IRS Issues Safe Harbor for Application of Section 199A Deduction to Rental Activities

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On September 24, 2019, the IRS issued much-needed guidance clarifying whether owners of rental real property may qualify for the 20 percent qualified business income deduction under Section 199A of the Code. The guidance, set forth in Revenue Procedure 2019-38, provides a safe harbor for real estate owners who meet certain requirements, particularly with respect to the amount of "real estate" services spent in the real estate business each year, and recordkeeping with respect to those services.

Background

Section 199A, enacted as part of the Tax Cuts and Jobs Act of 2017, provides a deduction to non-corporate taxpayers of up to 20 percent of the taxpayer's "qualified business income" generated from the taxpayer's qualified trades or businesses. Section 199A and the related regulations provide that rental activity is treated as a qualified trade or business (and thus generally eligible for the deduction), if it is an active business under Section 162 of the Code. Whether a rental business is active under Section 162, however, requires a facts-and-circumstances analysis based on several factors, including (i) the type and number of rented properties, (ii) the taxpayer's day-to-day involvement in the real estate business, (iii) the types and significance of any ancillary services provided under the lease, and (iv) the terms of the lease arrangement (i.e, whether a net lease versus a traditional lease, and whether short-term or long-term). Despite numerous comments to the proposed Section 199A regulations requesting more certainty in applying Section 199A to rental activity, the IRS declined to do so in the Final Regulations.

Safe Harbor under Rev. Proc. 2019-38

The IRS has now provided that certainty in the form of a revenue procedure. Rev. Proc. 2019-38 provides a safe harbor for taxpayers to claim the Section 199A deduction with respect a "rental real estate enterprise" ("RREE"), 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." The safe harbor also applies to a trade or business conducted by an individual or relevant passthrough entity ("RPE") to which a taxpayer rents property and which is commonly controlled by the taxpayer.

Taxpayers may choose to treat each rental property it owns as a separate enterprise, or may combine multiple similar properties into a single enterprise. Properties are considered similar if they are of the same class (i.e., residential or commercial). Mixed-use property may be treated as one enterprise or bifurcated into multiple enterprises. Each RREE is treated as a separate trade or business under Section 199A.

Each RREE will be treated as satisfying the safe harbor if it meets the following requirements:

- The taxpayer maintains separate books and records for each RREE;
- For RREE's that have been in existence less than four year, the taxpayer, or its employees, agents, or independent contractors perform 250 or more hours of rental services each year;
- For RREE's that have been in existence for more than four years, the 250 hour test may be met in any three of the last five taxable years;
- The taxpayer maintains time logs or similar documents regarding the hours of all services performed, a description of the services, dates on which the services were performed, and who performed the services.
- The taxpayer attaches a statement to its tax return for any year it relies on the safe harbor, providing a description of the real properties, a description of any properties acquired or disposed of during the taxable year, and a representation that the requirements of the Revenue Procedure have been satisfied.

"Rental services" include, but are not limited to:

- 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 property, including the purchase of materials and supplies;
- management of the real estate; and
- supervision of employees and independent contractors.

Rental services may be performed by owners, including owners of an RPE, 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; improving property; or hours spent traveling to and from the real estate.

The safe harbor clarifies that property rented under a triple net lease is not eligible for the deduction under the safe harbor. A triple net lease is defined as a lease agreement that requires the tenant or lessee to pay taxes, fees and insurance, and to pay for maintenance activities for a property in addition to rent and utilities. The safe harbor also excludes the following types of real property:

- real estate used by the taxpayer as a residence;
- real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled;
- property rented or leased to certain service businesses as discussed in Secion 199A-5(c)(2) of the regulations.

The safe harbor is effective for all tax years beginning after December 31, 2017; however, the contemporaneous records requirement will not be applicable to taxable years beginning prior to January 1, 2020. The determination of whether to use the safe harbor is made annually.