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Subject: Alan Gassman & Martin Shenkman - When is Rental Real Estate a "Trade or Business" Under 199A?

"The 2017 Tax Cuts and Jobs Act introduced the new, and sometimes problematic, Section 199A to the Internal Revenue Code. Section 199A was designed to provide taxpayers with a twenty percent (20%) deduction for qualified business income (QBI) earned through qualifying 'trades or business.' This deduction for business owners was added in response to the significant tax cut the Act created for large corporations. Unfortunately, among other myriad complexities and uncertainties in 199A, there is no single accepted definition of 'trade or business' so many taxpayers have been in limbo not knowing whether their activities qualify. Once a practitioner has parsed through this complexity to determine if a real estate rental arises to the level of a trade or business, the Regulations contain an array of ancillary provisions, exceptions and special rules that may affect the application of that determination or even negate it.

On January 18th, the IRS released the highly anticipated Final Regulations intended to shed light on the many confusing aspects of Section 199A. Much like the Proposed Regulations, the Final Regulations do not provide a bright line definition of 'trade or business.' The Final Regulations state that for the purposes of Section 199A, ***a qualifying trade or business is defined as a trade or business under Section 162 of the Internal Revenue Code other than the trade or business of performing services as an employee****.*

This newsletter will focus primarily on using the new Final Regulations as well as previous court decisions to define and understand what is meant by the term 'trade or business' for purposes of determining whether a real estate investor with a triple net lease can qualify for the 199A deduction under the Final Regulations, as corrected."

Alan Gassman and **Martin Shenkman** provide members with important commentary that examines an issue that many advisors and their clients are struggling with, namely, when is rental real estate a "trade or business" for Section 199A purposes?

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Here is their commentary:

EXECUTIVE SUMMARY:

The 2017 Tax Cuts and Jobs Act introduced the new, and sometimes problematic, Section 199A to the Internal Revenue Code.[i] Section 199A was designed to provide taxpayers with a twenty percent (20%) deduction for qualified business income (QBI) earned through qualifying "trades or business." This deduction for business owners was added in response to the significant tax cut the Act created for large corporations. Unfortunately, among other myriad complexities and uncertainties in 199A, there is no single accepted definition of "trade or business" so many taxpayers have been in limbo not knowing whether their activities qualify. Once a practitioner has parsed through this complexity to determine if a real estate rental arises to the level of a trade or business, the Regulations contain an array of ancillary provisions, exceptions and special rules that may affect the application of that determination or even negate it.

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COMMENT:

Section 199A points to Section 162 for the definition of a “trade or business,” however, even looking past the repetition of the phrase “trade or business,” Section 162 does not provide a clear definition either. Section 162 states that expenses can be deducted when they are incurred for a legitimate and active trade or business. Section 199A of the Act modifies the Section 162 definition of what constitutes “trades and businesses” by excluding “the trade or business of performing services as an employee and ‘specified service’ trades or businesses (“SSTBs”). SSTBs involve the performance of services in law, accounting, financial services, and several other enumerated fields, or when the business’s principal asset is the reputation or skill of one or more owners or employees.” Thus the 199A definition of “trade or business” begs the question: who actually qualifies as a trade or business for the 199A deduction?

We do know that SSTBs and services as an employee are both excluded. Those two concepts are also fraught with nuance and uncertainty but will not be addressed in this newsletter. Rather, this newsletter will explore the remaining territory of what is a business for 199A other than these two special situations, with a focus on how a real estate trade or business is defined for purposes of applying 199A.

While the definition of a “trade or business” under Section 162 and case law is complex and in many cases quite fact specific, the analysis is much more complicated. Even apart from the SSTB and employee exclusions, the 199A Regulations include a range of other comments affecting the definition of what is a trade or business for purposes of 199A. We will start by reviewing how the Courts have defined the term “trade or business” in order to give the Internal Revenue Code definitions some context, particularly since many of these cases are cited by the new Regulations.

Case History Defining “Trade or Business”

The Supreme Court has been faced with the task of defining a “trade or business” in tax context multiple times over the last century. Going back to 1911, the Court in *Flint v. Stone Tracey* used the Bouvier Dictionary to broadly define a business as “that which occupies the time, attention and labor of men for the purpose of a livelihood or profit.”[ii] In 1935, the U.S. Supreme Court provided a limitation to the definition by distinguishing between an active trade and an investor.[iii] In *Snyder v. Commissioner,* the Court determined that an investor seeking to merely increase his personal holdings was not engaged in a trade or business,[iv] however, Justice Brandeis also stated that a taxpayer who made his livelihood from buying and selling on the stock exchange would be a trade or business.[v] This was the first of many instances where the activity level of the taxpayer is a deciding factor in whether the definition of a “trade or business” applies.

Not long after *Snyder*, the Court was faced with two “trade or business” cases in one year which centered upon estate preservation. In the 1941 *Higgins v. Commissioner* case, also cited in the new Final Regulations, the Supreme Court stated that determining whether a taxpayer is ‘carrying on a business’ “requires an examination of the facts in each case” therefore highlighting that this is a factual determination.[vi] In *Higgins* specifically, the Court determined that a taxpayer managing and preserving his own estate did not qualify as carrying on a business.[vii] Additionally, in *City Bank Farmers Trust v. Helvering,* the Supreme Court used the same analysis to determine that asset conservation and maintenance by way of estate or trust efforts is not a trade or business.[viii]

These cases highlight the Supreme Court’s ongoing struggle in deciding whether a certain activity qualifies as a trade or business without a succinct definition from Congress or its agencies. In its 1987 sentinel case *Commissioner v. Groetzinger,* a case cited in the new Regulation, the U.S. Supreme Court laid out a definition for what qualifies as a trade or business that is still good law.[ix] In *Groetzinger*, the Court determined that a full-time gambler who wagered for himself alone was engaged in a “trade or business” within the meaning of the applicable Internal Revenue Code.[x] The Court rejected the previously used ‘goods and services’ test reasoning that almost every activity could potentially satisfy the test leading to litigation over the meaning.[xi]

The Court held that to be engaged in a trade or business:

1. The taxpayer’s involvement must be continuous and regular; and
2. The primary purpose of the activity must be for income or profit.[xii]

The Court cautioned future courts to examine the facts of each case, refusing to create a bright line rule, and highlighted that it is the responsibility of Congress to make changes or revisions to this Court's interpretation of the definition.[xiii] While it is true that Congress has the ultimate responsibility to define "trade or business" as used in its rules and proposed regulations, they have not done so. In fact, the new Final Regulations cite back to the two definitional requirement in *Groetzinger* so it follows that the best definition or test available still comes from the Supreme Court in *Groetzinger.*

It is important to keep in mind that the Supreme Court only hears a select number of cases. The majority of disputes related to tax matters are heard by the Tax Court. The Tax Court has held that, beyond the definition provided in *Groetzinger,* the threshold test for deduction of income expenses under Section 162 is twofold: (1) whether the primary purpose and intention of the taxpayer was to make a profit,[xiv] and (2) the level of activity involved. Along with the new Final Regulations, the IRS also released a Notice that included a safe harbor for real estate activities related to the level of activity necessary to qualify as a trade or business. This safe harbor will be discussed further below.

By way of illustration, if a taxpayer loses money by participating in a hobby, the taxpayer cannot receive benefits of income tax deductions by calling the hobby a trade or business. In the 1988 U.S. Tax Court case of *Seebold v. Commissioner,* a married couple decided to breed horses to add to their retirement income.[xv] In this case, the court explicitly placed greater weight on the objective factors showing the couple's intent to profit rather than simply their statement of intent.[xvi] For example, they worked hard to learn the subject area, sought advice from experts in the field, used a veterinarian for the purpose of breeding, and consulted an accountant.[xvii] Moreover, Mrs. Seebold eventually quit her job to work on the breeding farm full time.[xviii]

The Tax Court determined that this level of activity met the threshold in that the primary purpose and intention of the Seebolds was to incur a profit, regardless of the loss they sustained when they first started, and the Seebolds' horse breeding qualified as a trade or business.[xix] As a result, in addition to the *Groetzinger* test, taxpayers must also be able to show that the primary purpose and intent of the activity is to incur a profit, and the taxpayer bears the burden of proving they meet this threshold before benefitting from the 199A deduction.

There are several factors that taxpayers may wish to document if there is any uncertainty as to whether their real estate involvement may qualify as a trade or business. Real estate investors attempting to qualify for trade or business status could pursue and corroborate the following:

- Save internet research on real estate rental matters to corroborate work done in an effort to educate him/herself on the subject.
- Document consultations with experts, e.g. saving emails and other correspondence.
- Hire professional experts, including CPAs, and save all bills and payments thereto.
- Maintain time records.
- Prepare a financial plan to reflect the need for income to support the argument that the intent is to earn a profit.

As illustrated above, taking proactive steps to corroborate intent at the time activities and actions are completed may be a prudent way to prepare for the possibility of a future challenge.

Application to Real Estate

The issue of whether a taxpayer is engaging in a trade or business is an issue of fact that involves analyzing the scope of activities that the taxpayer is engaged in, either personally or through an agent. Many commentators on the Proposed Regulations requested a bright line rule or factor based test from the IRS to no avail. The new Final Regulations state: “Whether an activity rises to the level of a Section 162 trade or business, however, is inherently a factual question…accordingly, the Treasury Department and the IRS have concluded that the factual setting of various trades or businesses varies so widely that a single rule or list of factors would be difficult to provide in a timely and manageable manner and would be difficult for taxpayers to apply.”

Even without a definitive test, passive ownership of a rental property is commonly not enough to qualify as a trade or business, although active management of such a property historically has been viewed as a trade or business. Since qualifying as a trade or business is based on a question of fact, the line distinguishing passive ownership and active ownership can easily become blurry.

The new Final Regulations do provide four factors that have been used by courts for years to consider whether a real estate venture qualifies as a

trade or business.[xx] First, the IRS will consider the type of property owned and/or managed by the taxpayer (i.e. commercial, residential, condominium, or personal). Second, the court will consider the number of properties rented out by the taxpayer. Third, and what seems to be most important, the court will consider the day to day involvement of the owner or agent, and fourth, the court will consider the type of rental (i.e. triple net lease, traditional lease, short term lease, or long-term lease).

Based on this analysis, taxpayers seeking to qualify might take the following proactive steps:

- When making a new investment, consider the likelihood that the type of property being considered will qualify if this is not inconsistent with overall goals. For example, purchasing a commercial property is more likely to qualify then renting a vacation home, and purchasing multiple properties may be more favorable than a four-family house.
- Document the daily activities. This can be done with a calendar program or perhaps an Excel spreadsheet. Even documenting simple and easily overlooked items may be useful to "fill-out" the documentation and demonstrate a more regular involvement, such as providing the dates on which supplies are purchased, the dates on which internet research is conducted, the dates emails are sent to an agent, prospective tenant, repair contractor, and so on.
- Taxpayers should be certain that the real estate attorney drafting and negotiating the lease understands the implications. It may be possible to charge a higher rent and leave property tax, insurance, and other expenses to be paid for by the owner. That might not meaningfully impact the economics of the transaction but it may impact the potential characterization of the transaction for Sections 162 or 199A trade or business characterization.

In the 1946 case *Hazard v. Commissioner,* the Tax Court ruled that even one single family rental was a trade or business.[xxi] The Internal Revenue Service has since adopted the same reasoning and the rule still stands in most jurisdictions.[xxii] It would therefore be reasonable for the IRS to continue to follow the *Hazard* standard with regards to 199A deductions and allow single family or single property rentals to qualify as a trade or business, however, much case law has shown that simply renting the property alone is not enough. As noted above, if the taxpayer has options when purchasing a new real estate investment, such as structuring a more sustainable investment for QBI purposes, doing so may be feasible.

Practically speaking, how much change will a taxpayer tolerate for the amount of the deduction?

In *Neill v. Commissioner*, the 1942 Tax Court ruled that the mere collection of rent without any other activity was not enough to constitute a trade or business.[xxiii] In *Hendrickson v. Commissioner*, the Tax Court ruled that a passive investment in an oil gas well where the owner simply purchased the lease and collected income from it did not qualify as a trade or business.[xxiv] Therefore, while it is possible for a rental business to constitute a "trade or business", simply owning the business and collecting money is not enough. Even so, as indicated above, it may not be difficult for taxpayers to document a quantum of activity, modify lease terms, etc. to support the active trade or business characterization.

Based on the relevant case law, in order to qualify as engaging in a trade or business, the taxpayer must have some active role in running the rental. In *Schwarcz v. Commissioner,* the Tax Court determined that a landlord owning, managing, and operating apartment buildings was engaging in a trade or business.[xxv] Interestingly, the owner could do so through an agent and would still qualify.[xxvi] While most or all rental activities can be handled through an agent, having the owner personally visit and inspect the property at least once a month (even if from the outside so as not to disturb a tenant) to take photos that can be stored to prove the dates and actuality of the inspections may be prudent to help support the taxpayer's position.

In certain tax cases not related to the 199A deduction, taxpayers may have want to avoid being labeled as a trade or business in order to avoid paying additional taxes as a trade or business. In *Bennett v. Commissioner,* two partners leased equipment to site organizations allowing people to play a form of lottery called keno under the company name of Lucky Keno.[xxvii] The partners both reported their business income from Lucky but did not report self-employment tax.[xxviii] The partners argued that they did not have to pay the self-employment tax because Lucky was a passive owner of the equipment and not actively engaged in trade or business.[xxix] The Tax Court disagreed, stating that the partners oversimplified their role.[xxx] Lucky's name was on all of the keno advertisements and Lucky controlled the funds and distributed them to the winners, municipalities, the state, and the site organizations.[xxxi] Therefore, Lucky was not a passive owner and the partners were required to pay self-employment taxes because they owned a trade or business.[xxxii]

Application Specifically to Triple Net Leases

In a triple net lease, the tenant is mostly responsible, and the lessor does very little by way of managing the rental. The tenant usually agrees to pay the normal fees, like rent and utilities, plus the three “nets” – real estate taxes, building insurance, and maintenance. Using the *Groetzinger* test, a triple net leaseholder will most likely not qualify as having a trade or business because, while owning the property for the purpose of making a profit would meet the second prong of the test, the involvement of the leaseholder is not continuous and regular enough to meet the first prong.

The Proposed Regulations under Section 199A offered two examples of real estate initiatives qualifying as a trade or business. In the first example, an individual who owns and manages land leased to airports for parking lots qualified as a Section 162 business. The management aspect of the owner is the likely reason why this example qualified as a trade or business. It is unclear how this example could apply practically because if the land is leased to airports, there is not much management left for the owner to handle. In the second example, the owner developed the same land to build parking structures and then leased the parking structures to the airports. It is noteworthy that in those prior examples the dollar value of costs incurred by the owner were insignificant relative to the rental income involved, yet those examples skirted the trade or business issue and merely assumed without further indication that they qualified. Despite this, relevant case law would suggest that this example would not qualify as a trade or business.

To alleviate the confusion here, the new Final Regulations have removed all references to land in both of these examples. The Regulations state that the examples “were not intended to imply that the lease of the land is, or is not, a trade or business for the purposes of Section 199A beyond the assumption in the examples.”

Along with the new Final Regulations, the IRS also released a special notice (Notice 2019-7) to provide “notice of a proposed revenue procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for the purpose of Section 199A.”

Under the new safe harbor, rental real estate may be treated as a trade or business for the purposes of Section 199A alone as long as the following criteria are met:

1. Separate books and records are maintained for each rental activity (or the combined enterprise if grouped together);
2. Two hundred and fifty (250) hours or more of "rental services" are performed per year for the activity (or combined enterprise); and
3. The taxpayer maintains contemporaneous records, including time reports or similar documents, regarding the hours of all services performed, a description of all services performed, the dates on which such services are performed, and who performed the services.[xxxiii]

To this end, taxpayers should:

1. Be certain to maintain separate books and records. If the taxpayer uses Quicken or a similar program to track records, he/she may want to set up a new account for this.
2. If the taxpayer has commingled rental income and expenses in his/her personal checking account, then set up a new separate account for the business.
3. If the taxpayer has used one account for all rental properties then, unfortunately, separate bank accounts should be created.
4. The taxpayer should maintain a calendar and also a supporting file of saved emails, internet research, photos saved with date/time stamp, etc. to show ongoing involvement and corroborate that actions were taken supporting the hours tracked.

Suprisingly, the Notice specifically excludes triple net leases as ineligible for the safe harbor! This does not prevent the taxpayer from arguing that the real estate enterprise *should* qualify as a trade or business under the Section 162 definition if there are other considerations at play.[xxxiv] Although it is important to remember that both the Final Regulations and relevant case law say that qualifying under Section 199A involves a factual case-by-case analysis, triple net lease arrangements will most likely need to be altered in order to qualify.[xxxv] Practitioners should consider the structure of the ownership of the triple net leased properties and the aggregation rules. It may be possible to alter the structure, e.g. have all separate non-qualifying LLCs restructured into disregarded entities so that they can be aggregated for this test.

While the regulations and safe harbor are brand new and case law is scant, one Revenue Ruling has addressed the issue regarding whether a triple net lease specifically qualifies as a trade or business. Under Section 871, there are special rules for the taxation of nonresident aliens who are engaged in trade and business in the United States. This could be used as

a potential argument for meeting the Section 162 definition of trade or business, nonetheless, Revenue Ruling 73-522, 1973-2 C.B. 226 stated that a rental under a net lease is not considered a trade or business for the purposes of Section 871.

The question of whether a triple net lease can constitute a trade or business was also raised with regard to withdrawal liability under the Multiemployer Pension Plan Amendments Act (MPPAA) in the 2001 7th Circuit U.S. Court of Appeals case of *Central States, Southeast and Southwest Areas Pension Fund v. Fulkerson*.[xxxvi] Thomas and Dolly Fulkerson owned several triple net leases and were also shareholders of Holmes Freight Lines, Inc. (Holmes) when it became bankrupt.[xxxvii] As a creditor, Central States used the MPPAA of 1980 to calculate the withdrawal liability of Holmes.[xxxviii] Under the MPPAA, all "trades or businesses" are treated as one employer.[xxxix] Under that theory, the Fulkerson's leasing business and Holmes were under the common control of the Fulkersons and the leasing business was thereby pulled in to help pay the remainder of what was owed to Central States.[xl] Because the leasing business was unincorporated, the Fulkersons became personally liable.

The MPPAA, like the IRC, uses the term "trade or business" but does not define it. Therefore the appellate court affirmed the Supreme Court's test in *Groetzinger,* reasoning that the test comports with the common meaning and can be used generally.[xli] In order to meet the first prong of the *Groetzinger* test, the taxpayer's involvement must be continuous and regular. Since the leases were triple net leases, Mr. Fulkerson only spent about five hours per year involved with the properties.[xlii] The properties were purchased with the intent of pure investment. The court held that the "mere holding of leases for ten years by shareholder was not such continuous and regular activity as to constitute a trade or business, for purpose of imputing withdrawal liability to company."[xliii] A similar ruling today would probably be upheld with regards to Section 199A, even with the new safe harbor, due to the 250 hour requirement. Practitioners should also be mindful of the special rules in the final Regulations as to these matters of aggregation.

In the 7th Circuit U.S. Court of Appeals case of *Central States v. Personnel,* the court reached the opposite decision with similar facts as *Fulkerson*.[xliv] In *Personnel*, the defendant was held responsible for withdrawal of liability because the defendant was much more frequently

engaged in activities related to leasing, such as buying and selling multiple properties annually and advertising.[xlv] The court concluded that this conduct was both regular and continuous.[xlvi]

Based on the reasoning in these cases along with the new Final Regulations, it is clear that: (1) the *Groetzinger* test is still applicable and used by courts to determine whether an activity is a trade or business, and (2) courts truly use activity level of the taxpayer as a deciding factor. Based on the relevant case law as well as the new safe harbor provision, it seems as though the courts and the IRS are really looking for some degree of activity/time spent working with the enterprise or legal responsibility of risk on part of the taxpayer. In order to show that, an owner of a triple net lease can do a few things to increase their level of activity with the rental such as: take on responsibility for maintenance, participate in tenant management, participate in advertisement initiatives, and be more active in pursuing new leases or selling leases. Also consider the additional suggestions in previous sections of this newsletter.

For further clarification on the complex ripple effects of the new Final Corrected Regulations, the esteemed co-author to this newsletter, Martin Shenkman, has provided the following breakdown.[xlvii]

Complex Ripple Effects of the New Final Corrected Regulations

The Regulations include a myriad of provisions that might affect how a trade or business is defined and whether or not that trade or business will qualify for the QBI deduction. Many of these nuanced rules have direct application to determining whether real estate activities will or will not qualify. Some of these are discussed below.

- **Multiple Trades or Businesses**: "Whether a single entity has multiple trades or businesses is a factual determination. However, court decisions that help define the meaning of "trade or business" provide taxpayers guidance in determining whether more than one trades or businesses exist." The aggregation, or decision not to aggregate, or the inability to aggregate (e.g. real estate properties that are not trades or businesses cannot be aggregated), may all affect the outcome of the analysis.
- **Activity to Constitute a Trade or Business**: The Regulations refer to case law to interpret what it means "…to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity

and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. Groetzinger, at 35."

- **Books and Records**: 'Section 1.446- 1(d) explains that no trade or business is considered separate and distinct unless a complete and separable set of books and records is kept for that trade or business. Further, trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected." This appears to mean that if several businesses do not have "complete and separable sets of books and records" they cannot be separate businesses. If there is a shifting of profits that is not "clearly reflected" then to businesses cannot be separated. This might all affect the calculus of QBI for the overall enterprise. This adds requirements that practitioners will have to address in delineating businesses for purposes of the QBI deduction.
- **Aggregation**: The determination of a trade or business is made more complex by the possibility of aggregation. "As described in part II of this Summary of Comments and Explanation of Revisions, the final regulations incorporate the principles of section 162 for determining whether a trade or business exists for purposes of section 199A. A taxpayer can have more than one section 162 trade or business. See §1.446-1(d)(1). Multiple trades or businesses can also be conducted within one entity. A trade or business, however, cannot generally be conducted across multiple entities for tax purposes. The preamble to the proposed regulations acknowledges that it is not uncommon for what may be thought of as single trades or businesses to be operated across multiple entities, for various legal, economic, or other non-tax reasons. It is because trades or businesses may be structured this way that the proposed regulations permit aggregation." So merely determining whether the developer's activities constitute a trade or business is only part of the analysis. The Regs further provide: "The aggregation rules are intended to allow aggregation of what is commonly thought of as a single trade or business where the business is spread across multiple entities. Common ownership is an essential element of a single trade or business."
- **Consistency**: The Regulations also impose a consistently requirement on the delineation of a trade or business: "In cases in which other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted

in these final regulations, taxpayers should report such items consistently. For example, if taxpayers who own tenancy in common interests in rental property treat such joint interests as a trade or business for purposes of section 199A but do not treat the joint interests as a separate entity for purposes of §301.7701-1(a)(2), the IRS will consider the facts and circumstances surrounding the differing treatment." This may be a factor in determining whether future restructuring can be done to enhance QBI deductions from real estate and related endeavors since a restructuring that changes prior reporting may violate the consistency requirement.

- **Allocations**: The consistency requirements are broad and appear in several contexts in the proposed regulations. So, in addition to the above provision, consistency in allocations is also required. "The proposed regulations provide that if an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI which are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business."
- **1099 Filings**: The Regulations also impose an additional requirement that if an operation does not comply with Form 1099 reporting requirements, it may not meet the requirements of constituting a trade or business. The Regulations provide: "Similarly, taxpayers should consider the appropriateness of treating a rental activity as a trade or business for purposes of section 199A where the taxpayer does not comply with the information return filing requirements under section 6041." Section 6041 provides in part: "All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations,… of $600 or more in any taxable year…required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Secretary, under such regulations" So a failure of a rental activity to file 1099s will preclude it from being characterized as a trade or business for 199A even if it passes the gauntlet of the 162 analysis discussed below.

- **Disregarded Entities**: "…trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of section 199A." This could be useful for real estate developers. For example, most developers structure operations so that every property is in a separate LLC. So, if a developer has brother-sister disregarded entities the trade or business test should be determined at the aggregate/developer level. If a developer has a family limited partnership ("FLP") that owns brother-sister "subsidiary" single member LLCs holding each property, then the trade or business test should be handled at the FLP level. However, if as many developers do the structure is a non-disregarded management company that owns 1% of each property LLC and the developer or a grantor trust owns the other 99% then it would appear that the trade or business testing and QBI calculations would have to be done at the level of each property LLC.
- **Entity Level Calculations**: Apropos to the above comments concerning disregarded entities is further comments in the Regs about testing at the entity level: "For purposes of section 199A, the determination of whether an activity is a trade or business is made at the entity level. If an RPE is engaged in a trade or business, items of income, gain, loss, or deduction from such trade or business retain their character as they pass from the entity to the taxpayer – even if the taxpayer is not personally engaged in the trade or business of the entity. Conversely, if an RPE is not engaged in a trade or business, income, gain, loss, or deduction allocated to a taxpayer from such entity will not qualify for the section 199A deduction even if the taxpayer or an intervening entity is otherwise engaged in a trade or business. As described in part II.A.3 of this Summary of Comments and Explanation of Revisions, a trade or business for purposes of section 199A is generally defined by reference to the standards for a section 162 trade or business. A rental real estate enterprise that meets the safe harbor described in Notice 2017-07, released concurrently with these final regulations, may also treated as trades or businesses for purposes of section 199A. Additionally, the rental or licensing of property if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under §1.199A- 4(b)(1)(i) is also treated as a trade or business for purposes of section 199A. In addition to these requirements, the items must be effectively connected to a trade or business within the United States as described in section 864(c)." For

developers who have, as illustrated above, an entity that is not disregarded, if that entity's activities do not rise to the level of a trade or business then its revenue will not qualify as QBI. This appears to be so even if the aggregate of the taxpayer's activities with respect to all entities arises to the level of a trade or business, as these cannot be aggregated if the individual entities themselves do not meet the trade or business requirement.

- **Penalties**: The Regs provide for the following: "Section 6662(a) provides a penalty for an underpayment of tax required to be shown on a return. Under section 6662(b), the penalty applies to the portion of any underpayment that is attributable to a substantial underpayment of income tax. Section 6662(d)(1) defines substantial understatement of tax, which is generally an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. Section 6662(d)(1)(C) provides a special rule in the case of any taxpayer who claims the section 199A deduction for the taxable year, which requires that section 6662(d)(1)(A) is applied by substituting "5 percent" for "10 percent." Section 1.199A-1(e)(6) cross-references this rule. One commenter asked for guidance on how the section 6662 accuracy penalty would be applied if an activity was determined by the IRS not to be a trade or business for purposes of section 199A. The Treasury Department and the IRS decline to adopt this suggestion as guidance regarding the application of section 6662 is beyond the scope of these regulations." Thus, when the continued lack of clarity on what real estate rentals activities might constitute a trade or business is discussed later in this newsletter, practitioners should bear in mind that the penalty for incorrectly making that determination is based on the lower 5% threshold and the Treasury refused to provide further guidance in this regard. Perhaps practitioners making "close calls" for real estate clients might mention the harsher penalty rules.
- **Previously Suspended 469 Losses**: The Regs provide that previously suspended losses under Section 469 are to be treated as losses from a separate trade or business for purposes of section 199A.
- **Guaranteed Payments for Use of Capital**: "…for purposes of section 199A, guaranteed payments for the use of capital should be treated in a manner similar to interest income. Interest income other than interest income which is properly allocated to trade or business

is specifically excluded from qualified items of income, gain, deduction or loss under section 199A(c)(3)(B)(iii)."

- **U.S. QBI**: "Section 199A(c)(3)(A)(i) provides that for purposes of determining QBI, the term "qualified items of income, gain, deduction, and loss means items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States…" So, for a real estate developer with international interests even if the trade or business hurdle is surmounted allocations of non-US source QBI will have to be made removing that revenue.

CONCLUSION

Under the Proposed Regulations, being classified as a "trade or business" can provide a taxpayer with a significant tax reduction on business income. In order to be classified as a "trade or business," an owner must show that he or she is regularly and continuously involved with the property. Therefore, under the classic definition of a triple net lease, the lessor would not qualify for the 199A deduction, but may qualify based on other facts and circumstance. For non-triple net lease holders, the safest action would be to spend sufficient time on the real estate activity while maintaining contemporaneous time records in order to qualify under the safe harbor of Notice 2019-7.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman

Martn Shenkman

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[i] Because this newsletter is centered on new Final Regulations, as corrected, released by the IRS, a significant portion of the language used in this newsletter comes from a prior newsletter published in LISI by the same authors based on the Proposed Regulations released in 2018. *See* LISI Income Planning Newsletter #161, (November 8, 2018) at http://www.leimbergservices.com.

[ii] Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

[iii] Snyder v. Commissioner, 295 U.S. 134 (1935).

[iv] Id.

[v] Id.

[vi] Higgins v. Commissioner, 312 U.S. 212 (1941).

[vii] Id. at 217.

[viii] City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121 (1941).

[ix] Commissioner v. Groetzinger, 480 U.S. 23 (1987).

[x] Id.

[xi] Id.

[xii] Id.

[xiii] Id.

[xiv] Seebold v. Commissioner, 55 T.C.M. 723 (1988).

[xv] Id.

[xvi] Id.

[xvii] Id.

[xviii] Id.

[xix] Id.

[xx] *See also* Tony Nitti, IRS Provides Guidance On 20% Pass-Through Deduction, But Questions Remain, FORBES (Aug. 9, 2018), https://www.forbes.com/sites/anthonynitti/2018/08/09/irs-providesguidance-on-20-pass-through-deduction-but-questionsremain/#7cf566562ff8.

[xxi] Hazard v. Commissioner, 7 T.C. 372 (T.C. 1946).

[xxii] The Second Circuit decided in Grier v. US that "broader activity" on the part of the owner was needed in order for a rental to constitute a trade or business.

[xxiii] Neill v. Commissioner, 46 B.T.A. 197 (1942).

[xxiv] Hendrickson v. Commissioner, 78 T.C.M. 322 (1999).

[xxv] Schwarcz v. Commissioner, 24 T.C. 733 (1955).

[xxvi] Id. See also Elek v. Commissioner which states that having an agent actively manage and maintain the rental property does not disqualify the owner from engaging in a trade or business.

[xxvii] Bennett v. Commissioner, 83 T.C.M. 1429 (2002).

[xxviii] Id.

[xxix] Id.

[xxx] Id.

[xxxi] Id.

[xxxii] Id.

[xxxiii] Toni Nitti, *supra* note 22.

[xxxiv] Id.

[xxxv] The specific requirements for this safe harbor are discussed further in the newsletter: “One Particular Harbor: New Regulatory Guidance on If and When a Rental Real Estate Activity Can Qualify for the 20% Section 199A Deduction.” LISI Income Tax Planning Newsletter #170, (January 21, 2019) at http;//www.leimbergservices.com.

[xxxvi] C. States, S.E. and S.W. Areas Pension Fund v. Fulkerson, 238 F.3d 891 (7th Cir. 2001).

[xxxvii] Id.

[xxxviii] Id.

[xxxix] Id.

[xl] Id.

[xli] Id.

[xlii] Id.

[xliii] Id.

[xliv] C. States, S.E. and S.W. Pension Fund v. Personnel, Inc., 974 F.2d 789 (7th Cir. 1992).

[xlv] Id.

[xlvi] Id.

[xlvii] All quotations in the following section have been pulled directly from the New Final Corrected Regulations for Section 199A.