(revised January 10, 2019)

New 20% Pass-Through Deduction – Potential Impact on Real Estate Rentals

The Tax Cuts and Jobs Act (TCJA) signed into law in December 2017 made sweeping changes to Federal tax law. One major change was the addition of the new §199A deduction, also referred to as the "20% Pass-Through Deduction". This new deduction applies to pass-through trade or business entities such as sole proprietorships, LLCs, partnerships, and S-Corporations. This new provision allows a tax deduction of up to 20% on qualified business income from qualifying trade or business entities, including certain real estate rental activities defined as a "trade or business". The deduction is currently only temporary in tax law and will expire on December 31, 2025 without an extension from Congress. As we approach the 2019 tax filing season, we want to make you aware of some §199A rental real estate issues that may impact your 2018 tax return.

Currently, there is a lot of confusion in the tax community regarding the application of §199A to rental real estate activities. The confusion stems from the ambiguous language used in §199A and the lack of a formal definition by Congress or the IRS as to what constitutes a trade or business. Historically, most small real estate rental activities were defined as passive and not rising to the level of trade or business. The tax community has relied on court cases to assess whether a business activity rises to the level of a trade or business, but the courts have reached inconsistent results in their tax treatment of certain activities. One Supreme Court case (Commissioner v. Groetzinger) concluded that the activity in question was a trade or business because it was engaged in with regularity, consistency, and an intent to make a profit. The interpretations of a trade or business from Groetzinger and other cases are often relied on by tax professionals when determining if an activity rises to the level of a trade or business.

The determination of whether §199A may apply to a rental real estate activity is based in part on whether the rental real estate activity of a specific taxpayer rises to the level of a trade or business. §199A, and the potentially beneficial 20% Pass-Through Deduction, does not apply to rental real estate that does not rise to the level of a trade or business.

Prior to §199A, taxpayers often did not consider the issue of trade or business treatment for rental real estate unless the taxpayer materially participated in the rental real estate activity and/or the taxpayer was seeking classification as a real estate professional. If the rental real estate activity did rise to the level of trade or business treatment, then the taxpayer was obligated to issue Forms 1099-MISC annually to all qualifying service providers who provided services to the taxpayer's rental real estate business during the tax year, among other tax reporting requirements. The requirement to issue Forms 1099-MISC is an administrative and costly burden to taxpayers. (Please see our Letter regarding Form 1099-MISC for more information.)

What This Means for You

Taxpayers who have net taxable rental income (e.g., net taxable income on Form1040 or through a passive entity) or who have lost significant value in their real estate investment may benefit from the §199A deduction (up to 20% tax deduction on qualified business income) and/or trade or business treatment.

However, there are issues to consider:

1. We believe that, for long-term rentals, a taxpayer cannot easily change and decide to classify previous rental activity as a trade or business currently in order to claim the §199A deduction unless there has been a material change to the rental activity in the current year versus prior years, which supports an assessment that the rental property is now a trade or business but was not in prior years. Absent a material change to the rental activity, the rental activity either was always a trade or business or was never a trade or business.
2. If the taxpayer did not properly classify the rental activity as a trade or business in prior years, then the taxpayer may be found deficient from non-issuance of Form 1099-MISC reporting for those prior years. The IRS can assess penalties and interest to a taxpayer who has not properly filed Forms 1099-MISC in prior years.
3. If the rental activity is properly classified as a trade or business, then the taxpayer must issue Forms 1099-MISC annually to all qualifying service providers, and follow other requirements.
4. The §199A deduction is only available to taxpayers whose rental activities are properly treated as a trade or business.

We are sending you this information so you can decide if you would like us to re-evaluate whether your rental activity rises to the level of a trade or business. As previously stated, neither Congress nor the IRS has defined what activities constitute a trade or business, though the recently proposed 199A regulations now provide some examples. Consequently, upon your request, we will provide our recommendation based on the facts and circumstances concerning your specific rental activities and the trade or business criteria as defined by various applicable court rulings and other information available to us. Since Form 1099-MISC carries penalties for non-filing, and since there are other implications from claiming a rental property as a trade or business, it is critical that a correct determination regarding the nature of rental activities is made and corrected if necessary. If you would like our assistance to evaluate this issue as it relates to your rental property, please contact us at your convenience.

(We will be sending various emails to selected clients during the coming weeks to describe other potentials tax matters. We will also be posting articles of broad interest on our website. Please let us know if you would like us to drop you name from our mailing lists.)

Sincerely,
Brenner & Elsea-Mandojana LLC

Other 2018 Changes Affecting Rental Real Estate

- Certain bonus depreciation rules have changed, generally in the taxpayer's favor.
- For real estate rentals outside the U.S. and certain U.S. commercial rentals, ADS depreciation for buildings drops from 40 years to 30 years.
- Foreign real and tangible property taxes are no longer deductible.

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