



TAX ALERT

Federal Income Tax

Pass-Through Entity 20% Qualified Business Income Deduction

IRS Gives Final Favorable Guidance for Rental Real Estate

The Internal Revenue Service ("IRS") has published important and favorable guidance for allowance of the 20% qualified business income deduction by owners of pass-through entities such as partnerships, limited liability companies, S corporations, or sole proprietorships.

IRS Revenue Procedure 2019-38 ("Rev. Proc. 2019-38") provides for a "safe harbor" allowing certain interests in rental real estate, including interests in mixed-use property, to be treated as a "trade or business" for purposes of the 20% qualified business income deduction under Internal Revenue Code section 199A ("section 199A deduction").

[Rev. Proc. 2019-38](#) was published following the IRS earlier publication of Notice 2019-07 in which the IRS stated that it was aware the question of whether an interest in rental real estate rises to the level of a trade or business for purposes of section 199A is a subject of uncertainty for some taxpayers; and that to help mitigate this uncertainty a proposed version of a revenue procedure containing a safe harbor for treating a rental real estate enterprise as a trade or business solely for purposes of section 199A was released for public comment. Rev. Proc. 2019-38 is issued following IRS consideration of public comments received by it on the subject.

Rev. Proc. 2019-38 provides that if all the safe harbor requirements are met, an interest in rental real estate will be treated as a single trade or business for purposes of the section 199A deduction. If an interest in real estate fails to satisfy all the requirements of the safe harbor, it may still be treated as a trade or business for purposes of the section 199A deduction if it otherwise meets the definition of a trade or business in the section 199A regulations.

The safe harbor for section 199A deduction of expenses incurred with respect to rental real estate is available for taxpayers who seek to claim the section 199A deduction with respect to a rental real estate enterprise.

The IRS guidance provides that solely for purposes of the special safe harbor, a "rental real estate enterprise" is defined as an interest in real property held to generate rental or lease income. It may consist of an interest in a single property or interests in multiple properties.

The taxpayer or a relevant pass-through entity (“RPE”) relying on the guidance stated in Rev. Proc. 2019-38 must hold each interest directly or through an entity disregarded as an entity separate from its owner, such as a limited liability company with a single member.

The guidance in Rev. Proc. 2019-38 states that taxpayers or RPEs must meet the following requirements to qualify for the safe harbor in order for rental real estate to be treated as a trade or business for purposes of the section 199A deduction:

- (1) Separate books and records must be maintained to reflect income and expenses for each rental real estate enterprise.
- (2) For rental real estate enterprises that have been in existence less than four (4) years, two-hundred fifty (250) or more hours of rental services must be performed per year. For other rental real estate enterprises, two-hundred fifty (250) or more hours of rental services must be performed in at least three (3) of the past five (5) years.
- (3) The taxpayer must maintain 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.
- (4) The taxpayer or RPE must attach a statement to the federal income tax return filed for the tax year(s) the safe harbor is relied upon.

The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2020; although the IRS guidance states that taxpayers are reminded that they bear the burden of showing the right to any claimed deductions in all taxable years.

The IRS guidance in Rev. Proc. 2019-38, provides that certain types of property may not be included in a rental real estate enterprise and therefore are not eligible for the safe harbor treatment as a “trade or business” for purposes of the section 199A deduction. These are real estate used by the taxpayer as a residence of the taxpayer, real estate rented or leased under a triple net lease, real estate rented to a trade or business conducted by the taxpayer or an RPE which is commonly controlled, and the entire rental real estate interest if any portion of it is treated as a specified service trade or business under section 199A.

If you would like to discuss section 199A, including the guidance released by the IRS on its application to rental real estate ownership and income, please contact your GableGotwals attorney or any member of our Tax Law Practice Group:

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