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IRS Treats Rental Real Estate qualified for IRC 199A

The Internal Revenue Service issued final regulations last year that provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for the purposes of Internal Revenue Code Section 199A, the qualified business income deduction.

Tax Cut and Jobs Act (TCJA) Created Trade or Business under IRC 199A

The Tax Cut and Jobs Act (TCJA) of 2017 created Internal Revenue Code Section (IRC) 199A to provide a deduction to non-corporate taxpayers of up to 20% of the taxpayer's qualified business income from each of the taxpayer's qualified trades or businesses including those operated through a partnership, S corporation, or sole proprietorship as well as a deduction of up to 20% of aggregate qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income.

Code Section 199A(d) defines a qualified trade or business as any trade or business other than a Specified Service Trade or Business (SSTB) or the trade or business of performing services as an employee.

Regulation 1.199A-1(b)(14) defines a trade or business as defined under IRC 162 other than the trade or business of performing services as an employee.

IRS issues final Revenue Procedure

The IRS finalized the safe harbor rules treating rental real estate as qualified for IRC 199A last year which opens the door for many real estate investors to take the additional 20% business deduction under that IRC section.

The general rules that now apply as safe harbor rules are available to taxpayers who seek to claim the deduction under Code Section 199A with respect to a rental real estate enterprise as defined under "Rental real estate enterprise".

If the safe harbor requirements are met the rental real estate enterprise will be treated as a single trade or business as defined in Code Section 199A(d) for purposes of applying the regulations under Code Section 199A including the application of the aggregation rules.

A Relevant Passthrough Entity (RPE) includes a partnership (other than a publicly traded partnership), or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust.

RPEs may also use this safe harbor rule.

In order to rely upon the safe harbor taxpayers and RPEs must satisfy all of the requirements of the revenue procedure.

Failure to satisfy the requirements of this safe harbor does not preclude a taxpayer or IRS from otherwise establishing that an interest in rental real estate is a trade or business.

The safe harbor provided by the revenue procedure applies solely for purposes of Code Sec. 199A.

Rental real estate enterprise

Solely 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 and may consist of an interest in a single property or interests in multiple properties.

The taxpayer or RPE relying on the Revenue Procedure must hold each interest directly or through an entity disregarded as an entity separate from its owner under any provision of the Internal Revenue Code.

Except for those property interests described under "Excluded real estate arrangements" taxpayers and RPEs may either treat each interest in similar property held for the production of rents as a separate rental real estate enterprise or treat interests in all similar properties held for the production of rents as a single rental real estate enterprise.

For purposes of applying the Revenue Procedure properties held for the production of rents are similar if they are part of the same rental real estate category.

The two types of rental real estate categories for the purpose of combining properties into a single rental real estate enterprise are residential and commercial. Thus commercial real estate held for the production of rents may only be part of the same enterprise with other commercial real estate, and residential properties may only be part of the same enterprise with other residential properties.

Once a taxpayer or RPE treats interests in similar commercial properties or similar residential properties as a single rental real estate enterprise under the safe harbor the taxpayer or RPE must continue to treat interests in all similar properties, including newly acquired properties as a single rental real estate enterprise when the taxpayer or RPE continues to rely on the safe harbor.

A taxpayer or RPE that chooses to treat its interest in each residential or commercial property as a separate rental real estate enterprise may choose to treat its interests in all similar commercial or all similar residential properties as a single rental real estate enterprise in a future year.

An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests.

For purposes of the Revenue Procedure mixed-use property is defined as a single building that combines residential and commercial units.

Each rental real estate enterprise that satisfies the requirements of the safe harbor rules is treated as a separate trade or business for purposes of applying these rules.

The Safe Harbor Defined

The determination to use this safe harbor must be made annually.

Solely for the purposes of IRC199A each rental real estate enterprise will be treated as a single trade or business if the following requirements are satisfied during the tax year with respect to the rental real estate enterprise:

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

If a rental real estate enterprise contains more than one property this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated;

2. For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (as described under "Rental services" below) per year with respect to the rental real estate enterprise.

For rental real estate enterprises that have been in existence for at least four years in any three of the five consecutive tax years that end with the tax year, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise; and

3. 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.

If services with respect to the rental real estate enterprise are performed by employees or independent contractors the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of IRS.

4. The taxpayer or RPE attaches a statement to a timely filed original return (or an amended return for the 2018 tax year only) for each tax year in which the taxpayer or RPE relies on the safe harbor.

An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement, but the statement must list the required information separately for each rental real estate enterprise. The statement must include the following information:

- A description (including the address and rental category) of rental real estate properties acquired and disposed of during the tax year; and
- A representation that the requirements of the Revenue Procedure have been satisfied.

Rental Services

Rental services for purpose of the Revenue Procedure include, but are not limited to:

- i. Advertising to rent or lease the real estate;
- ii. Negotiating and executing leases;
- iii. Verifying information contained in prospective tenant applications;
- iv. Collection of rents;
- v. Daily operation, maintenance, and repair of the property, including the purchase of materials and supplies;
- vi. Management of the real estate; and
- vii. 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.

Excluded Real Estate

The following types of property may not be included in a rental real estate enterprise and are therefore not eligible for the safe harbor:

- A. Real estate used by the taxpayer (including an owner or beneficiary of an RPE) as a residence under Code Sec. 280A(d).
- B. Real estate rented or leased under a triple net lease. For purposes of the Revenue Procedure, a triple net lease includes 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.
- C. Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled.
- D. The entire rental real estate interest if any portion of the interest is treated as an SSTB.

Effective date

The Revenue Procedure applies to tax years ending after December 31, 2017.

Alternatively, taxpayers and RPEs may rely on the safe harbor set forth in Notice 2019-7 for the 2018 tax year.

The contemporaneous records requirement will not apply to tax years beginning prior to January 1, 2020, however, IRS reminds taxpayers that they bear the burden of showing the right to any claimed deductions in all tax years.

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