Partnership Activity Aggregation Rules: Unpacking the "Specified Service Trade or Business" Definition

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January 29, 2020

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Partnership Activity Aggregation Rules: Overview, SSTB, W-2 Wage Rules & Special Considerations for Real Estate

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January 29, 2020

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Overview

- Section 199A Overview
- Exclusion for Specified Service Trade or Business (SSTB)
- W-2 Wage Calculation Rules
- Real Estate Safe Harbor

Section 199A Overview

20% Pass-Through Deduction

- The 2017 Tax Cuts and Jobs Act (the "TCJA") created a new deduction that effectively lowers the tax rate on non-corporate taxpayers. It applies to income allocated by an entity taxed as a partnership, an S corporation or a sole proprietorship.
- Individuals, trusts and estates can reduce the taxable income allocated through a pass-through by 20% in certain circumstances. (Does not apply to C corporations that are partners.)
- Assuming an individual was subject to the new top rate of 37%, this will lower the effective tax rate on pass-through income to about 30%.
- The deduction ends after 2025.
- There are <u>many</u> limitations on this benefit.

20% Pass-Through Deduction

- Conceptually, it may be easiest to understand the pass-through deduction as having four major limitations:
    1. The trade/business limitation
    2. The netting limitation
    3. The specified service limitation
    4. The wage/property limitation
- We will discuss each of these in turn, but note that the limitations #3 and #4 do not apply to taxpayers under certain income thresholds.

Trade/Business Limitation

- Under the current regulations, the pass-through deduction generally only applies to a trade or business.
- The term “trade or business” is not defined in the IRC. There are many cases that address the term, but in general it appears not to apply to passive undertakings, such as investment real estate.
- Thus, as a preliminary matter, real estate investments and activities have be analyzed to determine if they are eligible for the pass-through deduction.
- Key – recently the IRS has finalized a rental real estate safe harbor that clarifies matters (see discussion below).

Netting Limitation

- The deduction is computed at the taxpayer level by netting all income and losses from all qualified trades and businesses (QTBs).
- Thus, losses from a QTB will offset qualified business income (QBI) and therefore reduce the benefit of the deduction.
- Example: Taxpayer has QBI of $25,000 from QTB X and losses of $15,000 from QTB Y. The amounts are netted and total QBI is $10,000. The overall 199A deduction, therefore, is $2,000.

Netting Limitation

- Note that if in a given year the losses from QTBs exceed the income from QTBs, then QBI is zero and the loss carries forward to offset QBI in the following year.

- Example: Taxpayer has QBI of $15,000 from QTB X and losses of $25,000 from QTB Y. The amounts are netted and produce an overall loss. Thus, QBI is zero for the year and no 199A deduction is permitted. Moreover, the net QTB loss of $10,000 carries forward to the next year and offsets any QTB income.

Specified Service Limitation

- The pass-through deduction generally only applies to “qualified business income” (QBI).
- QBI is income from a US trade or business, but generally excludes passive investment income and compensatory income.
- By definition, QBI means the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business (QTB).

QTB/Service Limitation

- A QTB means any trade or business other than a specified service trade or business and other than the trade or business of being an employee.
- The definition of “specified service trade or business” has two parts: a fixed list of occupations and a general definition.
- The general definition is any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.
- Note that this is an extremely broad definition that could capture many situations that were not intended.

QTB/Service Limitation

The fixed list includes any trade or business involving the performance of services in the fields of:

- health,
- law,
- accounting,
- actuarial science,
- performing arts,
- consulting,
- athletics,
- financial services,
- brokerage services,
- investing and investment management, and
- trading, or dealing in securities, partnership interests, or commodities.

QTB/Service Limitation

- Note that late in the legislative process, the fields of engineering and architecture were dropped from this list.
- As discussed below, if a taxpayer comes below certain income thresholds, the specified service limitation does not apply.

Wages/Property Limitation

- Generally, the 199A deduction is the lesser of:
  - 20% of the taxpayer's QBI, or
  - the alternative base amount.
- The alternative base amount is the greater of:
  - 50% of the W-2 wages with respect to a business, or
  - The sum of 25% of the W-2 wages and 2.5% of the tax basis of the qualified property of the business
- These limitations are meant to restrict the deduction to "real" businesses rather than investment partnerships or structured arrangements.

Wages/Property Limitation

- The amount of W-2 wages for this limitation is subject to several caveats.
  - First, the term “W-2 wages” means, with respect to any partnership for any taxable year of such partnership, the amounts properly reported and paid by the partnership on an employee’s W-2 statement as wages (section 6051(a)(3) and (8)).
  - Second, the wages at issue must be properly allocable to the QBI at issue and cannot be unrelated wage expense.
  - Third, the term only include wages properly included in a return properly and timely filed with the Social Security Administration.

Wages/Property Limitation

- In the case of a partnership, the pass-through deduction is determined at the partner level. Accordingly, the amount of W-2 wages allocated to the partner must be determined.
- Each partner is treated as having W-2 wages equal to such person's "allocable share" of the partnership's W–2 wages.
- For these purposes, a partner's allocable share of W-2 wages is determined in the same manner as the partner's allocable share of wage expense.

Wages/Property Limitation

The definition of “qualified property” for purposes of the wages/property limitation means:

- tangible property of a character subject to the allowance for depreciation under section 167,
- which is held by, and available for use in, the QTB at the close of the taxable year,
- which is used at any point during the taxable year in the production of QBI, and
- for which the depreciation period has not ended before the close of the taxable year.

Wages/Property Limitation

- The term “depreciable period” means the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of:
- the date that is 10 years after such date, or
- the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to section 168(g)).
- Thus, even if you elect to expense an asset, you get the benefit of the acquisition date tax basis.
- For calculation purposes, the key amount is the adjusted basis of property on the placed in service date. The regulations define this as the “unadjusted basis immediately after acquisition” (UBIA).

Wages/Property Limitation

- As with the wage component, the amount of UBIA allocated to a partner must be determined.
- Each partner is treated as having an “allocable share” of the partnership’s UBIA.
- For these purposes, a partner’s allocable share of UBIA is determined in the same manner as the partner’s or shareholder’s allocable share of depreciation expense.

Thresholds and Limitations

- As noted, the “specified service” limitation and the wage/property limitation do not apply to taxpayers under certain income thresholds.
- The threshold is taxable income of $157,500 ($315,000 for joint filers).
- There is a transition zone from $157,500 to $207,500 ($315,000 to $415,000 for joint filers). The pass-through deduction limitations ratable apply over this transition zone.
- Finally, for taxable income in excess of $207,500 to $207,500 ($415,000 for joint filers), all the limitations apply.

Other Details

- Certain specified items are excluded from the QBI calculation:
  - capital gains and losses
  - dividends and dividend equivalents
  - interest income other than interest income that is properly allocable to a trade or business
  - commodity transactions and foreign currency gains and losses
  - income and deductions arising from notional principal contracts

Other Details

- REIT dividends are generally excluded from QBI, but to put REITs on the same footing as pass-through entities an amount equal to 20% of a taxpayer's qualified REIT dividends is included in QBI and thus eligible for the 199A deduction.
- A qualified REIT dividend is any dividend from a REIT that isn't a capital gain dividend and isn't qualified dividend income.
- Note that REIT dividends are not subject to the complicated specified service limitations or the wage/property limitations but are subject to the netting limitation.

Other Details

- Like the REIT rule, income from a publicly traded partnership ("PTP") is generally excluded from QBI, but an amount equal to 20% of a taxpayer's PTP income included is included in QBI and thus eligible for the 199A deduction.
- Like REIT dividends, PTP income is not subject to the complicated specified service limitations or the wage/property limitations, but are subject to the netting limitation.

AGGREGATION

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- Can maximize 199A deduction
- In most cases T/B
- C/N/B conducted > 1 entity
- Comments requested § 469
- §469 describes activities

Introduction

- §199A applies to T/B
- §199A applies a deduction
- Not based on activity level
- 199A applies to passive O's
- 469 may cover SSTB

T/B

- §162
- Groetizinger
- Regular/Continuous Activity
- Facts and Circumstances
- Profit Motive 1 Building May Qualify
- Self/Rental – “Treated AS”

§ 1411 Preamble

- Even 1 building may qualify
- Several applicable cases
- *Fackler* (6th cir.) 6 Story Apt Bldg.
- *Gilford* (2nd cir.) 8 Buildings

Common Ownership

- Person or Group of Persons
- Directly / Indirectly
- Own 50% or more
- O/S shares; Capital or Profits
- Spouse, Children, G’ch, Parents
- O Majority of Year & Last Day
- Businesses same tax year

Final Regulations

- Adopt Attribution
- 267(b)
- 707(b)

Only T/B's can be aggregated

Need 2 of 3:

1. Same products/services/or property
   OR Customarily offered together
2. Share Facilities **OR**
   Share Significant Centralized business elements ex. Personnel, Legal, HR, purchasing, accounting, IT
3. T/B's operated Coordination/Reliance
   ex. Supply Chain Interdependence

Real Estate

- Not commercial and residential
- Rev. Proc. 2019-38 Permits Bifurcation
- Guidance Needed
- Safe Harbor – Single T/B
- May Aggregate

NOT SSTB!

- But RPE may now Aggregate!
- Reporting – by RPE & Owners

Incidental to SSTB

- **FINAL REGULATIONS REMOVE**
- Part of the SSTB
- Shared Expenses & Common O
- If T/B represents no more than
- 5% Gross Receipts
- Of Combined Business
- **De Minimis Threshold Retained**

Reporting, Disclosure, Consistency

- Statement Identify ea. T/B
- Description T/B
- Name & EIN
- Any new or ceased
- Change in Circumstance

FAIL TO DISCLOSE

- Election timely return
  2018 May elect on amended
- Annually
- Commissioner can disaggregate
- 3 year Rule to Aggregate

PROCEDURE

- If directly operate T/B
- Compute QBI, W-2 wages, UBIA
- For each T/B
- Before applying Aggregation

IF AGGREGATE T/B

- Combine – QBI, W-2, UBIA
- For all aggregated T/B's
- Then apply limitations
- **If under threshold no benefit**

Example – Restaurant & Catering

- Both owned by A in LLC's
- Central Purchasing, Accounting, Web
- Restaurant prepares for Catering
- Same product food, Same Kitchen
- May Aggregate

Example – Four Hardware Stores P'ships

- E owns 60%; F owns 10%
- Central Mgmt., Accounting, HR
- E aggregates 1, 3, & 4 - #2 loss
- Loss netted against profits
- F may also aggregate
- Why not aggregate #2?

Self-Rental § 469 & 199A

- § 469 Heads they win – Tails …
- But not subj. to 3.8
- 199A – **Treated as** a T/B
- Common Control
- Rented/Licensed to T/B
- Final Regulations Proportional

Self Rental – S Corp Bldg

- Used by LLC #1, Factory
- + LLC #2 Retail
- Common Mgt. & Advert
- S **treated as** T/B §1.199A-1(b)(13)
- Rented/Licensed T/B Common owned
- S included in Aggregated group

What if Not Self-Rental ?

- §162 T/B?
- Notice 2019-7
- Rev. Proc. 2019-38

LLC Sells Cleaning Supplies

- LLC 2 Trucking for LLC 1
- Meet Reliance Test But Fails –
- Cannot Aggregate
- Need another factor
- Proper Planning Important

RPE

- May conduct several T/B
- Each T/B – Separate Books

→Must be separately reported

- Final Regulations

→ **RPE MAY AGGREGATE**

LOSSES

- Sec. 199A Carryover Losses
- Excess Business Losses
- Net Operating Losses

STILL HERE

- Basis Rules
- At-Risk Rules
- Passive Activity Loss Rules

SECTION 199A LOSS

- Net Losses from QT/B
- Loss from QT/B in Succeeding Year
- Reduces Future QBI Deduction
- May still use loss to offset income

SEC. 199A LOSS EXAMPLE

- Year 1
- QB1: QBI = $20,000
- QB2: Net Losses = <$50,000>
- No QBI deduction in Year 1
- Future QBI Deduction reduced

2019 Example XYZ Restaurants

- T Owns 70% A 30%
- A Executive Chef; Central Ordering
- T married TI = $520,000
- Negative QBI carryforward $150,000
- Not NOL Not EBL
- Loss may offset wages

SECTION 199A LOSS

- Net Losses from QT/B
- Loss from QT/B in Succeeding Year
- Reduces Future QBI Deduction
- May still use loss to offset income

EXAMPLE CONTINUED

	X	Y	Z
• QBI	$200,000	$150,000	<$120,000>
• W-2	$100,000	0	500

- Loss Allocated:
- Carryover $150,000 + $120,000
- **Net Positive QBI $80,000**

Loss Allocated

- To X = 57.14% (200/350)
- To Y = 42.86%

	X	Y
QBI	$45,722	$34,278
W-2	$100,000	$0

199A Deduction

	X	Y
20% QBI	$9,144	$6,856
50% W-2	$50,000	0
199A	$9,144	0

20% TI higher - **199A = <u>$9,144</u>**

Aggregated XYZ

- 20% QBI $80,000 = $16,000
- 50% Wages $100,500 = $50,250
- 199A Deduction = $16,000

EXAMPLE

- 3 Rental Properties, 200 hours each
- 3 Net Lease properties, 100 hours each
- Unless aggregate fail, 750 hour test
- NII Considerations – grouping respected

W-2 Wage Calculation Rules

- Definition of W-2 Wages for QBI
- Rev. Proc. 2019-11 Permissible Methods
- Allocating W-2 Wages to Pass-Through Entity Owners
- Impact of Reasonable Compensation Requirements on QBI Deduction Calculations

Definition of W-2 Wages for QBI

Wages Limitation

- Generally, the deduction is the lesser of:
  - 20% of the taxpayer's QBI
  - The alternative base amount.
- The alternative base amount is the greater of:
  - 50% of the W-2 wages with respect to a business, or
  - The sum of 25% of the W-2 wages and 2.5% of the tax basis of the qualified property of the business
- These limitations are meant to restrict the deduction to "real" businesses rather than investment partnerships or structured arrangements.

Wages Defined – General

- The amount of W-2 wages for this limitation is subject to several caveats.
  - First, the term “W-2 wages” means, with respect to any partnership for any taxable year of such partnership, the amounts properly reported and paid by the partnership on an employee’s W-2 statement as wages.
  - Second, the wages at issue must be properly allocable to the QBI at issue and cannot be unrelated wage expense.
  - Third, the term only include wages properly included in a return properly and timely filed with the Social Security Administration.

Wages Defined

- Section 199A(b)(4)(A) provides that W-2 wages means, with respect to any person for any taxable year of such person, the sum of the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.
- Accordingly, for these purposes, W-2 wages include:
  - the total amount of wages as defined in §3401(a);
  - the total amount of elective deferrals under §402(g)(3);
  - compensation deferred under §457; and
  - the amount of designated Roth contributions as defined in §402A.

Rev. Proc. 2019-11 Methods

Permitted Methods – General

- Rev. Proc. 2019-11 sets forth three permitted methods to determine W-2 wages for purposes of the Section 199A limitation:
  1. the unmodified Box method
  2. the modified Box 1 method, and
  3. the tracking wages method
- Generally, the first method allows for a simplified calculation while the second and third methods provide greater accuracy.
- Note that each of these methods assumes a full tax year. In the case of short tax years, special adjustments are required.

The Unmodified Box Method

- Under the unmodified box method, W-2 wages are calculated by taking, without modification, the lesser of:

  (A) The total entries in box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or

  (B) The total entries in box 5 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

- Recall that box 1 of IRS Form W-2 lists all "wages, tips, other compensation," while box 5 lists all "Medicare wages and tips."

The Modified Box 1 Method

Under the Modified Box 1 method, W-2 wages are calculated as follows:

- (A) total the amounts in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer;
- (B) subtract any amounts included in Box 1 that are not wages for Federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under section 3402(o) (e.g., supplemental unemployment compensation benefits); and
- (C) add the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

The Modified Box 1 Method

Note W-2 Box 12 codes relevant here are:

- Code D -- elective deferrals to a section 401(k) cash or deferred arrangement plan
- Code E -- elective deferrals under a section 403(b) salary reduction agreement
- Code F -- elective deferrals under a section 408(k)(6) salary reduction Simplified Employee Pension (SEP)
- Code G -- elective deferrals and employer contributions to any section 457(b) deferred compensation plan
- Code S -- employee salary reduction contributions under a section 408(p) simple retirement account

The Tracking Wages Method

Under the tracking wages method, the taxpayer actually tracks total wages subject to federal income tax withholding, with appropriate modifications. W-2 wages under this method are calculated as follows:

- (A) Total the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with SSA by the taxpayer for the calendar year; plus
- (B) The total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

Allocating W-2 Wages

Allocating Wages

- In the case of a partnership, the pass-through deduction is determined at the partner level. Accordingly, the amount of W-2 wages allocated to the partner must be determined.
- Each partner is treated as having W-2 wages equal to such person's "allocable share" of the partnership's W–2 wages.
- For these purposes, a partner's allocable share of W-2 wages is determined in the same manner as the partner's allocable share of wage expense.

Allocating Wages

- Example 1: A, B and C are equal owners of Newco, an LLC taxed as a partnership. Under the operating agreement, all items of income and deduction are allocated equally among A, B and C.
- In 2019, Newco has $90 of W-2 wages. For purposes of Section 199A, each member is allocated $30 of W-2 wages.
- Example 2: Same facts, A is entitled to a preferred return. If Newco does not generate sufficient income, then B and C are allocated expense items as necessary. Assume as a result that B and C are allocated $45 each of W-2 expense. Accordingly B and C are each allocated $45 of W-2 wages for Section 199A purposes.

Allocating Wages

- Example 3: Same facts, but the operating agreement provides that no allocations are permitted that would result in negative capital accounts.
- Assume that at the start of 2019, A and B have zero capital accounts and that any allocation of W-2 wages to A or B is barred because it would create negative capital accounts. Thus, all $75 of wages are allocated to C for tax purposes. Accordingly C is allocated $75 of W-2 wages for Section 199A purposes.

Impact of Reasonable Compensation Requirements on QBI Calculations

General

- The final regulations clarify that amounts received by an S corporation shareholder as reasonable compensation or by a partner as a payment for services under sections 707(a) or 707(c) are not taken into account as qualified items of income, gain, deduction, or loss, and thus are excluded from QBI.
- Note that these concepts do not appear to apply to sole proprietors.

S Corporation Example

- Jane is a shareholder-employee of Newco, an LLC taxed as an S corporation.
- In 2019, she received stated wages of $100 and an allocation of $500. Assume the $100 of wages is reasonable compensation under all the facts and circumstances.
- Under the final regulations, Jane's $100 of wages is added to any other proper W-2 wage amounts for purposes of computing the W-2 wages of Newco
- However, Jane cannot count the $100 as QBI. She is limited to her allocation of $500.

Partnership Example

- Jane is a member of Newco, an LLC taxed as a partnership.
- In 2019, she received a guaranteed payment of $100 and an allocation of $500.
- Under the final regulations, Jane's $100 of guaranteed payments is not treated as W-2 wages for purposes of the 199A limitation.
- In addition, Jane cannot count the $100 as QBI. She is limited to her allocation of $500.

Sole Proprietor Example

- Jane is the sole member of Newco, an LLC taxed as a disregarded entity.
- In 2019, Newco had $600 of profits. Assume Jane would otherwise be entitled to $100 for services provided to Newco.
- Under the final regulations, Jane has $600 of QBI.
- Jane's $100 worth of services are not treated as W-2 wages for purposes of the 199A limitation.

Special Considerations for Real Estate

- Affiliated Real Estate Activities
- Rental Real Estate Safe Harbor

Affiliated Real Estate Activities

- As noted above, Section 199A generally only applies to an activity that is a “trade or business.”
- However, the final regulations carve out an exception in the case of the activity of renting or licensing tangible or intangible property to a related trade or business.
- In general, if the rental activity and the related trade or business are under common control under the aggregation rules, then the rental activity can be aggregated with the related trade or business.
- The net effect is to convert the rental activity into a trade or business.

Rental Real Estate Safe Harbor

General

- Recall that Section 199A only applies to an activity that is a “trade or business.”
- This is a term of art that is not explicitly defined in the Code and for which vague guidance can be found in case law.
- In general, the case law would suggest that many real estate activities might not qualify under this definition.
- Moreover, in the final regulations no effort is made to provide clarity on the application of this term to real estate activities.
- Real estate owners, developers and investors thus faced uncertainty as to whether the incentives under 199A could apply to them.

Safe Harbor for Rental Real Estate

- On January 18, 2019, along with the issuance of the final regulations, the government released Notice 2019-07 which describes a safe harbor for rental real estate.
- Demonstrating a gift for understatement, the notice prefaces the safe harbor by stating that the “Treasury Department and the IRS are aware that whether a rental real estate enterprise is a trade or business for purposes of section 199A is the subject of uncertainty for some taxpayers.”
- The gist of the proposed relief is to create a safe harbor under which rental real estate will be treated as a trade or business for purposes of 199A.

Notice 2019-07

The safe harbor sets out three requirements:

1. Separate books and records must be maintained to reflect income and expenses for each rental real estate enterprise.
2. At least 250 hours of rental services must be performed each year with respect to the rental enterprise.
3. The taxpayer must maintain contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records must be made available for inspection at the request of the IRS.

Rental Real Estate Enterprise

- Note that the safe harbor only applies to a “rental real estate enterprise” or RREE
- An RREE is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties.
- The individual or pass-through entity relying on this revenue procedure must hold the interest directly or through a DRE.

Aggregation Rules for Safe Harbor

- Taxpayers must either treat each property held for the production of rents as a separate RREE or treat all similar properties held for the production of rents as a single RREE.
- Commercial and residential real estate may not be part of the same enterprise.
- Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances.

Rental Services

- The second and third requirements of the safe harbor require the performance of “rental services.”
- Under the safe harbor, rental services include:
  1. advertising to rent or lease the real estate;
  2. negotiating and executing leases;
  3. verifying information contained in prospective tenant applications;
  4. collection of rent;
  5. daily operation, maintenance, and repair of the property;
  6. management of the real estate;
  7. purchase of materials; and
  8. supervision of employees and independent contractors.

Rental Services – Exclusions

- Although the above list is not stated as exclusive, the safe harbor specifically excludes:
  - financial or investment management activities, such as arranging financing; procuring property;
  - studying and reviewing financial statements or reports on operations;
  - planning, managing, or constructing long-term capital improvements; and
  - hours spent traveling to and from the real estate.

Who Can Perform Rental Services

- Rental services can be performed by owners, employees, agents, and/or independent contractors of the owners.
- KEY – unlike the passive activity rules that require the taxpayer or a spouse to work a certain number of hours in the activity each year, this requirement is met even if the services are carried out by a third party.
- Accordingly, it will become very important that vendors who perform services that could be counted towards the 250-hour requirement provide documentation.
- It may be necessary to condition the payment to the vendor on the receipt of such records.

250-Hour Requirement

- The 250-hour requirement is an annual requirement, but the safe harbor relaxes this starting in 2023. At that point, the 250-hour requirement need only be satisfied in any three of the five consecutive years ending with the taxable year.
- The contemporaneous documentation requirement does not appear to apply to the 2018 tax year.
- However, the wording here is ambiguous. The government may mean that documentation is always required, but that the 2018 documentation can be created after the fact.

Safe Harbor – Exclusions

The safe harbor sets our four significant limitations or exclusions:

1. The safe harbor only applies to rental real estate.
2. The safe harbor does not apply to triple net leases.
3. The safe harbor does not apply to owner residences.
4. The safe harbor does not permit aggregation of commercial and residential real estate.

Exclusion for Non-Rental Real Estate

- The safe harbor only applies to rental real estate. Thus, some traditional forms of real estate development may not come within the safe harbor.
- But -- in some cases traditional development activities can qualify as a trade or business under the vague standards of the case law. Documenting these activities and the hours involved will be helpful.
- However, because of the benefit of coming within the safe harbor it may be worth considering changing the activity's business model to come within the rental real estate limitation.
- Finally, if the activity does not qualify as rental real estate but is designed to result in a disposition at long-term capital gains rates, then the incentive may not apply in any event. In general, the Section 199A benefit does not apply to income taxed as long-term capital gains.

Exclusion for Triple Net Leases

- The safe harbor excludes real estate rented or leased under a triple net lease.
- For these purposes, a “triple net lease” includes a lease that requires the lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities.
- Note that this limitation may be very difficult to stomach for many existing rental real estate arrangements.
- One solution may be to amend existing leases to eliminate maintenance activities. In exchange, the projected expense would be built into the rents. (A pure pass-through of maintenance expenses incurred by the lessor may not work.)
- Note that if the lessor takes on maintenance activities, then these activities would appear to meet the definition of rental services and thus facilitate achievement of the 250-hour requirement.

Exclusion for Owner Residences

- The safe harbor does not apply to real estate used by a taxpayer or any owner or beneficiary of a pass-through entity relying on this safe harbor as a residence for any part of the year.

Commercial/Residential Aggregation

- The aggregation rule can help taxpayers in cases where the 250-hour requirement cannot be satisfied for individual rental arrangements, but can be satisfied on an aggregate basis.
- However, the safe harbor stipulates that commercial and residential real estate may not be aggregated. This may make it harder to satisfy the 250-hours requirement.
- Example: Assume a taxpayer has two rental activities, one of which is commercial real estate for which 150 hours of rental services are performed each year, and one of which is residential real estate for which 150 hours of rental services are performed each year. The taxpayer does not appear to meet the 250-hour requirement unless the activities can be aggregated.
- The safe harbor does not cite any rationale for preventing a taxpayer from aggregating commercial and residential real estate activities.

Thanks!

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