Section 199A

Guidance for Real Estate Investors on the 20% Deduction

1031 Knowledge

The tax code provides incentives to encourage taxpayers to invest in real estate. Section 1031 exchanges, which have been a valuable tax deferral strategy since 1921, help real estate investors redeploy capital on a tax-deferred basis at the time of disposition into more desirable "like-kind" replacement properties or a property that provides a better return on investment. A new section of the tax code, Section 199A, offers the potential for certain real estate investors to also receive favorable tax benefits in the form of an added deduction while owning and managing investment properties. The potential to receive tax benefits while owning investment property, coupled with the option for tax deferral in a 1031 exchange at the time of sale, provide investors who own real estate with significant and meaningful tax advantages.

The Tax Cuts and Jobs Act of 2017 ("TCJA") created a new section of the tax code, §199A. Section 199A provides a 20% deduction for owners of certain pass-through entities such as limited liability companies, partnerships and other entities. The intent of this new 20% deduction is to provide some additional tax rate relief and parity to pass-through entities since C-Corporations permanently benefitted from the reduction in the corporate tax rate from 35% down to 21%.

On January 18, 2019, the Treasury released additional guidance regarding the 20% deduction for qualified business income ("QBI") and the 20% deduction provided by §199A of the code. The IRS provided a proposed revenue procedure and proposed safe harbor describing when a "rental real estate enterprise" will be treated as trade or business for purposes of §199A. In Notice 2019-07, the IRS introduced a new tax term, a "rental real estate enterprise" along with conditions that must be met for a rental real estate enterprise to be considered a trade or business and eligible for the §199A deduction. For purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties. The following are requirements that investors must meet to qualify for the safe harbor:

1. Separate records must be maintained for each rental real estate enterprise:
   A. A real estate enterprise can consist of a single or multiple real estate rentals.
   B. Commercial and residential rentals must be in separate enterprises and cannot be combined into the same real estate enterprise.

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2. In the tax years, 2019 – 2023, at least 250 hours of rental services must be performed by the taxpayer or workers for the taxpayer for each rental real estate enterprise.
3. The taxpayer must maintain contemporaneous records including time reports, logs, or similar documents, to document the following:

   A. Hours of all services performed;
   B. Description of services performed;
   C. Dates on which such services were performed;
   D. Who performed the services.

   Rental services that may be counted toward the 250-hour requirement include:

   A. Advertising to rent or lease the real estate;
   B. Negotiating and executing leases;
   C. Verifying information contained in tenant applications;
   D. Collection of rent;
   E. Daily operation, maintenance, and repair of rental property;
   F. Management of the real estate;
   G. The purchase of materials for repairs;
   H. Supervision of employees and independent contractors.

   Rental services for purposes of the rental real estate enterprise safe harbor do not include the following:

   A. Financial activities, such as arranging financing;
   B. Procuring property;
   C. Reviewing financial statements or reports;
   D. Planning, managing, or constructing capital improvements;
   E. Hours spent traveling to and from rental real estate.

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Rental services counted toward the 250-hour requirement may be performed by owners or employees, agents, and/or independent contractors working for the owners. The activities of several individuals may be aggregated for purposes of meeting the 250-hour requirement.

The following types of rental real estate are not eligible for the safe harbor:

A. Real estate owned or managed under a triple net ("NNN") lease agreement.
B. Rental property leased under an agreement that requires the tenant or lessee to pay a portion of the taxes, fees, insurance, and to be responsible for maintenance activities allocable to the portion of the property leased by the tenant.
C. Vacation property used by the taxpayer for any portion of the year.

IRC SECTION 1031 EXCHANGES

The Treasury Regulations also provided clarification regarding the calculation of the unadjusted basis immediately after acquisition ("UBIA") of replacement property acquired by a taxpayer in a §1031 exchange.

The favorable guidance on qualifying for the 20% deduction and the positive outcome on calculating the replacement property basis in a 1031 exchange result in tax benefits that ultimately serve to increase return on investment ("ROI"). Opting for tax deferral via a 1031 exchange provides tax advantages at the time of disposition and now the §199A safe harbor provides investors for further tax benefits when owning investment property. Taxpayers should discuss the §199A deduction and their specific investment situation with tax and/or legal advisors as the 20% deduction rules are complex in some areas.

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