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CCM ALERT

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IRS Releases 199A Final Regulations, including Safe Harbor for Rental Real Estate

On January 18, 2019, the IRS released final regulations (the "Final Regulations") addressing Section 199A, a key and devilishly complicated component of the 2017 Tax Cut and Jobs Act (the "TCJA").

The IRS has released final Section 199A Regulations, including a Notice containing a proposed Revenue Procedure that provides a safe harbor for rental real estate to qualify as a "trade or business" for Section 199A.

Section 199A was intended to confer tax benefits upon owners of "pass through" entities, that is entities operated through a partnership (including multi-member LLC's taxed as partnerships), Subchapter S corporation, or sole proprietorships. Proponents of Section 199A asserted that if the corporate tax rate was to be reduced to 21%, then the TCJA should also benefit owners of pass through entities. Section 199A was a late addition to the TCJA, and not surprisingly generated considerable comments and confusion, including the extensive comments from the tax community available here www.regulations.gov.

The Final Regulations responded to the pleas for clarity by specifically addressing rental real estate and providing a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of Section 199A if the taxpayer meets the safe harbor requirements The safe harbor requirements are set in a proposed revenue procedure contained in IRS Revenue Notice 2019-07 (the "Notice"), which the IRS issued in tandem with the Final Regulations. The Notice also states that if the rental real estate enterprise fails to satisfy the requirements of the safe harbor, it may still be treated as a trade or business if it meets the definition of trade or business in Section 1.199A-1(b)(14) of the Final Regulations. This brief will review the rental real estate safe harbor requirements contained in the Notice.

What is a Rental Real Estate Enterprise?

The Notice defines a rental real estate enterprise as an interest in real property held for the production of rents and may consist of an interest in multiple properties. The individual or RPE relying on this revenue procedure must hold the interest directly or through an entity disregarded as an entity separate from its owner under the check the box regulations. Generally, taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents as a single enterprise. Commercial and residential real estate cannot be part of the same enterprise.

The Safe Harbor Requirements

A rental real estate enterprise will be treated as a trade or business for purposes of Section 199A if the following requirements are met:

(a) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise.

(b) For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise.

(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. The Notice also mandates that these records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement does not apply for 2018.

What are Rental Services?

The Notice describes rental services to include:

- 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;
- management of the real estate;
- purchase of materials; and
- supervision of employees and independent contractors.

The Notice also provides that the rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.

What are Excluded from Rental Services?

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.

Arrangements that Will not Satisfy the Safe Harbor

The following arrangements will not qualify for the safe harbor:

- Real estate used by the taxpayer as a residence for any part of the year under section 280A.
- Real estate rented or leased under a triple net lease.

How does the Revenue Procedure describe a Triple net Lease?

The Notice describes a triple net lease to include 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. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

Procedural Requirements to Avail of the Safe Harbor

The taxpayer must include a statement attached to the return on which it either claims the Section 199A deduction or is passing through the 199A deduction that the safe harbor requirements have been satisfied.

The statement 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." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the statement.

Concluding Thoughts

The Notice invites comments on the proposed Revenue Procedure for a period of 60 days following publication. We anticipate there will be significant comments, particularly now that the IRS has provided a bright line of 250 hours for rental services. Comments will likely focus on at least two areas:

- Expanding the definition of rental services and perhaps including certain of the activities that the IRS has specifically excluded from the definition, such as reviewing financial statements or reports on operations.
- Including triple net lease arrangement as qualifying for the safe harbor, or further clarifying those arrangements that constitutes a "triple net lease." It is interesting that Section 199A permits the deduction of up to 20% of REIT dividends and qualified publicly traded partnership income, but disqualifies triple net lease income. Like many other aspects of 199A arbitrary distinctions and categories do not appear to have any logical foundation.

Ultimately, commercial landlords (at least those that are not owned by REITs) must assess whether the 199A tax benefit is worth the disruption of changing from a triple net to gross lease regime.

If you have any questions about the matters addressed in this *CCM Alert*, please contact the following CCM author or your regular CCM contact.

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