Rental Tax Issues Worth Watching

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Rental real estate is an active area in terms of taxation. The Internal Revenue Service (IRS) and the courts are continually fleshing out positions and issues.

IIn recent times, the areas showing the most activity for new developments of rental real estate are passive loss limitations, whether real estate leasing is an investment or a business, the Section 199A Qualified Business Income (QBI) deduction, Subchapter S and real estate leasing, and the self-employment tax.

The Takeaway

Issues impacting rental real estate are constantly changing, and individuals who work in that market need to stay informed. Currently, passive loss limitations, whether real estate leasing is an investment or a business, the Section 199A Qualified Business Investment deduction, Subchapter S and real estate leasing, and the self-employment tax are the issues most worth watching.

Rental Real Estate and Passive Activities

Passive activity limitations are a principal conceptual idea that pervade tax reporting for a wide array of taxpayers, particularly real estate professionals. Generally speaking, the tax regime of passive activity limitations requires losses derived from passive activities (passive losses) to be offset only by gains from passive activities (passive gains). Conversely, losses from nonpassive activities can be offset against any income. The importance of passive loss limitations to real estate investors and professionals cannot be overstated, and neither can the complexity of the subject matter.

Income or loss from rental activities is generally considered to be passive. The exceptions to this rule offer hope that passive loss limitations can be avoided. There are four major exceptions to consider:

- **Transient lodging leasing.** Certain rental-related activities are deemed nonpassive because they are considered trades or businesses, not rental activities. Transient lodging activities, such as hotels, are obvious examples. Income or loss from activities under this exception are nonpassive if the taxpayer materially participates (as opposed to only invests). Material participation requires regular, continuous, and substantial involvement. The IRS has released temporary regulations amplifying this exception. The conceptual idea of the temporary regulations is that if property is rented for a short period (such as seven days or less, on average) or if significant personal services are provided, then the rental real estate activities resemble a trade or business, not passive rental activity. If an activity satisfies the rules of the temporary regulations for this exception, then whether income or loss from the activity is passive or nonpassive depends on material participation by the taxpayer.

- **$25,000 loss deduction.** Active participation by a taxpayer in rental real estate activity enables the taxpayer to deduct up to $25,000 of losses from rental real estate under certain circumstances free of the bar of passive loss limitations. This rule applies only to individuals. Any loss above $25,000 is carried over to the next year. To qualify, the individual taxpayer must own 10 percent of the value of the enterprise or activity and must "actively participate" in the rental property's operations. To be an active participant in a rental real estate activity, an individual's participation need not be regular, continuous, and substantial, but the individual must participate "in a significant and bona fide sense." Active participation is thus defined to be less stringent than material participation and would include making management decisions or arranging for others to provide services.

  For example, the lower threshold of the active participation requirement is met by an individual who rents out a house that was previously his principal residence or rents out a vacation home when the property is not being used, even if a rental agent is retained and repairs and other services in connection with the property are performed by contractors. However, this minimal level of involvement must be shown by the taxpayer's activities alone because the activities of agents and employees are not considered.

  The $25,000 loss amount is reduced for those whose adjusted gross income exceeds $100,000 and is totally phased out for adjusted gross income more than $150,000. Current developments in this self-rental exception include such issues as combining various self-rented properties and whether spousal activities should be combined with the taxpayer's activities.

- **Self-rental property.** Income from activity such as self-rental of property can be characterized as nonpassive even though the activity is passive. For example, property a taxpayer rents to a trade or business in which the taxpayer materially participates is self-rented property. Losses from self-rented property are characterized as passive, but income is nonpassive income.

- **Real estate trade or business status.** For taxpayers who qualify as real estate professionals, losses from rental real estate activities can offset nonpassive (or active) income from wages, interest, and dividends. To qualify for real estate professional status:
  - more than 50 percent of the taxpayer's personal services during the year must be performed in real property trades or businesses in which the taxpayer materially participates, and
  - the taxpayer must perform more than 750 hours of service in the real estate trades or business.

  For a taxpayer to treat losses from a rental real estate activity as active (rather than passive), he must both materially participate in that specific rental real estate activity and meet the 50 percent and 750-hour eligibility requirements.

  Current developments in this exception include issue of aggregation of rental real properties to meet the material participation test. The Tax Court ruled that a trust that held and developed rental and other real estate properties qualified for the exception for real estate professionals (*Frank Aragona Trust v. Commissioner*).

Rental Real Estate as Investment or as Trade or Business

The tax law contains a significant fault line over whether an activity qualifies as a trade or business or as an investment. Historically, the capital gain-ordinary loss rule has served to distinguish between the two. Today, however, that distinction involves other tax provisions, such as the QBI rule of Section 199A (discussed later).

The question is whether the taxpayer's activities in connection with rental real estate property, whether conducted personally or through an agent, are so extensive that the activities give rise to a trade or business. Generally speaking, a taxpayer must be engaged in the activity with continuity and regularity, and the primary purpose for engaging in the activity must be for income or profit.

Based on IRS Chief Council Advice 201427016, taxpayers may group together one or more trades or businesses into one trade or business. In the pronouncement, the IRS permitted a taxpayer with a real property development trade or business and two rental properties to treat the three activities as one real property trade or business.

In addition, in *Miller v. Commissioner* the taxpayer was engaged in both construction and rental activities. In measuring the hours spent on real property trades or business, the Tax Court combined hours spent on the activities as one real property trade or business. Grouping in this way is advantageous because the next step to qualify as a real estate professional requires the taxpayer to materially participate in his or her real property trades or businesses. Combining activities into one real property trade or business increases the likelihood the combined hours spent on the grouped business will satisfy the material participation requirement.

Current developments involving this fault line mostly include judicial decisions in which property is sold at a loss, with the taxpayer arguing that he is engaged in a trade or business that enables him to take an ordinary loss rather than a capital loss. When ruling on such cases, the courts commonly consider the:

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

In a decision rendered in 2020, taxpayers were denied trade or business treatment for restoration of a historical Newport, RI, home (*Keefe v. Commissioner*). The husband was a physician, the wife an art educator and historian. They extensively rehabilitated the home over a period of years. The house was never rented. They sold the property in 2009 at a substantial loss and took the loss as ordinary, claiming they were in the real estate leasing business. The Tax Court (later affirmed by the Second Circuit) found the taxpayer did not have regular and continuous rental activities, and thus held the sale produced a capital loss.

Rental real estate can be on either side of this fault line with significantly different tax outcomes. For example, in one case the Tax Court found a taxpayer operating a sole proprietorship in the sale and rental of portable signs was engaged in a trade or business (*Stevenson v. Commissioner*). The taxpayer purchased the portable signs, advertised their availability, received telephone calls for their rental, and maintained bank accounts for the rental venture.

The QBI deduction relies on the basic definition of trade or business (found in Section 162), so there is a high likelihood that a continuous line of judicial decisions will try to determine whether or not a trade or business exists.

The IRS requires consistency of reporting. If a taxpayer owns tenancy-in-common interests in rental real estate and owns joint venture interests treated as a partnership, the IRS will be interested in whether the taxpayer treats both in the same manner for the QBI deduction.

Qualifying Business Deduction of Section 199A

Congress enacted Section 199A on Dec. 22, 2017, to provide noncorporate taxpayers a QBI deduction of up to 20 percent of the taxpayer's qualified business income from each of the taxpayer's qualified trades or businesses. These include those operated through a partnership, S corporation, or sole proprietorship. Section 199A provided a deduction of up to 20 percent of aggregate real estate investment trust dividends and qualified publicly traded partnership income. Since enactment, the deduction allowed by Section 199A has attracted much attention.

Revenue Procedure 2019-36 is a principal current development in the area of rental estate and Section 199A. In the procedure, which was issued Oct. 15, 2019, the IRS provides a safe harbor for a rental real estate enterprise to be treated as a trade or business for obtaining the QBI deduction under IRC Section 199A. The IRS offers the safe harbor because of the substantial uncertainty over whether an interest in rental real estate rises to the level of a trade or business for purposes of Section 199A.

Regulations Section § 1.199A-1(b)(14) provides that rental or licensing of tangible or intangible property (rental activity) that does not constitute a Section 162 trade or business is nevertheless treated as a trade or business for purposes of Section 199A if the property is rented or licensed to a trade or business conducted by the individual or a relevant pass-through entity, which is commonly controlled under Section 1.199A-4.

Safe harbor requirements include:

- A taxpayer (or pass-through entity) relying on the safe harbor must hold the interest directly or through a disregarded entity.
- Multiple properties of the same category (residential or commercial) can be treated as a single enterprise provided the individual or pass-through entity also includes all other properties of the same category in the enterprise.
- With the exception of mixed-use property, residential and commercial properties cannot be combined into a single enterprise.
- Once a taxpayer treats interests similarly (i.e., either residential or commercial properties as a single rental real estate enterprise), he must continue to treat interests in all similar property, including newly acquired properties, as a single enterprise while he relies on the safe harbor.
- A taxpayer who treats his interest in each residential or commercial property as a separate enterprise may treat his interests in all similar properties as a single enterprise in a future year.

Triple net leases offer a layer of complexity. The IRS' position is that triple net leases cannot qualify for the rental real estate safe harbor of Rev. Proc. 2019-38, especially when the tenant pays all of the expenses, but facts and circumstances may change the outcome so that a certain triple net lease could qualify as a trade or business.

The safe harbor is just that. Failure to meet the safe harbor does not mean that a rental real estate enterprise is not capable of qualifying as a trade or business. Those who are not in the safe harbor face the risk of an IRS challenge.

Self-Employment Income

Net earnings from self-employment equals gross income less allowable deductions from a taxpayer's trade or business, as determined under the income tax rules, plus a distributive share of partnership taxable income or loss from any trade or business in which the taxpayer is not a limited partner, regardless of whether the partner's involvement is passive or active. Certain deductions for income tax purposes are not allowed when calculating net earnings from self-employment even though they relate to the trade or business activity generating the self-employment tax liability.

Rent from real estate is not self-employment income unless it is received by a real estate dealer in the ordinary course of business or unless substantial services are provided for the occupants. In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real estate dealer. Rents received on property held for sale in the ordinary course of business qualify as self-employment income, but rents received on property held for investment or speculation do not.

Current developments in this area of applying self-employment income to rental real estate are mostly judicial decisions. For example, the Tax Court decided that business interruption proceeds were not subject to self-employment tax unless the individual is currently involved in the day-to-day conduct of his trade or business (*Newberry v. Commissioner*). The IRS took exception to the decision. Other cases involve the question of whether work by agents or employees or even downline agents is sufficient to subject the taxpayer to self-employment taxes.

From time to time, the IRS announces positions that influence how issues are interpreted. For example, the IRS has taken the position that annual rental payments a farmer receives for land enrolled in the U.S. Department of Agriculture's Conservation Reserve Program (CRP) are self-employment income regardless of whether the taxpayer is actively engaged in farming or is an inactive landlord or investor. The Eighth Circuit disagreed with the IRS and held that CRP payments made to nonfarmers constitute rentals from real estate and are excluded from the self-employment tax (*Morehouse v. Commissioner)*. The IRS treats CRP payments as self-employment income when received by nonfarmers who purchase land already enrolled in the CRP program by previous owners and who personally take on the responsibility to fulfill the remaining CRP contractual obligations.

Subchapter S and Real Estate Leasing

Real estate leasing activities impact a Subchapter S status in subtle ways and should be included in any list of current developments. An S election is terminable if the corporation derives more than 25 percent of its gross receipts from passive investment income for three consecutive years and the corporation had regular corporate (not S Corp) earnings and profits at the close of each of those years.

If a corporation's S election is terminated because of the existence of excess passive investment income for three years, the termination is not retroactive. To add to the punishment, in addition to the termination rules, if an S corporation has passive investment income in excess of 25 percent of gross receipts and has Subchapter C earnings and profits at the close of any taxable year, it will be subject to a corporate tax.

With a few exceptions, "passive investment income" consists of royalties, rents, dividends, interest, annuities, and amounts received from the sale or exchange of stock or securities (but only to the extent of the gains therefrom). In some circumstances, this means income from real estate rentals could threaten an S Corporation election.

In a surprising announcement, the IRS indicated in Revenue Procedure 2011-3, 2011-1 IRB 111 that it would no longer rule on whether gross receipts from royalties, rents, dividends, interest, and annuities were passive investment income for purposes of IRC § 1362(d)(3). Given the lack of specificity in the regulations and taxpayers' previous reliance on private letter rulings in these areas, the no-rule position was an unfortunate development.

One of the most difficult questions raised by the passive investment income rule is what constitutes rent. The regulations say the term "rents" means amounts received for the use of, or the right to use, real property.

Rent does not include rents derived in the active trade or business of renting property. The regulations provide that rents are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business.

A significant body of cases and rulings speak to this issue. The intent of this article is not to provide a listing of all authorities in the area, but rather to point out that this issue is about facts and circumstances and should be of interest to anyone who operates a rental real estate business through an S Corporation.

Stay Vigilant

The reality is that new developments do not provide clarity on rental real estate issues. Judicial decisions are slightly helpful to those not directly involved. IRS interpretative pronouncements frequently leave as many questions as they answer.

The bottom line for those in rental real estate is to remain vigilant for current issues.

Tax laws are complicated, so be sure to consult a tax accountant or tax attorney before making financial decisions.

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