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Sec. 199A: A new deduction for QBI from sole proprietorships and passthrough entities - by Sandy Klein

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The 2017 tax reform legislation, known as the Tax Cuts and Jobs Act, includes a new deduction for qualified business income (QBI) from sole proprietorships and passthrough entities such as LLCs, partnerships and S Corporation. Sec. 199A allows individuals (and some trusts and estates) to deduct up to 20% of the combined QBI from qualifying trades or businesses, subject to certain limitations. QBI includes the net amount of qualified items of income, gain, deduction, and loss for any qualified trade or business of the taxpayer.

In the rental real estate area, a significant issue to taxpayers is whether rental real estate activities would constitute a trade or business and thus qualify for QBI deduction. The IRS has said such a question would depend on a number of factors including, type of property rented, number of properties rented, the owner's or owner's agents' day to day involvement, ancillary services provided under the lease and terms of the lease. Notably, the IRS has declined to provide a bright line rule on whether rental real estate is a trade or business for purposes of the QBI deduction.

Nevertheless, in response to questions from practitioners, the IRS did provide a formal notice this year that provides what they call a "safe harbor," under which, what they term a "rental real estate enterprise" (RREE) will be treated as a trade or business under the QBI deduction rules.

The notice contains detailed rules but in general an entity that qualifies as a RREE will be treated as a trade or business for the QBI deduction if the RREE keeps separate books and records to track income and expenses for each RREE and 250 or more hours or rental services are performed per year with respect to the RREE, and simultaneous records are maintained for the services that track dates, hours, descriptions and persons involved. Rental services include advertising to rent, negotiating leases, verifying tenant application information, collecting rents, daily operation of the property, management and supervision of employees. Of particular note to the real estate community, the IRS notice says real estate rented or leased under a triple net lease is not eligible for the safe harbor. Nevertheless, failure to qualify under the IRS notices' "safe harbor" does not automatically disqualify the rental real estate (including a triple net lease) from being a trade or business. The rental activity would need to show that under the facts and circumstances the activity

risers to the level of a trade or business under other provisions of the tax law.

For taxpayers with multiple real estate activities, the “aggregation” rules must also be considered. A taxpayer may aggregate real estate trades or businesses if a complex “50% ownership test” is met, and if at least 2 of 3 additional factors are satisfied: 1) the trades or businesses provide products, property, or services that are the same or customarily offered together; 2) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or, 3) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group. As it applies to rental real estate, it may be advantageous for tax purposes to aggregate real estate trades or businesses that includes interests in multiple properties thru multiple legal entities and related management companies that provide back office services to the rental real estate operations, as payroll is a key component in determining the limitation of the Sec. 199A QBI deduction. Notably, commercial and residential real estate cannot be part of the same aggregated group.

Determining how to apply the QBI deduction rules to rental real estate activities is a factually based and complex process. As such, consultation is needed with a tax adviser regarding the application of the various relevant factors to specific facts and circumstances.

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