davis & hodgdon
ADVISORY GROUP

www.dh-cpa.com
Williston: 802.878.1963
Rutland: 802.775.7132

Safe Harbor for Rental Real Estate

On January 18th, 2019 the IRS released final Section 199A regulations for the 20 percent pass-through deduction enacted under the Tax Cuts and Jobs Act (TCJA). For taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026, non-corporate taxpayers (individuals, trusts and estates) may take a deduction of up to 20 percent of qualified business income (QBI) from partnerships, S corporations and sole proprietorships that are considered a trade or business. As part of the regulations, the IRS also provided a safe harbor for rental real estate to be treated as a trade or business solely for purposes of Section 199A. As noted above, the significance of meeting the criteria of a trade or business is that it allows the individual to take a 20% deduction of the business income in determining their taxable income.

Eligibility Requirements

Under the safe harbor, a "rental real estate enterprise" (defined below) will be treated as a trade or business for Section 199A purposes if it meets the following requirements:

1. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
2. 250 or more hours of rental services (examples below) are performed per year for tax years beginning before Jan. 1, 2023, ***and***
3. Starting in 2019, *contemporaneous* records are maintained, including time reports, logs or similar documents regarding hours of all services performed, a description of all services performed, dates on which the services were performed and who performed the services.

A "rental real estate enterprise" is defined as an interest in real property held to produce rents *and may consist of an interest in multiple properties.* The individual or relevant pass-through entity must hold the interest directly or through a disregarded entity.

Taxpayers can treat each rental real estate property as a stand-alone enterprise or group together similar properties and treat each group as an enterprise. Commercial and residential real estate may not be a part of the same rental real estate enterprise. Taxpayers must be consistent with this treatment in the future unless there is a significant change in facts and circumstances.

Rental services that count toward the 250 hour requirement may be performed by the owners, as well as by their employees, agents or independent contractors. Rental services include:

- Advertising to rent or lease the real estate;
- Negotiating and executing leases;
- Verifying information contained in prospective tenant applications;
- Collecting rent;
- Daily operation, maintenance and repair of the property;
- Managing the real estate;
- Bookkeeping and tax return preparation;
- Purchasing materials; and
- Supervising employees and independent contractors.

Treating rental properties as a trade or business may also require filing Form 1099 to report the rental expenses paid to third parties.

Qualifying rental services that do not count toward the 250 hour safe harbor requirement include financial or investment management activities such as arranging financing, procuring property, reviewing financial statements or operations reports, planning, managing or constructing long-term capital improvements or *travel to and from the real estate properties.* (Don't ask, we don't get it either.)

Real Estate Rented or Leased Under a Triple Net Lease is Not Eligible for the Safe Harbor.

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. Also ineligible for the safe harbor is a property leased under an agreement that requires the tenant or lessee to pay ***a portion*** of the taxes, fees, and insurance, and to be re-

Safe Harbor for Rental Real Estate

sponsible for maintenance activities allocable to the portion of the property rented by the tenant.

Further, real estate used by the taxpayer as a residence for any part of the year is not eligible for the safe harbor.

Disclosure requirement. In order to apply the safe harbor, a taxpayer must attach a signed statement to the tax return reporting the Section 199A deduction. (see below)

Key Takeaways.

1. The safe harbor is just that. If you meet the safe harbor rules you qualify for the 20% QBI deduction.
2. There is no requirement you must follow the safe harbor rules. You may still meet the trade or business test by providing a regular and continuous activity level, and this could even apply to triple net lease property.
3. Self-rental activities automatically qualify as QBI without regard to triple net leases.

For 2018 – and only for 2018 – you do not need to have maintained contemporaneous records; however, moving forward you will need to. Along those lines, you will now need to **request of anyone performing services on the property that they provide you with a detailed invoice that includes the time spent working on your property.**

As noted above, in order to take advantage of the safe harbor rules, you must meet the three tests (two for 2018) and attest to that fact by including a statement with your tax return (applied separately to each property or at your discretion for grouping properties of the same type: residential or commercial).

The Good and the Bad of the Safe Harbor.

The 199A deduction is 20% of a taxpayer's qualified business income from all of the taxpayer's trades or businesses, subject to certain limitations. Many rentals do not show a profit and a rental that is treated as a trade or business that shows a loss for the year will reduce the qualified business income of other trades or businesses of an individual, and as a result, reduces the 199A deduction of that individual.

Although we can't generalize how the safe harbor provisions should apply in each circumstance, there are some general guidelines we can provide. For starters, you will first need to determine whether you meet the criteria and if so you will have some additional decisions to make. On the other hand, if you do not meet the safe harbor or other trade or business criteria, there is no need to go further.

Assuming the safe harbor provisions are met and all similar properties show income, then there does not appear to be a downside to signing off as complying with the 199A safe harbor. In addition, if you do own multiple properties that all show income and you need to combine the various properties in order to meet the 250 our test, then it also makes sense to sign off as meeting the safe harbor as an enterprise.

On the other hand, if one or more of your properties reflects a loss, depending upon the size of the loss **you may not** want to include those properties as a part of the combined real estate enterprise. In those cases we will probably want to have an additional conversation as to what if any statements you want to include with your return.

For those of you that own some or all of your real estate in a partnership, please keep in mind that as long as the combined hours of the partners and anyone engaged to perform qualifying services for the partnership exceeds 250 hours, then the entity meets the criteria for trade or business pursuant to Section 199A.

There are a couple of comments we would like to emphasize here. First of all, this is an annual election which means should the circumstances change next year you have the option of either indicating that you did not meet the safe harbor or changing the properties that are included as a part of the enterprise. Secondly, in some cases you will not be able to make the determination until we have completed your return – at which time we should discuss your specific fact pattern.

Although it would appear that the safe harbor provisions are fairly taxpayer friendly and straightforward, each situation will be a little different. Please don't hesitate to reach out to us if you have any questions. If you do feel confident in signing off on how you would like to move forward for this year, we will provide a statement for you to use for this year's tax return.