Heinold Banwart, Ltd.
Certified Public Accountants

Third Floor
201 Clock Tower Drive
East Peoria, IL 61611-2449

Tel (309) 694-4251
Fax (309) 694-4202
Web www.hbcpas.com

August 24, 2018

Tax Reform Alert: Pass-Thru Deduction & Rentals

The Tax Cuts and Jobs Act made significant changes to flow-thru entity taxation with the enactment of new code Section 199A – pass-thru deduction. This article discusses how the new deduction may apply to rental real estate income and the uncertainties surrounding its application.

Eligibility for the Deduction

All taxpayers, other than C corporations, are eligible for the new deduction. Therefore, property owners with rental property inside an S corporation, partnership (LLC), trust or estate, or who directly own the property are eligible for this new deduction. The activity must relate to a "qualified trade or business," however. The new statute defines a qualified trade or business as (1) any trade or business other than a specified service trade or business, or (2) the trade or business of performing services as an employee. For most rental properties, the specified service trade or business or employee trade or business will not be applicable, so it remains unclear exactly what is a qualified trade or business.

Trade or Business in General

Recently issued proposed regulations state that Section 162 is the guide for determining whether an activity is a qualified trade or business. Under Section 162(a), a taxpayer's adjusted gross income is computed by deducting all ordinary and necessary expenses incurred in carrying on a trade or business. "Trade or business" in this context, however, has not been defined in the Code, regulations, or IRS guidance. Therefore, the determination whether a taxpayer's activities qualify as a trade or business is made on a case-by-case basis.

The Supreme Court has identified regularity (i.e., activity over a certain period) and a profit motive as factors that the courts have widely accepted as indicating the presence of a trade or business. The Court in *Groetzinger*, 480 U.S. 23, 35 (1987), said, "We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."

Trade or Business & Rental Property

Determining the extent of activity required for the rent and management of real property to reach the status of a trade or business is particularly difficult. Whether or not rental real estate constitutes a trade or business has been the subject of many court cases over the years. For example, a common issue was whether a loss on the sale of real estate was an ordinary loss (trade or business) or investment loss (non-trade or business).

Tax Court cases have generally held that property offered for rent will be treated as property used in a trade or business. The leading case is *Hazard v. Commissioner*, which involved the sale of a former primary residence of a taxpayer. The Tax Court has generally found that a taxpayer is engaged in a trade or business even if the taxpayer only holds a single property for rent and irrespective of the extent of the taxpayer's management activities.

The IRS in Private Letter Ruling (PLR) 9426006 noted that the rental of a single property may constitute a trade or business. However, the PLR stated that ownership and rental of property does not, as a matter of law, constitute a trade or business. The issue is ultimately one factor in which the scope of the taxpayer's activities, either personally or through agents, in connection with property are so extensive as to rise to the stature of a trade or business (citing *Bauer v. United States*).

In Revenue Ruling 73-522, the IRS held that rental of real property under a "net lease" does not render the lessor engaged in a trade or business with respect to such property for purposes of Section 871 (nonresident alien rules). The leases were such that the lessee was to pay the real estate taxes, operating expenses, repairs, and insurance on the property.

Two Seventh Circuit Court of Appeals cases (Illinois jurisdiction) decided in 1954 and 1955 appear on the surface to be contradictory to each other. In both cases, the court considered not only the extent of the taxpayers' activities, but also considered the taxpayer's intent, whether to produce rental income or make an investment. In the first case (*Chicago Title & Trust*), the court held that the taxpayer's supervision of the rental properties does not amount to a trade or business, and that regular operation of a business requires such continuity and expenditure of time in the transactions as to indicate a permanent engagement in the business. In the second case (*Reiner*), the taxpayer rented a residence in Austria to several tenants, but no rental payments were ever received. The property was destroyed by a bombing raid in 1944, and the court held that the taxpayer was engaged in a trade or business.

In summary, it appears that while it can be expected that the Tax Court and the Seventh Circuit may adhere to their position that mere ownership of rental real property (and perhaps minimal management activities) will cause an owner to be engaged in a trade or business, it can also be expected that other appellate courts and the IRS may adopt an alternate view, namely, that there must be evidence of management activities before trade or business status will be conferred on the taxpayer. Requiring a taxpayer's activities to be more extensive than mere ownership appears to be the predominant method of distinguishing trade or business status from mere investment activities of a taxpayer.

Specific Taxpayers & Situations

Self-Rental (Owner-Occupied Real Estate)

The proposed regulations under 199A issued by the IRS in August provide a safe harbor for rental income received from commonly controlled entities. This was welcome news to taxpayers. If a taxpayer rents tangible or intangible property to a commonly controlled operating business, the self-rental activity is treated as a trade or business. A commonly controlled business is one in which the same person or group of persons own 50% of both the operating and real estate entity. Family attribution rules apply such that a taxpayer's spouse, children, grandchildren, and parents can be included in the 50% test.

There is a special rule for self-rental if the operating company is a "specified service trade or business." This can include businesses such a doctors, lawyers, accountants, and consulting firms among others. In this case, the rental income from the real estate will be considered a specified service trade or business and ineligible for the 199A deduction. In cases where a portion of the real estate is leased to third parties (not all is self-rental), there is an additional set of rules:

- If 80% or more of the rent income is from the specified service trade or business, then 100% of the rental income is not eligible for the 199A deduction.
- If less than 80% of the rent income is from the specified service trade or business, then just the portion that is self-rented is ineligible.
    - Therefore, if a landlord rents 60% of its facility to a commonly controlled law firm, and the other 40% is rented to third parties, then 40% of the landlord's income will be eligible for the deduction.

Triple Net Leases

Based on the above analysis, it appears likely the IRS will challenge a taxpayer who takes the 199A deduction on net income from triple net leases, where the tenant is responsible for items such as real estate taxes, insurance, and maintenance, and where there is little-to-no involvement by the landlord.

Farmland

Crop Share Lease (Form 4835)

The treatment of income earned by a landlord under a crop share lease is largely dependent upon the landlord's level of participation in the farming activities governed by the lease. It seems likely that a typical crop share arrangement (where the landlord pays for a portion of the crop inputs, pays all real estate taxes, and is responsible to market the grain produced) would be considered a qualified trade or business under Section 199A.

Cash Rent Lease (Schedule E)

Cash rent received on farmland is passive income subject to the passive activity loss rules. In addition, cash rent is considered investment income and is generally subject to the net investment income tax. Most leases are written so that the landlord is responsible for the real estate taxes, which would be favorable, but overall it is likely that the IRS would challenge cash rent being eligible for the Section 199A deduction. However, there could still be a position taken that it is eligible depending on facts and circumstances.

Summary

The above discussion reflects our understanding of how the new Section 199A deduction would apply to rental real estate. The self-rental rules in the proposed regulations are helpful in that it does not require changing any lease agreements between related parties. Even if a related party lease is "triple net," it will be considered a trade or business as long as the rent being received is not from a specified service trade or business. Please contact our office so that we can help you think through this important issue.