# Determining if Your Rental Real Estate is a Qualified Trade or Business

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The Tax Cuts and Jobs Act of 2017 (TCJA) has proven to be one of the most significant overhauls of the US tax system in decades. One of the major changes to the tax code includes the Section 199A Qualified Business Income Deduction. This provides for a 20% deduction on qualified business income, a seemingly huge break for passthrough business owners, which is meant to equalize the playing field after TCJA approved cutting corporate tax rates to a flat 21%. While one of the primary purposes behind the passage of TCJA was to simplify the filing process for taxpayers, that pesky word "qualified" always has a tendency to muddle the lines between black and white reporting requirements and creates grey areas. The interpretations of Section 199A's applicability to income (and loss) from rental real estate property are a glaring example of how the new so called "simplicity" of the tax reform can be called into question.

When it comes to the 199A deduction, the real issue with rental real estate arises with the determination of whether or not the operation rises to the standard of what the IRS considers a "Trade or Business". While in a majority of cases, the answer may be clear and obvious, there are always cases that hover in that grey area. Here are a couple examples. A taxpayer owns 12 houses near a college campus that he rents out, typically to enrolled students. Due to high turnover and the need for maintenance, he spends a significant amount of time each month managing upkeep, collecting rent, and listing empty houses in local magazines and on websites. The taxpayer pays for a QuickBooks subscription and has a home office dedicated to tracking and managing the activity of the rental properties. Even though the taxpayer has another part time job, his rental real estate activities would certainly qualify as a trade or business and therefore be eligible for inclusion as qualified business income. On the other end of the spectrum, there is a taxpayer that buys a two-bedroom house and rents out the guest room to a friend. A month after buying the house, his employer offers him a promotion on the condition that he moves out of state. Before moving, he comes to an agreement with another friend to rent out his room in the house. While the taxpayer is away, his mom handles any maintenance issues that may arise. In this case, the rental property would be considered an investment by the IRS rather than a trade or business, and the activity would not qualify for the 199A deduction.

Given that there are scenarios where a rental real estate clearly qualifies as a trade or business, and scenarios where it clearly doesn't, there logically must be a line drawn somewhere in between. However, finding and defining just where the line is drawn is not always an easy task. The IRS has been intentionally vague when releasing language describing what will or will not qualify as a trade or business, stating that the qualification relies on the facts and circumstances in a case by case basis, and that no single factor or list of factors will adequately encompass all possible scenarios.

In Code Section 162, the IRS states that for an activity to be considered a "trade or business", there must be "regular and continuous conduct of the activity" and its "primary purpose must be to make a profit". Again, the downfall of this language is its ambiguity and, aside from a few exceptions where the IRS has issued specific guidance, a rental real estate's status is left up to the subjectivity of whomever is making the judgement.

One such exception, added in hope of mitigating some of the ambiguity, is Revenue Procedure 2019-38. In this ruling, the IRS issued a safe harbor with some specific guidelines that will sufficiently qualify an activity as a qualified trade or business. In order to qualify for the safe harbor, the tax payer must meet the following conditions:

- Perform 250 or more hours of "rental services" each year. For enterprises that have been in existence for more than four years, the 250-hour requirement must be satisfied in three of the five years ending with the tax year. The 250 hours of rental services can be performed by owners, employees, agents, or independent contractors. A rental real estate enterprise can include multiple properties of the same general category (commercial or residential).
    - Examples of rental services include advertising, collecting rent, paying expenses, daily operations, and repairs/maintenance. Rental services do not include investing activities such as arranging financing, purchasing property, and travel to and from.
- Keep contemporaneous records documenting the real estate services performed.
    - Examples include who provided services, as well as the hours, description, and dates of all services performed.
- Keep separate books and records showing income and expenses for each rental real estate enterprise, as well as a separate bank account for each enterprise.
- Must not personally use for the greater of 14 days or 10% of the number of days rented.
    - An example of this would be a vacation home.

The safe harbor is completely optional and even if the specific conditions outlined above are not met, it is still possible to qualify as a trade or business if another valid argument exists. Keep in mind that a statement must be attached to any tax return on which the safe harbor qualification is being claimed. Another caveat when it comes to record keeping, and the safe harbor in general, can be found in how taxpayers with multiple properties group them together. Each property may be listed separately or similar activities may be aggregated together. For example, residential and commercial rentals are not allowed to be aggregated. While aggregating several like properties together may be easier from a tracking and reporting standpoint, it is important to be aware that the decision to aggregate activities together is permanent and partial dispositions are not allowed. Any losses stemming from a partial disposition of aggregated properties will be suspended until the rest of the group is disposed of as well.

The IRS has also provided additional guidance when it comes to renting property to a related party. In these cases, even if the rental activity itself is not a qualified trade or business, if it is being rented to a qualified trade or business with common ownership (50% or more), it is considered to be qualified as well. It is important to note that rentals to a commonly owned Specified Service Trade or Business (SSTB) are considered to be SSTB's as well, and are subject to the applicable thresholds.

A vast majority of taxpayers with rental real estate will be able to make a clear determination whether they are qualified as a trade or business. Many more will be able to qualify their rental activities under the umbrella safe harbor or related party rulings described. But the rest will find themselves floating somewhere in that grey area, unsure of their eligibility and whether they can include their rental income as qualified business income, subject to the enticing 20% deduction. The burden of proof, unfortunately, falls on the taxpayers who decide to take the deduction in the event of an IRS audit or inquiry. These landlords are essentially left sorting through an ever-growing pool of IRS and tax court case rulings to find supporting evidence as to why their circumstances should qualify. If you find yourself wondering whether or not your rental real estate activities qualify, it may be a good idea to consult a tax professional, who can come up with the right course of action for your circumstances.

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