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On February 27, 2019, the *Daily Transcript* featured Miller Monson attorney, Judy Bae, as one of San Diego's Influential Women in the field of law for 2019. The article featured Judy and her work with San Diego's legal community and organizations.

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SAFE HARBOR FOR PASS-THROUGH DEDUCTION FOR REAL ESTATE: LANDLORDS SHOULD TAKE ACTION NOW

By Katie Lepore, CPA, J.D., LL.M., Taxation

Landlords should be aware of new recordkeeping requirements if they want to qualify for tax breaks.

Internal Revenue Code ("IRC") Section 199A was instituted in December 2017 under the Tax Cuts and Jobs Act. It allows a deduction of up to 20% of "qualified business income." The Section is effective for tax years 2018 through 2025. Proposed Regulations were released August 8, 2018, which stated that only "trades or businesses" would qualify for the deduction, as defined under IRC Section 162. This requirement leaves much uncertainty since the IRC Section 162 "trade or business" qualification is largely a facts-based test and is not actually defined in IRC Section 162. Taxpayers and tax advisors alike submitted comments to the IRS about this uncertainty, especially with regard to rental real estate.

Final Regulations were released on January 18, 2019 along with Revenue Procedure 2019-11 (guidance to calculate W-2 wages). In conjunction with the final Regulations and Revenue Procedure, the IRS also released a proposed Revenue Procedure in Notice 2019-07, which provides a safe harbor for rental real estate to qualify as a trade or business for purposes of Section 199A. Section 199A is rather complex and multi-faceted; the safe harbor and its application to rental real estate will be the sole focus of this article. Taxpayers may rely on the safe harbor provided in the Notice until it is published as a final Revenue Procedure.

General Background

Section 199A is applicable to non-corporate taxpayers only, including some trusts and estates[1]. The Section allows a deduction for

[1] Prop. Reg. 1.199A-6(d)(3)(vii) provides that a trust formed or funded with the principal purpose of receiving a

"qualified business income," which is a defined term in Section 199A. Sole proprietorships are included as a source of pass-through income in addition to partnerships, S-corporations, limited liability companies, and some trusts and estates. The Section is complex and has different calculations depending on the type of business and the income levels of the taxpayer, and has further possible restrictions based on the wages paid or depreciable assets of the business. Only qualified trades or businesses are eligible for the deduction. Provided next is analysis of the safe harbor distinguishing whether the rental real estate qualifies as a trade or business eligible for the deduction. If it does qualify, taxpayers will need to analyze their income levels and, if required, the further restrictions based on wages paid and depreciable assets, in order to calculate the allowable deduction.

Notice 2019-07

Notice 2019-07 solely applies to Section 199A trade or business analysis. Therefore, whether a real estate enterprise qualifies as a trade or business for Section 199A will not extend automatically to make the same real estate enterprise qualify as a trade or business under Section 162 or any other section. If a taxpayer's rental real estate does not qualify as a trade or business under the safe harbor, it may still qualify for Section 199A if it can be considered a "trade or business" under Section 162; therefore, the two Sections are not mutually exclusive. The Notice also applies to taxpayers and pass-through entities that hold real estate through a disregarded entity. Rental real estate is defined in the Notice as "an interest in real property held for the production of rents."

Separate Books and Records

The first requirement to qualify as a trade or business under the Notice is to keep separate books and records. The taxpayer must either treat each real property held for the production of rents as a separate "enterprise," or treat all similar properties as a single enterprise. Therefore, for example, several single-family homes used to collect rents may be grouped together as the same "enterprise." However, commercial properties must be separated from residential properties and cannot be part of the same enterprise. Triple net lease properties unequivocally do not qualify as a real estate enterprise under the safe harbor. Once the taxpayer chooses the grouping to define the enterprise, the grouping cannot be changed unless there is a significant change in facts and circumstances. The taxpayer must maintain separate books and records to reflect income and expenses for *each enterprise.*

250 Hours

The second requirement to qualify for the safe harbor is that the taxpayer must perform 250 hours or more of "rental services" with respect to the enterprise, for taxable years prior to 2023. For tax years 2023 and beyond, taxpayers must have 250 hours or more of rental services for 3 of the past 5 consecutive years (or in each year if the enterprise has been held less than 5 years).

Rental services include: advertising to rent or lease the real estate; negotiating and executing leases; verifying information contained in prospective tenant applications; collection of rent; daily operation, maintenance, and repair of property; management of real estate; purchasing materials; and, supervising employees and independent contractors.

Rental services do not include: arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing or contracting long term capital improvements; or travelling to/from the real estate enterprise.

The rental activities can be performed by the owner and/or employees, agents, or independent contractors of the owner.

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deduction under Section 199A will not be respected, to deter taxpayers from dividing assets among multiple trusts to maximize the deduction. Special rules also exist with regard to charitable remainder trusts and other split-interest trusts.

Contemporaneous Records
The final requirement under the Notice to qualify for the safe harbor is to maintain contemporaneous records including time reports, logs, and similar documents with regard to: hours of services performed; description of services performed; dates the services were performed; and, who performed the services. The contemporaneous records requirement must be maintained for tax years 2019 and forward to meet the safe harbor, since the Notice was not published until January 2019. For tax year 2018, contemporaneous records are not required but taxpayers must still meet the 250-hour requirement and sign a statement under penalty of perjury on the tax return that the taxpayer met such standards.

This seems to imply that unless the taxpayer can meet the 250-hour requirement solely by his own efforts, landlords should be requesting detailed invoices from all contractors and employees showing the hours worked, description of the services, dates performed, etc. The Notice does not restrict the definition of an agent or independent contractor, so that would presumably include everyone from the property manager to the weekly gardener to the plumber who fixes a leaky pipe. **Taxpayers who think they may qualify for the deduction should begin this detailed recordkeeping immediately since the recordkeeping requirement is contemporaneous and 2019 is already underway.**

Exclusions
As mentioned previously, triple net leases do not qualify as a trade or business for purposes of the safe harbor; they may still qualify as a trade or business under IRC Section 162. Also, any property used by the taxpayer as a residence for any part of the year under IRC Section 280A is ineligible under the safe harbor.

Claiming the Safe Harbor
In order to claim the safe harbor, the taxpayer must include a statement attached to the return specifying that the requirements have been met. This statement must say, "Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete." The individual(s) signing the statement must have personal knowledge of the facts and circumstances related to the statement.

Losses
Previously disallowed losses including suspended passive activity losses are taken into account in calculating qualified business income so long as the losses were incurred in tax year 2018 or after. Disallowed or suspended losses are deducted on a first in, first out basis. Therefore, if the taxpayer wishes to deduct a loss in 2018 or after that was generated in a year before Section 199A was instituted (2017 and prior), the loss will not offset qualified business income for the Section 199A calculation. However, if the taxpayer wishes to deduct a loss that was generated in a year in which Section 199A was in effect (2018 through 2025), such loss will offset qualified business income for the Section 199A calculation in the year the taxpayer is actually deducting the loss. *See Regulation 1.199A-3(b)(1)(iv) and Proposed Regulation REG-134652-18.*

Entities
Entities that hold rental properties must undergo the same analysis as outlined above and then report to the ultimate taxpayer (individual, trust, or estate) on a Schedule K-1 whether it was engaged in a qualified trade or business. The K-1 must also report each owner's allocable share of any qualified business income, wages, and unadjusted basis of depreciable assets to compute the deduction. The test for whether an entity which holds real estate meets the safe harbor is at the entity level. *See Regulation 1.199A-6.* It would follow, therefore, that the combined efforts of partners/members, agents, employees, and contractors of the entity need to meet the 250-hour requirement rather than each partner/ member individually.

Conclusion

Section 199A is complex and has many moving pieces. Although the safe harbor relating to rental real estate is cumbersome, it provides helpful guidance in an otherwise gray area. Taxpayers who own rental real estate should immediately make sure their recordkeeping meets the safe harbor requirement if they think they may qualify for the deduction. If you have questions about the safe harbor, please reach out to our office or your tax advisor.

FEDERAL TAX UPDATE

By Katie Lepore, CPA, J.D., LL.M., Taxation

Excess Trust Deductions. The December 2017 Tax Cuts and Jobs Act eliminated miscellaneous itemized deductions subject to the 2% floor for individuals, ordinarily reported on Schedule A to the Form 1040. This caused some discrepancy in the tax law since excess trust deductions in the year of trust termination are passed out to beneficiaries, to be deducted as an excess itemized deduction subject to the 2% floor in accordance with IRC Section 67. In 2018, the IRS issued Notice 2018-61 announcing that it intends to issue regulations clarifying the ability of individuals to deduct excess trust deductions. However, on the instructions to the 2018 Schedule A to the Form 1040, excess trust deductions are not mentioned as an "other deduction", but they are mentioned in the instructions to the 2018 Form 1041 trust return. This may be an oversight by the IRS but the answer as to the deductibility of excess trust deductions remains unclear.

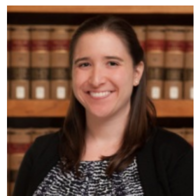
Allocating GST to Prior Years. The Joint Committee on Taxation issued its most recent Blue Book which contains a footnote indicating that taxpayers may allocate remaining Generation Skipping Transfer Tax (GST) exemption (recently increased to $11,400,000 due to Tax Cuts and Jobs Act) to assets contributed to trusts in prior years. The footnote implies that taxpayers can allocate their extra GST exemption to fix mixed inclusion ratio trusts. The footnote in question is footnote 372 under Part VI, Increase in Estate and Gift Tax Exemption, found in the December 2018 Blue Book entitled *General Explanation of Public Law 115-97*.

IRS Releases New Tax Forms. The IRS released Form 8996 to assist taxpayers in reporting the usage of qualified opportunity funds in accordance with brand new IRC Section 1400Z-1, instituted in December 2017 under the Tax Cuts and Jobs Act. The form will be used by corporations or partnerships that are organized and operating as a qualified opportunity fund. Additionally, the IRS issued revised 2018 Form 2210 and instructions, *Underpayment of Estimated Tax by Individuals, Estates, and Trusts*, to reflect recently announced tax relief for 2018 that taxpayers who timely paid at least 85% of the tax shown on the 2018 return will not incur a penalty for underpayment of taxes. Also, the IRS will issue revised Forms and instructions to account for the recent changes to Section 199A from the final regulations, as described in more detail in our feature article.

State Nexus for Out-of-State Trust Beneficiaries. The U.S. Supreme Court will hear oral arguments on April 16 with regard to the right of a state to tax a trust because a beneficiary of the trust lives in that state. In *North Carolina Dept. of Revenue v. Kaestner Family Trust,* North Carolina courts denied the right of the state to tax a trust's income solely because a beneficiary of the trust lived in North Carolina. In *Kaestner*, the trust's books and records were housed in New York, the trustee was a resident of Connecticut, and assets were managed and held in Boston, with trust beneficiaries living in multiple states. With each state having different rules regarding the ability of the state to tax a trust and when that right arises, the Court's ruling should provide needed guidance.

Supreme Court Addresses State Tax Agency Immunity. On January 9, 2019, the U.S. Supreme Court heard oral argument in *Franchise Tax Board v. Hyatt*, regarding the issue of whether state tax agencies have sovereign immunity from lawsuits in other state courts. The case arose when a California taxpayer moved to Nevada and was later audited by the California Franchise Tax Board (FTB). He filed suit against the FTB in a Nevada state court for tort claims. California claims the FTB would enjoy immunity if the case were heard in California and therefore it should be extended similar immunity in its sister states, under the full faith and credit clause of the U.S. Constitution. A decision on this matter is expected later this spring.

Bill to Make Tax Code LGBTQ-inclusive. Representatives Judy Chu (D-CA) and Andy Levin (D-MI) introduced the *Equal Dignity for Married Taxpayers Act*, on Valentine's Day. The bill would overhaul the Tax Code to make it more gender neutral by replacing terms such as "husband" or "wife" with the term "spouse." Senator Ron Wyden (D-OR), the Ranking Member of the Senate Finance Committee, is expected to introduce a similar bill in the Senate.



STATE TAX UPDATE

By Katie Lepore, CPA, J.D., LL.M., Taxation

Collection of Tax for Out-of-State Retailers. As a reminder, beginning April 1, 2019, the California Department of Tax and Fee Administration (CDTFA) will begin collecting sales and use tax on out-of-state retailers for sales made into California. All retailers registered, or those required to be registered, with the CDTFA must collect and pay a district's use tax to the CDTFA, if: (1) the retailer's sales into the state/into the district exceed $100,000 during the preceding or current calendar year; or (2) the retailer made sales into the state/into the district in 200 or more separate transactions during the preceding or current calendar year. Taxpayers are required to continue to self-report all purchases on which no sales tax was paid.

California Nonconformity to Federal Laws. As a reminder, California does not conform to several of the new federal tax laws instituted under the Tax Cuts and Jobs Act. Some major differences include California not recognizing the pass-through income tax deduction under Section 199A and the new Opportunity Zone deferral of gains under Sections 1400Z-1 and 1400Z-2. Additionally, California law does not conform to the federal repeal of technical terminations of a partnership in Section 708(b)(1)(B), so partners still need to be careful to not transfer partnership interests that could cause the partnership to terminate under state laws.

New Real Estate Laws for Landlords and Tenants. Several new landlord-tenant laws were instituted in California in 2018. To help protect tenants, renters now have 3 *business* days instead of 3 days to fight an eviction. Landlords also must have a licensed professional inspect balconies every six years to ensure they are sturdy. To help protect landlords, if rent is paid by a third party instead of the tenant, the landlord can request the third party include a letter saying they are not a tenant and do not have tenant rights. Also, if a business abandons its space without paying rent, commercial landlords can give the tenant notice after 3 instead of 14 days. Additionally, if that abandoned business left behind personal property worth over $750, it previously had to be sold at a public auction. That limit has now been raised to $2,500.

Extension of Time to File for Disaster Victims. The Franchise Tax Board announced that taxpayers affected by a disaster, such as the 2018 Northern and Southern California wildfires, are granted an extension of time to file their income taxes until April 30, 2019. The IRS granted relief to individuals and businesses in

Butte, Los Angeles, and Ventura Counties and the FTB will follow the IRS extension.

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