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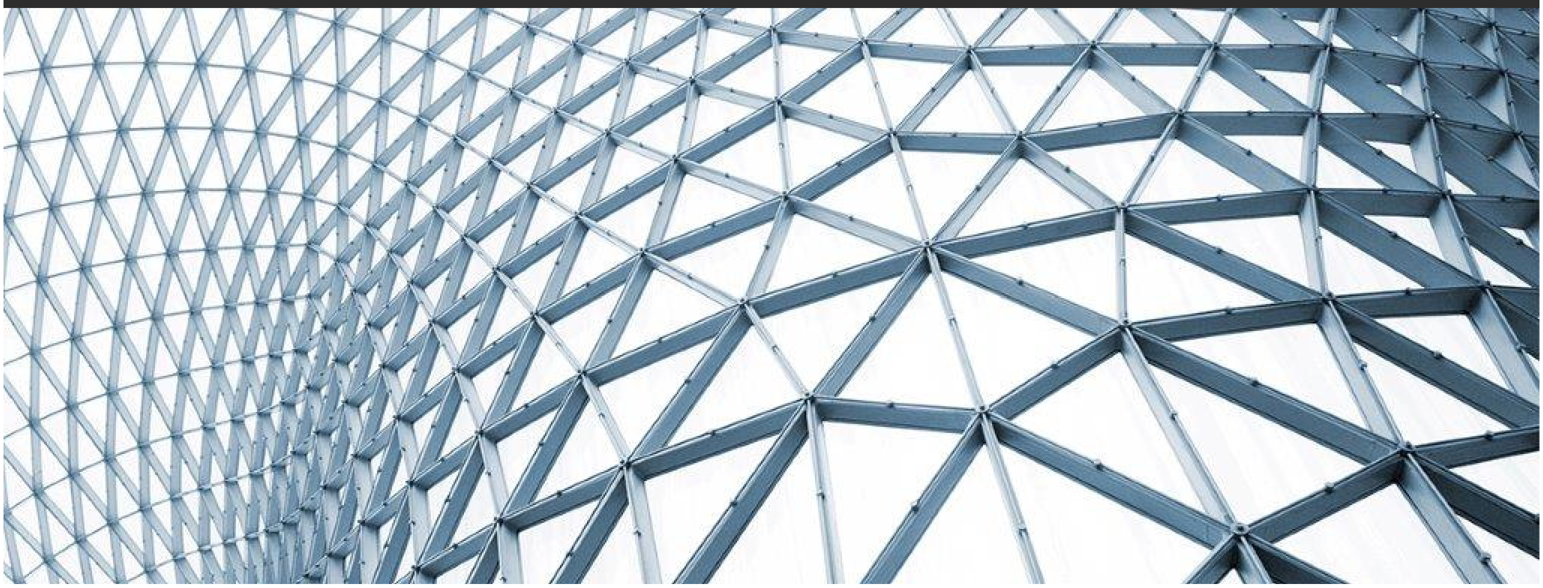
Final IRS Guidance for Rental Deduction Still Leaves Triple Net Leases Out in the Cold



Many real estate investors hoping for clarity on whether they will be eligible for the tax break for pass-through entities under the Tax Cuts and Jobs Act (TCJA) will be disappointed that guidance from the Internal Revenue Service (IRS) will not help much for projects leased on a triple-net basis.

By Marvin Kirsner | December 2, 2019 | Daily Business Review

The TCJA created a new Section 199A, which allows a deduction of up to 20% of qualified business income from each of the taxpayer's qualified trades or business conducted through pass-through entities, such as partnerships, LLCs and subchapter S corporations, or a business held directly by an investor. This can result in a discount of up to 20% on the taxes due on income from a qualified business, assuming all the requirements are satisfied. The deduction applies for tax years beginning in 2018 through 2025.

The first threshold to be eligible for this tax break is that the income must be from a qualified trade or business. For a rental real estate project, the question is whether the level of activity to operate the property rises to the level of being a trade or business. For many types of rental real estate investments, this "trade or business" requirement might not be a problem, because of the high level of activity required to operate the property. For example, a large residential rental complex where leases are constantly being signed and the landlord performs maintenance and repairs shouldn't have a problem satisfying the trade or business requirement. However, some types of real estate investments would probably not qualify; for example, a single tenant commercial project on a long-term lease where the tenant pays all expenses and maintains the property. Then there is everything else in between, which calls for guidance from the IRS.

The regulations under Section 199A, punted on this question, stating that the issue of whether an enterprise is a trade or business must be determined under the criteria for business-related deductions, clearing up little for real estate investors. This can be a complex analysis for some type of real estate projects and would need to be analyzed by reviewing tax cases, rather than being able to rely on a black line rule. The same day the regulations were finalized last January, the IRS also released interim guidance on this issue, Notice 2019-07, which set out a safe harbor for rental real estate enterprises to be classified as a trade or business for Section 199A purposes. If a real estate investment fits into this safe-harbor, then it would be a qualified trade or business, and be eligible for the Section 199A tax break. However, properties leased on a triple net basis were not eligible to rely on this safe harbor.

The IRS finalized this safe-harbor requirements recently when it published Revenue Procedure 2019-38. This final safe-harbor rule provides that a rental real estate enterprise will be considered a trade or business if the following requirements are satisfied:

- Two hundred and fifty hours or more per taxable year must be spent providing "rental services" including advertising, lease negotiations, rent collection, daily operation, maintenance and repairs; purchase of materials; supervision of employees and contractors. Such rental services may be performed by owners, employees, agents or independent contractors (it is not necessary for the taxpayer to spend this time doing the tasks personally—these hours can be put in by third parties). However, acquisition, financing, review of financial statements, planning and constructing capital improvements are not "rental services which count toward this 250-annual hour annual minimum. If a rental real estate enterprise has been in existence for at least four years, it is allowed to meet the 250-hour requirement in any three of the five consecutive years ending with the applicable tax year.

- This 250-hour minimum must be documented with contemporaneous records (time reports and logs) regarding hours of all services performed; description of all series performed; dates when the services were performed, and who performed the services. This means that the hours must be tracked for work done by independent contractors (but this record keeping requirement does not go into effect until Jan. 1, 2020); and,

- Separate books and records must be maintained for each rental real estate enterprise. A taxpayer has the option to treat every property that produces rents as a separate rental real estate enterprise or to treat all "similar" properties as a single rental real estate enterprise.

The 250-hour per year of rental services requirement can be tough to meet, but the rule allows multiple properties held for the production of rent to be aggregated and treated as a single rental real estate enterprise. For purposes of this aggregation rule, a taxpayer must hold the properties directly or through disregarded entities. Thus, a rental property held by a partnership cannot be aggregated with a rental property held by a partner in that partnership. Residential properties may be lumped together to satisfy this 250-hour per year requirement, and so can commercial properties, but not both. For example, if an investor owns two commercial properties, and one takes 200 hours of rental services a year to operate and the other takes 100 hours, the two properties can be aggregated so that the combined 300 hours of rental services would satisfy the 250-hour minimum. However, if one property is commercial, and the other is residential, they cannot be combined, and since neither one reaches the 250-hour threshold they would not be eligible for the safe harbor. Revenue Procedure 2019-38 clarifies that if a single building has residential and commercial units (defined as a mixed-use property), a taxpayer may treat such a mixed-use property as a single rental real estate enterprise or may bifurcate into separate residential and commercial interests. If a taxpayer does not bifurcate a mixed-use property, such property cannot be aggregated with other residential, commercial or mixed-use properties.

Unfortunately, as in the initial guidance, this final safe harbor rule is not available to rental enterprises where property is leased on a triple net basis. It was hoped the final safe harbor rule would narrow the definition of a triple net lease, so that only lease arrangements where the landlord performs little or no activities in regard to the property would be treated as a triple net lease. However, the final guidance, Revenue Procedure 2019-38, actually broadened the definition of a triple net lease, so that a triple net lease would exist if the tenant merely pays its portion of the property expenses in the form of common area maintenance charges. This would be the case even if the landlord is responsible for performing the maintenance and making the repairs. Consequently, most commercial real estate rental projects would not be eligible for this safe harbor to qualify as a trade or business to entitle the owner to the § 199A tax benefit.

This does not mean that owners of triple net leased projects cannot take advantage of the Section 199A tax break, but they will need to demonstrate that the level of activity to operate the project rises to the level of a trade or business under the rules for business deductions. This might not be easy for some smaller projects.

Furthermore, this safe harbor is not available to residential property that is also used by the owner for personal purposes (for example, an individual who owns condos in Vail and Miami Beach, and leases them 30 weeks a year, but uses them personally for four weeks each). The safe harbor also does not apply to real estate rented to a trade or business conducted by the taxpayer or certain commonly controlled pass-through entities. Further, if any portion of the interest in the real estate is treated as a specified service trade or business, which is excluded from being treated as a qualifying trade or business (including most professional practices), the entire rental real estate interest would not be eligible for the safe harbor.

This uncertainty over the ability to benefit from the Section 199A deduction seems to be counter to the idea of this being a tax break for small business owners. The primary rationale for enacting Section 199A was to bring small business owners into parity with large corporations whose tax rate was cut from 34% to 21%. It should be easy for a large commercial real estate operator that employs dozens of workers to operate and maintain a property to prove that it is engaged in an active trade or business; however, it might not be so easy for an investor who leases a few single-family homes. We will need to wait to see how the IRS deals with the question of whether a smaller rental real estate project under a triple net lease is a "trade or business" pans out under audit, but it does seem unfair that owners of small properties might have to bear the expense and the aggravation that an audit entails in order to flesh out this issue.

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