

# Mann Report

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## How Was Real Estate Affected by the Tax Cuts and Jobs Act? Part 1

Edward J. Reitmeyer

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Edward J. Reitmeyer

*This is the first of a two-part series. The second part will be published in the April 2020 issue.*

The most common form of ownership of real estate is as a pass-through entity, typically a Limited Liability Company (LLC) or a Limited Partnership (LP). The Tax Cuts and Jobs Act (TCJA) created the widely discussed Internal Revenue Code Section 199A, Qualified Business Income Deduction.

For commercial real estate, the threshold to be able to receive the benefit of the 20% Qualified Business Income (QBI) deduction is that the activity must constitute a trade or business. The basic definition used for a trade or business under the proposed and final regulations is a trade or business under Internal Revenue Code section 162, other than performing services as an employee.

In most non-real estate circumstances, it will be clear whether the activity being considered is a trade or business (e.g. attorney's office, retail store or manufacturer). However, the issue is less certain when it comes to real estate rental activities. This was a significant issue raised at the hearing on the proposed regulations held in October 2018. The real estate industry requested a safe harbor as well as other guidance.

## **Safe Harbor**

The IRS issued a notice that proposes a safe harbor under which certain real estate enterprises will be treated as a trade or business under IRC section 199A. The service notes that failure to satisfy this safe harbor does not prevent the taxpayer from establishing, under other tax analysis, that the real estate activity constitutes a trade or business.

For purposes of the safe harbor, a “rental real estate enterprise” is defined as an interest in real property held for the production of rents. This may consist of an interest in multiple properties which can be aggregated for applying this safe harbor. However, the individual or entity relying on this safe harbor must hold the interest directly or through a disregarded entity. This means that properties held in different LLCs taxed as partnerships, or through separate S corporations, cannot be aggregated for this safe harbor rule. Additionally, commercial rental properties cannot be combined with residential properties.

The safe harbor permits treatment of the tested real estate (or combined real estate activities) as a trade or business where:

- Separate books and records are maintained to reflect the income and expenses of each rental real estate enterprise (or combined real estate enterprises),
- For tax years beginning before January 1, 2023, 250 or more hours of “rental services” are performed per year with respect to the rental real estate enterprise. For tax years beginning after December 31, 2022, 250 hours or more of “rental services” must be performed per year in any three of the five consecutive tax years ending in the current tax year. If the enterprise was held for less than five years, then this test is satisfied by 250 hours or more of “rental services” with respect to the rental real estate enterprise, and
- The taxpayer must maintain a contemporaneous record (including time reports, logs or similar documents), regarding: (i) hours of all services performed; (ii) description of the services performed; (iii) dates on which such services were performed and (iv) who performed the services. However, this contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.
- If a taxpayer is taking the position that a rental activity is a trade or business for section 199A purposes, there will be a requirement to file Form 1099 where applicable.

For purposes of the safe harbor, “rental services” exclude: financial or investment management activities (e.g. arranging financing, procuring property), studying or 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.

“Rental services” include: advertising to rent or lease the real estate, negotiating and executing leases, verifying information in prospective tenant applications, collection of rent, daily operations, maintenance and repair of property, management of the real estate, purchase of

materials and supervision of employees and independent contractors. The rental services can be performed by owners or by employees, agents and/or independent contractors.

The major problem with utilizing the safe harbor is that certain real estate operations are excluded:

- Property used as a residence for any part of the year under IRC sec 280A (e.g. more than 14 days for the year) is not eligible for the safe harbor.
- Real estate rented or leased under a “triple net lease” is excluded. This includes a lease agreement requiring the tenant or lessee to pay taxes, fees and insurance and to be responsible for the maintenance activities in addition to rent and utilities. It also 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. This would include many commercial real estate leases.

It is important to reiterate that although a “triple net lease” property is ineligible for the safe harbor, not having the safe harbor election does not bar the taxpayer from utilizing the benefit of the 199A deduction.

Anyone using the safe harbor is required to attach a statement to the return, subject to a penalty of perjury, that these requirements have been satisfied.

The final regulations maintain the special rule for commonly controlled entities, which provides that the rental of real estate to a commonly controlled entity (based on 50% or more common ownership) is automatically deemed to be a trade or business (so there is no reason to satisfy either the safe harbor or the section 162 standard). However, unlike the proposed regulations, the final regulations use attribution rules to determine constructive ownership. We’ll offer more insight next month.

*Edward J. Reitmeyer is Mid-Atlantic regional partner-in-charge of Tax and Business Services at Marcum LLP and chair of the Philadelphia Real Estate Services Group. He can be reached at [edward.reitmeyer@marcumllp.com](mailto:edward.reitmeyer@marcumllp.com).*