenue procedure and the final regulations for Section 199A leave open the question: who actually qualifies for the Section 199A deduction and where do real estate investors fall?

The conservative approach might be to take the position that in order to be classified as a "trade or business" under Section 199A, a rental real estate enterprise must show that it is regularly and continuously involved with the subject property. This answer, however, would disqualify rental real estate enterprises with property subject to a triple net lease for the Section 199A deduction. However, this approach is not fatal for the rental real estate enterprise in that if it can show it is more active than a normal lessor with respect to a triple net lease, then it may be able to take the Section 199A deduction.