
FOR
RENT

DEMYSTIFYING §199A and Rental Activities

I READ GIL CHARNEY'S ANALYSIS OF THE APPLICATION OF §199A to a rental activity in the September/October 2019 edition of *EA Journal* ("Your Questions Answered," pp. 12-13) and I do not agree with it. In that case, I believe the taxpayer clearly qualifies to take the §199A deduction on the rental income. Since there has been much practitioner confusion about when a rental activity qualifies for the §199A deduction, this topic deserves additional explanation and discussion.

Big Picture

Under the final §199A regulations, a rental activity qualifies for the §199A deduction in one of three ways:

- It is a §162 trade or business.[i]
- A commonly controlled trade or business is the lessee.[ii]
- It meets the safe harbor requirements.[iii]

§162 Trade or Business

Under Supreme Court precedent, for an activity to be a trade or business activity, "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify."[iv]

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There is no black-and-white test for whether an activity rises to the level of a §162 trade or business – it is dependent on the facts and circumstances of that taxpayer's particular situation.[v]

In a 2001 Service Center Advice (SCA), the IRS opined that most rental activities qualify as §162 trade or business activities: "...Where it is clear from the facts that real estate is devoted to rental purposes, the courts have repeatedly held that such use constitutes use of property in a trade or business, regardless of whether or not it is the only property so used..."[vi] The SCA cites numerous United States Tax Court cases over the last 70 years to support that statement.[vii]

In *Hazard*, a case from the 1940s, the Tax Court determined that the rental of a single residential rental property rose to the level of a trade or business, even though the court record had no information regarding the activity level of the owner.

The IRS acquiesced to the *Hazard* decision and has not changed that position; a General Counsel Memorandum stated the IRS view on *Hazard* and the amount of activity required for a rental to rise to the level of a trade or business: "The problem that you raise is not with the legal standard applied by the courts, but with the relatively small amount of activity that the courts have found to be indicative of a trade or business. In view of the number of cases that have been decided on this issue, only some of which have been cited above, it is unlikely that the Service could now persuade the courts to take a more restrictive approach with respect to the amount of activity required to find that a taxpayer's rental activity constituted a trade or business."[viii]

The preamble to the final §199A regulations provides factors to consider when determining if a rental activity rises to a §162 trade or business:[ix]

- Type of rented property (commercial real property versus residential property).
- Number of properties rented.
- Owner's or the owner's agent's day-to-day involvement.
- Types and significance of any ancillary services provided under the lease.
- Terms of the lease (a net lease versus a traditional lease, and a short-term lease versus a long-term lease).

In general, a single triple net lease has insufficient owner involvement for the activity to rise to the level of a §162 trade or business.[x] However, it is possible that the rental of a triple net lease property in conjunction with other rental activities could cause all of the rental activities to collectively rise to the level of a §162 trade or business.[xi]

Whether or not a rental activity is passive under §469 is not relevant to the §162 trade or business determination.[xii] A rental activity can be both a passive activity and a §162 trade or business.

Commonly Controlled Trade or Business

A rental activity can fail to be a §162 trade or business and yet qualify for the §199A deduction if the taxpayer rents the property to a commonly controlled trade or business. This is an exception to the general rule in the §199A final regulations.

Common control exists when the same person or group of persons, directly or by attribution under §267(b) or §707(b), owns 50 percent or more of both the rental activity and the trade or business.[xiii] An individual or pass-through entity must conduct the trade or business; a C corporation is ineligible for this provision.[xiv]

If a rental activity qualifies for the §199A deduction under this provision, and the commonly controlled business is a specified service trade or business (SSTB), then that portion of the rental property being rented to the 50 percent or more commonly-owned SSTB is treated as a separate SSTB with respect to the related parties.[iv]

Safe Harbor

In September 2019, the IRS issued the final rental safe harbor, which applies to tax years ending after December 31, 2017. Taxpayers can still rely on the proposed rental safe harbor in Notice 2019-07 for the 2018 taxable year.[xvi]

The purpose of the safe harbor is to assist taxpayers in determining whether or not rental activities are a trade or business for purposes of the §199A deduction. Use of the safe harbor is completely optional and failure to meet the safe harbor requirements does not indicate that the rental activity does not meet the §162 trade or business standard.[xvii] Use of the safe harbor is an annual determination.[xviii]

To use the safe harbor, an individual or pass-through entity arranges its rental activities into one or more rental real estate enterprises. If the enterprise meets the safe harbor requirements, then taxpayer treats each enterprise as a single trade or business that qualifies for the §199A deduction. Since the enterprise is a single trade or business for §199A purposes, the taxpayer would add together the qualified business income (QBI), wages, and unadjusted basis in assets (UBIA) for each rental activity and do one §199A calculation for the enterprise.

The enterprise is only relevant for purposes of the safe harbor; it is separate from the §469 grouping election or aggregation under Treas. Reg. §1.199A-4. However, since the safe harbor treats the rental activities in an enterprise as a single trade or business for §199A purposes, aggregation is unnecessary for those rental activities since the single trade or business treatment has the same effect.

A taxpayer may either treat each rental activity as its own enterprise or put all commercial rental activities into one enterprise and all residential rental activities into another enterprise. A taxpayer can treat a mixed-use rental activity as either one enterprise or bifurcate it into separate residential and commercial interests. The taxpayer cannot place

multiple mixed-use rental activities into one enterprise.[xix]

Once a taxpayer arranges multiple rental activities into a single enterprise, the taxpayer must continue to treat all similar rental activities as a single enterprise as long as the taxpayer continues to rely on the safe harbor. If a taxpayer chooses to treat each rental activity as its own enterprise, then the taxpayer may choose in a later tax year to combine multiple rental activities into one enterprise, as allowed.[xx]

The following rental activities are ineligible for the safe harbor and a taxpayer cannot place them into an enterprise:[xxi]

- Real estate used by the taxpayer as a residence under §280A(d).
- Real estate leased under a triple net lease, with a triple net lease 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.
- Real estate where a commonly controlled trade or business conducted by an individual or pass-through entity is the lessee.
- The entire real estate interest if any portion of it is treated as a SSTB.

To qualify for the §199A deduction under the safe harbor, a rental real estate enterprise must meet three requirements:[xxii]

1. At least 250 hours of rental services performed with respect to the enterprise per year by owners, employees, contractors, or agents. Enterprises in existence for at least four years only need to meet the 250-hour requirement in any three of the five consecutive taxable years that end with the taxable year.
2. Contemporaneous records to document hours of all services performed, descriptions of all services performed, dates of services performed, and who performed the services. If employees or contractors perform the services, then the taxpayer should retain a description of the rental services performed by such employee or independent contractor, the amount of time each employee or independent contractor generally spends performing such services, and time, wage, or payment records for such employee or independent contractor.
3. Separate books and records to reflect income and expenses. If a rental real estate enterprise contains more than one property, then the taxpayer meets this requirement if he or she maintains income and expense information statements for each property and then consolidates them.

Rental services that qualify for the 250-hour requirement 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.[xxiii]

Activities that do not qualify as rental services for the 250-hour requirement include financial or investment management activities, such as arranging financing or procuring property; studying and reviewing financial statements or reports on operations; improving property per Treas. Reg. §1.263(a)-3(d); and hours spent traveling to and from the real estate.[xxiv]

It is important to note that the contemporaneous records requirement does not apply for tax years beginning before January 1, 2020.[xxv] However, taxpayers will need to provide information to substantiate their qualifying for the §199A deduction, contemporaneous or not.

To use the safe harbor, the individual or pass-through entity must attach a statement to a timely filed tax return (amended tax returns for tax year 2018 only). The taxpayer can list multiple enterprises in one statement. The statement must include descriptions (including address and rental category) of all properties in each enterprise, descriptions (including address and rental category) of all properties acquired and disposed of during the tax year, and a representation that the taxpayer satisfied Rev. Proc. 2019-38.[xxvi]

While the safe harbor provides additional certainty to individuals and entities whose rental activities clearly meet the §162 trade or business standard, it does not help taxpayers with limited rental activities who could have most benefitted from a safe harbor.

Example

In the question in the original article, the taxpayer owned multiple rental properties, which she directly managed herself. She estimated 300 hours of activity per year with respect to the rental activities, and those hours included tasks such as managing maintenance, collecting rent, advertising, and showing units. She did not track her time in a log.

Assuming the properties are all residential rentals, and that the claimed 300 hours are "rental services" as defined in the safe harbor, she qualifies for the §199A deduction using the safe harbor. For tax year 2018, the safe harbor time documentation requirement does not apply. Therefore, as long as the taxpayer

is willing to certify that she met the hours requirement in 2018, and met all other requirements, she can use the safe harbor. For tax year 2019 and forward, the taxpayer should start maintaining a contemporaneous log of the hours spent by both her and her contractors if she wishes to use the safe harbor in future tax years.

The taxpayer's rentals also meet the §162 trade or business test. She spends approximately 25 hours per month managing multiple rental activities, and those activities generate one-third of her total income for the year. She has regular and continuous involvement with the rentals and clearly has an intent to make income or profit (and actually does!).

The original article claimed that "a taxpayer can treat rental activity as a trade or business for purposes of the QBI deduction based on the same facts-and-circumstances test IRS uses for the hobby-loss rules," then claims the lack of a time log and other documentation for the safe harbor suggests she does not have sufficient documentation to show the rental activities rise to the level of a trade or business.

While the §183 regulations are instructive when discerning an intent to make a profit in an activity, they are by no means controlling for the overall §162 trade or business determination –in fact, neither the final §199A regulations nor the preamble to those regulations reference §183. The lack of a log documenting one's time spent hardly indicates it was not carried on in a business-like manner, as there was no need to even consider keeping a time log until the safe harbor made it material to the §199A deduction determination.

Setting aside the fact that the taxpayer in this case clearly made a profit each year, as the rentals are a significant portion of her annual income, seven of the nine factors in the §183 regulations clearly favor her rental activities are engaged in for profit: time and effort expended; expectation of asset appreciation; success of the taxpayer in carrying on similar activities; history of income or loss; amount of profits, if any; financial status of the taxpayer; and no elements of personal pleasure or recreation.

In fact, it is not a common situation for a rental activity to not be engaged in for profit. Taxpayers generally do not buy and manage rental properties for personal pleasure or recreation. Most owners have either positive cash flow or plan to hold the asset for appreciation while the renter pays the carrying costs — or both.

Summary

Most rental activities will qualify for the §199A deduction as §162 trade or business activities as existing case law sets a relatively low bar as to the level of involvement required.

Practitioners have an ethical duty to consistently apply the law regardless of whether the rental activity generates positive qualified business income (possibly generating a §199A deduction) or negative qualified business income (possibly reducing current or future §199A deductions).

[i] *Treas. Reg. §1.199A-1(b)(14).*

[ii] *Treas. Reg. §1.199A-1(b)(14).*

[iii] *Rev. Proc. 2019-38.*

[iv] *Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987).*

[v] *Higgins v. Commissioner, 312 U.S. 212, 217 (1941).*

[vi] *Service Center Advice 200120037, at 2-3.*

[vii] *Curphey v. Commissioner, 73 T.C. 766 (1980); Fegan v. Commissioner, 71 T.C. 791, 814 (1979); Elek v. Commissioner, 30 T.C. 731 (1968); O'Madigan v. Commissioner, 19 T.C.M. 1178 (1960); Lagreide v. Commissioner, 23 T.C. 508 (1954); Hazard v. Commissioner, 7 T.C. 372 (1946).*

[viii] *General Counsel Memorandum 38779.*

[ix] *TD 9847, Federal Register, Vol. 84, No. 27, p.2955.*

[x] *Neill v. Commissioner, 46 B.T.A. 197, 198 (1942); Herbert v. Commissioner, 30 T.C. 26*

(1958); Rev. Rul. 73-522.

[xi] *Lewenhaupt v. Commissioner, 20 T.C. 151 (1953); CRSO v. Commissioner, 128 T.C. 153 (2007).*

[xii] *TD 9847, Federal Register, Vol. 84, No. 27, p.2955.*

[xiii] *Treas. Reg. §1.199A-4(b)(1)(i).*

[xiv] *Treas. Reg. §1.199A-1(b)(14).*

[xv] *Treas. Reg. §1.199A-5(c)(2)(i).*

[xvi] *Rev. Proc. 2019-38, Section 4.*

[xvii] *Rev. Proc. 2019-38, Section 1.*

[xviii] *Rev. Proc. 2019-38, Section 1.*

[xix] *Rev. Proc. 2019-38, Section 3.02.*

[xx] *Rev. Proc. 2019-38, Section 3.02.*

[xxi] *Rev. Proc. 2019-38, Section 3.05.*

[xxii] *Rev. Proc. 2019-38, Section 3.03.*

[xxiii] *Rev. Proc. 2019-38, Section 3.04.*

[xxiv] *Rev. Proc. 2019-38, Section 3.04.*

[xxv] *Rev. Proc. 2019-38, Section 4.*

[xxvi] *Rev. Proc. 2019-38, Section 3.03(D).*

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FOR YOUR REVIEW

1. To qualify for the §199A deduction under Rev. Proc. 2019-38, how many hours of rental services are required each year with respect to a rental real estate enterprise?
   A. 250 B. 500
   C. 750 D. 1000

2. Which of the following is NOT a factor to consider when determining if a rental activity rises to the level of a §162 trade or business?
   A. Lease terms
   B. Location of property
   C. Number of properties rented
   D. Services provided under lease

**See page 54 for the answers.*