IRS Addresses QBI and Rental Properties

On Friday, January 18, 2019, IRS released Notice 2019-07 with a title of "Section 199A Trade or Business Safe Harbor: Rental Real Estate." Finally, we receive better guidance from IRS on QBI & rentals other than "read case law", especially since case law is not consistent. We really like the part of this Notice where it says "The Treasury Department and the IRS are aware that whether a rental real estate enterprise is a trade or business is the subject of uncertainty for some taxpayers." Yes, we thought you would enjoy a little humor before reading the details of the Notice. Inside the Notice is a 7-page proposed revenue procedure containing the requirements. Here is a summary of the safe harbor rules for rental real estate enterprises (rentals) and QBI. Read the Notice for all of the details.

1) The rental must be held directly or through a disregarded entity.

2) The taxpayer must EITHER:
- a) Treat each rental as a separate activity, or
- b) Treat all similar (commercial and residential are NOT similar) rentals as a single activity.

In other words a taxpayer wanting to treat multiple rentals as a single activity would have TWO activities – one commercial rental and one residential rental. Once this treatment is made, it must continue unless there has been a significant change in facts and circumstances. This is a "one or all" option. For example a taxpayer with three residential rentals can't choose to combine two out of the three, it's either keep each one separate or combine all three.

3) Separate books and records are kept for each rental.

4) "250 hours test." For years beginning prior to January 1, 2023, the taxpayer must perform 250 or more hours of "rental services" during the year with respect to the rental. (Editor note: This provision may require some taxpayers to make the "treat as one" election in order to qualify.) For taxable years beginning after December 31, 2022, this "250 or more" test must be met in any three of the five consecutive years including the current year. If the rental has been held less than five years, the "five" is replaced with the number of years the rental has been held. These hours can be performed by the taxpayer or employees, agents, and/or independent contractors of the taxpayer.

5) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following:
-- Hours of all services performed,
-- Description of all services performed,
-- Dates on which such services were performed, and
-- Who performed the services.

“Rental services” for this purpose include:
i) Advertising to rent the property,
ii) Negotiating and executing leases,
iii) Verifying information contained in prospective tenant applications,
iv) Collection of rent,
v) Daily operation, maintenance, and repair of the property,
vi) Management of the real estate,
vii) Purchases of materials, and
viii) Supervision of employees and independent contractors.

“Rental services” for this purpose does NOT include financial or investment management activities, such as:
i) Arranging financing,
ii) Procuring property,
iii) Studying and reviewing financial statements or reports on operations,
iv) Planning, managing, or constructing long-term capital improvements, or
v) Traveling to and from the real estate.

Rentals that do NOT qualify for this safe harbor treatment include:
a) Real estate used by the taxpayer or an owner of a passthrough as a residence for ANY part of the year under the vacation home rules of Section 280A, or
b) Rentals under a triple net lease.

STATEMENT REQUIRED - To use this safe harbor provision the taxpayer must attach a statement to the tax return that the requirements of Section 3.03 of Revenue Procedure ____(currently unnumbered)___ have been met. The statement must be signed by the taxpayer or the passthrough entity’s authorized representative. The statement must also include: “Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete.” The signer must have personal knowledge of the facts and circumstances related to the statement.

Although this safe harbor is proposed to apply to taxable years ending after December 31, 2017, it is not effective until it is published in final form, BUT taxpayers can apply it immediately.

This applies to all taxpayers, including passthrough entities such as partnerships.

Remember that this is a safe harbor provision. This means a taxpayer who meets these rules can treat the rental property as QBI. If the taxpayer doesn’t meet the safe harbor rules, the rental property may still qualify as QBI if it meets the definition of a trade or business. (In other words, you can still argue about the issue.)

This News Release 2019-07 also contains links to the finalized regulations and the official Revenue Procedure 2019-11 which defines “wages” for purposes of QBI. These two items are very similar to the proposed regulations and revenue procedure IRS issued back in early August.

IRS also released additional proposed regulations on QBI which we are currently reading.

You can find this QBI package by going to irs.gov and entering “IR-2019-04” in the SEARCH box and then clicking on the link in the news release.

This text has been shared courtesy of David & Mary Mellem, EAs & Ashwaubenon Tax Professionals.