Pass-through Deductions for Property Owners: New Clarity on Who Qualifies

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As part of the 2017 tax overhaul, provisions were put in place that allowed those holding property for rental purposes to write off up to a fifth of their rental income for tax purposes. The deduction was included in Code Section 199A and it applies to non-corporate taxpayers of qualified businesses operating as partnerships, S corporations and sole proprietorships. The deductions also apply to up to 20 percent of aggregate real estate investment trust dividends and qualified publicly traded partnership income. Regulations issued earlier in the year allowed real estate agents and brokers to qualify for the deduction, but the restrictions in the deduction were limited to ?active? trades or businesses as defined by Code Section 162. Following the regulations, the IRS issued safe harbor provisions outlining the requirements to qualify for the deduction. These safe harbor provisions were issued as a final version to Notice 2019-07, which considered public comments.

Safe Harbor:

The IRS released Revenue Procedure 2019-38 (the ?Safe Harbor?) on September 24, 2019. The Safe Harbor outlines a requirements list for activities of real property rental needed to qualify as a trade or business to fall into the Safe Harbor.

The Safe Harbor requirements, which must be met annually, include keeping records of rental services performed and hours of services, and separating residential and commercial properties as distinct enterprises, with an allowance for mixed-use properties to be treated as separate real estate enterprises. Enterprises that have been in existence for at least 4 years must report 250 hours of rental services in each of any 3 consecutive years within the past 5 years, while enterprises operating for less than 4 years must perform 250 hours or more of rental services each year of existence.

For purposes of counting rental real estate services toward the required time allotments, the Safe Harbor provides that the services of supervising contractors and employees and making repairs should be included. Notably, the final version also removed ambiguity on which kinds of records are classified as work hours completed by independent contractors.

The Safe Harbor also makes clear that certain real estate arrangements are excluded. These include 1) real estate used as a residence by the taxpayer, including an owner or beneficiary of a relevant pass-through entity (?RPE?), 2) real estate rented or leased under a triple net lease, 3) real estate rented to a trade or business conducted by a taxpayer or an RPE that is commonly controlled under §1.1991-4(b)(1)(i) and 4) the entire real estate interest if any portion of the interest is treated as a specified service trade or business (?SSTB?) under §1.199A-5(c)(2). The Safe Harbor also specifically defines a triple net lease as 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 rents and utilities.

The changes provided by the IRS in Revenue Procedure 2019-38 provide helpful clarity, and allowing mixed-use properties to be categorized as separate entities is particularly useful as mixed-use spaces are becoming more common.

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