

## Tax Notes

# Does My Rental Property Qualify for the New 20% Deduction?

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That's a good question, and one that affects tens of thousands of taxpayers for the 2018 filing year. Included in the Tax Cuts and Jobs Creation Act of 2017 is a deduction for up to 20% of income generated from a qualified business. This is called the Qualified Business Income (QBI) deduction, also known as Section 199A deduction.

Does my rental property qualify for the new 20% deduction? We'll help you get to the answer.

### Qualified Business

So, the first question to consider is: "Do I have a qualified business?" In some circumstances, there is an easy answer to this question. For example, you own a business that sells furniture and generates a profit each year. This is clearly an example of a business. But all examples are not this easy.

### QBI Deduction: Stands Alone

Let's start with who gets to take advantage of the deduction. The deduction is taken at the taxpayer level (in many cases, on an individual's tax return). What's nice about this deduction is that it is separate from the itemized deduction or standard deduction. There has been much discussion on the limitations of itemized deductions in 2018 due to the ceiling of \$10,000 for state and local taxes as well as the elimination of many of the miscellaneous deductions. The QBI deduction is separate.

### Real Estate Connection

The deduction is based on QBI generated from relevant pass-through entities, which include partnerships, Subchapter S corporations, sole practitioners and, in some cases, real estate enterprises. So now we are back to our original question, further delineated: "Does my **rental property** qualify for the new 20% deduction?"

When this new law first was enacted at the end of 2017, this was a major topic of discussion in the accounting profession as to what would qualify as a real estate enterprise and if the activity is truly a business. If you have a shore/beach rental and you don't do anything with this property other than collect rent checks, are you running a business? The reason why this is important is: if it is not a business, the QBI deduction cannot be taken.

### Guidance on Qualifying Rental Property

The first piece of good news is that the IRS issued guidance to help determine if a rental property would qualify as a business. The general rule is if the management of the rental property rises to the level of a trade or business as defined in IRS Tax Code Section 162, then it qualifies for the deduction. Case law has determined that to reach the standard of a Section 162 trade or business, a 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. If, however, the property is rented to a qualified business with common control (similar ownership) then it is automatically considered a trade or business regardless of the involvement.

Determining if the activity rises to the level of a Section 162 trade or business will be based on facts and circumstances leading to a conclusion. In other words, you will need to build your case.

## Safe Harbor Rules for Automatic Qualification of Rental Property

The second piece of good news is that the IRS later released a tax notice which contained very specific circumstances where, if met, the real estate enterprise will automatically qualify as a business under certain safe harbor rules. Among these rules are:

- the requirements that the property must be owned by the taxpayer;
- books and records must be maintained; and
- 250 or more hours of rental services must be performed annually.

Rental services include: advertising, managing the property and overseeing daily operation, repairs and maintenance. It is worth noting that the rental services do not need to be performed by the taxpayer. These services can be done by employees or outsourced.

There are some facts that would exclude the property from the safe harbor rules such as using the property personally for any period of time or renting to a tenant under a triple net lease.

### IRC Section 162: Safe Harbor Workaround

If the activity does not meet the standards of the safe harbor, all is not lost. Remember that the business can still rise to the level of a trade or business under IRC Section 162. But in that case, it does not automatically qualify. The facts and circumstances would dictate.

### Caution

We believe that many real estate rental activities can rather easily meet the general trade or business requirements needed to qualify for the 199A deduction under the principles of IRC Section 162 and that making the safe harbor election (if you can meet and document all the requirements) is unnecessary and undesirable. We feel this way because the safe harbor record keeping requirements, as a condition to qualify for the safe harbor, are onerous, in many cases unmanageable, and require specific representations under penalties of perjury.

### Answer

So, the answer to the question — Does my rental property qualify for the new 20% deduction? — is that *it very well might*.

### Contact Us

If you would like more information about the qualified business income 20% deduction or have any other tax planning or compliance questions, please contact your PKF O'Connor Davies' tax advisor or either of the following partners:

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