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IRS Issued Proposed Regs on Using Rental Real Estate Income for QBI Deduction

As a follow-up to the ongoing discussion of the Tax Cuts and Jobs Act's qualified business income deduction, we're diving in-depth on how rental real estate income may qualify as QBI under Section 199A.

Overview of the QBI Pass-through Deduction

As a brief review, the TCJA offers a tax deduction of 20% of your qualified business income (QBI). This income may be derived from a partnership, S corporation, or sole proprietorship. While there are many requirements that must be met to qualify for this deduction, one area that has raised questions is that of rental real estate income. Let's take a look at new guidance from the IRS to identify whether or not your real estate income can be included as part of the new QBI deduction.

Using New Deduction for Rental Real Estate Income and Losses

Under the recently proposed IRS regulations, only income from a qualified trade or business is eligible for the QBI deduction. A *trade or business* is an activity carried on regularly and continuously for the purpose of making a profit. Sporadic or hobby activities don't qualify. So, landlords who spend substantial amounts of time managing rental properties will most likely qualify for the deduction.

The IRS and courts generally use a facts and circumstances test to determine if a rental real estate activity is a trade or business (as opposed to an investment). Various factors are considered, including the following:

- The landlord's efforts to rent the property.
- The maintenance and repairs supplied by the landlord (or an agent of the landlord).
- The landlord's employment of labor to manage the property or provide services to tenants.
- The purchase of materials, the payment of expenses, and the collection of rent.

These factors must show that the rental activities are regular and continuous enough to constitute a trade or business. Note that landlords who use an agent to manage the properties can still be engaged in a trade or business.

However, since there are no explicit safe-harbor tests in Section 199A regarding rental income, real estate professionals must rely on case law to prove that their activities amount to a trade or business.

Type of Lease Matters

The IRS and courts also consider the type of lease signed by the parties. One arrangement that is of particular concern is the triple net lease. This is where the tenant pays rent, as well as real estate taxes, building insurance, and maintenance costs. In this scenario, it might be difficult to argue that the property owner is regularly and continuously involved in a trade or business.

There is a special rule, however, for self-rentals. Under rules proposed by the IRS, the rental or licensing of property to a commonly controlled trade or business is treated as a trade or business for purposes of the qualified business income deduction. For this rule to apply, the same person or group of persons must own 50% or more of the rental activity and the related trade or business.

Next Steps

The more involvement you have in your rental real estate, the more likely your income may be included in your QBI deduction. While there is currently no safe-harbor test, practitioners have petitioned the IRS to include these guidelines in the final regulations. Until those may be released, contact your Seiler tax advisor to determine whether your level of involvement meets the trade or business standards using case law precedents.

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