DOES NET RENTAL INCOME QUALIFY FOR THE SECTION 199A DEDUCTION?

By David M. Fogel, EA, CPA, USTCP

One of the changes made by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97) was to introduce a new 20 percent deduction for qualified business income. The deduction is intended to benefit taxpayers who have net business income.

One of the questions being debated in the tax preparer community is whether a taxpayer who has net rental income (not a net rental loss) is eligible for this new deduction. Some practitioners say yes, some say no. I say it depends upon the facts and circumstances of the rental activity.

General Rules for the New 20 Percent Deduction

Congress added IRC §199A to the code to provide for the new 20 percent deduction. The section is a minefield with many limitations and special rules. Sole proprietors, shareholders of S corporations, partners of partnerships, trusts, and estates are eligible for the deduction, while C corporations are not.[1]

In general, the deduction is limited to 20 percent of the lesser of (1) the taxpayer's qualified business income, or (2) the taxpayer's taxable income with modifications.[2] The deduction is also

limited to 50 percent of the W-2 wages that the taxpayer paid in the qualified trade or business.[3] But if 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of qualified property is higher, then this limitation applies instead.[4]

The W-2 wage limitation does not apply if the taxpayer's taxable income (computed without the deduction) does not exceed $157,500 ($315,000 on a joint return).[5] If it does, then the W-2 wage limitation is phased in as taxable income and goes from $157,500 to $207,500 ($315,000 to $415,000 on a joint return).[6]

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Regarding the "2.5 percent of unadjusted basis" provision, "qualified property" means depreciable property used in the business for which the depreciable period has not yet ended.[7] The depreciable period is 10 years or the recovery period, whichever is longer.[8]

As mentioned above, the general limitation on the deduction is 20 percent of qualified business income. "Qualified business income" means the net amount of income, gains, deductions, and losses from the "qualified trade or business."[9] Losses carried over from the prior year are included in determining the net amount.[10]

To constitute qualified business income, the income must be "effectively connected with a United States trade or business" as that term is used in IRC §864(c), and must not be exempt or excluded from income.[11] Real estate investment trust (REIT) dividends, qualified publicly traded partnership income, and investment income are not included in qualified business income,[12] although REIT dividends and qualified publicly traded partnership income do qualify for the 20 percent deduction under separate provisions.[13] Special rules apply to income from agricultural or horticultural cooperatives.[14] Reasonable compensation received from a corporation, guaranteed payments received from a partnership, and wages received by an employee are not included in qualified business income.[15]

A qualified trade or business does not include a "specified service trade or business," which is a business engaged in the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset is the reputation or skill of one or more employees or the owner of the business.[16] A service-type business that engages in engineering or architecture *does* qualify for the deduction.[17]

A specified service trade or business *will* qualify for the deduction if the taxpayer's taxable income (computed without the deduction) does not exceed $207,500 ($415,000 on a joint return).[18] And if taxable income exceeds these amounts, then only a percentage of the net business income will qualify for the deduction.[19]

These are just the basic provisions of IRC §199A; there are numerous limitations and special rules I have not identified earlier. In addition, the limitations and special rules are especially complex for S corporation shareholders, members of an LLC, and partners of a partnership.

At this point, you're probably saying, "Whew! What a mess!" Keep reading. It gets better.

Does Net Rental Income Qualify for the Deduction?

As stated previously, to constitute qualified business income, the income must be "effectively connected" with a U.S. trade or business, as that term is used in IRC §864(c). This section applies to nonresident aliens and foreign corporations that conduct business in the United States.

IRC §864(c)(2) provides that whether income, such as rent, is effectively connected depends on a consideration of at least two factors: (1) whether the income is derived from assets used in the business (asset use test), and (2) whether the activities of the business are a material factor in realizing the income (business activities test).

A nonresident alien may elect to treat a rental activity as effectively connected,[20] but this election is not available for purposes of IRC §199A. Therefore, in the absence of the election, you need to look at cases and rulings that have dealt with whether rental income was effectively connected.

The court cases that have ruled on whether rental income was effectively connected have held that the mere ownership of real estate does not constitute the carrying on of a trade or business, and that a taxpayer must do more than merely own the property in order to establish that the rental activity is a business.[21] Collecting rent; paying operating expenses, taxes, and mortgage interest; arranging for repairs; hiring workers; buying materials; and entering into leases or other contracts are the types of activities that establish that the rental activity is a business.[22]

So, the test of whether a rental activity is effectively connected with a U.S. trade or business appears to be the same as the test of whether the rental activity constitutes a trade or business, which is an age-old question.

Whether the taxpayer's ownership and rental of real property constitutes a trade or business depends upon the facts and circumstances of the case.[23] Historically, the courts have held that the rental of even a single property may constitute a trade or business under various provisions of the code.[24]

The courts that have considered whether a rental activity was effectively connected with a U.S. trade or business appear to have applied the same rationale as the test under IRC §469(i) to qualify for the $25,000 special allowance for rental losses. A taxpayer qualifies for this special allowance if he or she "actively participates" in the rental activity. A taxpayer actively participates in the rental activity by making management decisions, such as approving new tenants, deciding on rental terms, approving capital or repair expenditures, or arranging for others to provide services, such as repairs, in a significant or bona fide sense.[25] A taxpayer who actively participates in the rental activity is doing more than merely owning the property and holding it for investment.

In my opinion, as long as the taxpayer actively participates in the rental activity within the meaning of IRC §469(i), the net rental income will be treated as effectively connected with a U.S. trade or business for purposes of IRC §199A. Even a single rental property will qualify as long as the taxpayer participates in the rental activity to a significant degree by making management decisions, collecting rent, arranging for repairs, etc. But the net rental income will not be treated as effectively connected if the taxpayer does not participate in the rental activity, turns everything over to a management company, and particularly if the lease is a "net lease."

Examples

Example 1 – Large Rental Property, Taxpayers Retired

John and Mary are retired and in their eighties. They own a 20-unit apartment building in Sacramento that generates $120,000 in net rental income every year. They have nothing to do with the management of the rental activity because they have hired a property management company that negotiates with tenants, secures leases, collects the rents, makes the mortgage payments, and pays all operating expenses, including taxes and insurance. Every month, the property management company determines the net rental profit, subtracts its commission, and sends a check to John and Mary with a statement showing all the income and expenses.

Under these circumstances, the net rental income that John and Mary receive is not effectively connected and is not eligible for the 20 percent deduction.

Example 2 – Single Rental Property

Mike and Barbara own a single residential house in Sacramento that they rent to a long-term tenant. Mike and Barbara originally occupied the house as their principal residence, but when they moved out five years ago, they converted it to a rental. The mortgage is paid off. The rental activity usually generates $12,000 in net rental income every year. Mike and Barbara manage the rental activity themselves. They collect the rent, pay the taxes and insurance, and hire workers to make all needed repairs.

Under these circumstances, the net rental income that Mike and Barbara receive is effectively connected and is eligible for the 20 percent deduction.

Example 3 – Two Rental Properties, Rental Loss Carried over from Prior Year

Bob and Susan own two residential houses in Sacramento that they have been renting to tenants for the past three years. Over that period, they have built up rental losses totaling $30,000, which they have not been able to deduct because their modified adjusted gross income was above the $150,000 phase-out threshold for the $25,000 special rental allowance. During 2018, they expect that the rental activity will generate $6,000 in net rental income. Just like Mike and Barbara, Bob and Susan manage the rental activity themselves.

Usually, losses carried over from the prior year are included in determining the net amount of qualified business income.[26] But the statute says that only a loss that is "qualified income" from a qualified trade or business is included in this carryover rule.[27] Because IRC §199A applies only to taxable years beginning after 2017,[28] losses sustained in years prior to the effective date are not included.

Under these circumstances, the $6,000 in net rental income that Bob and Susan will receive in 2018 is effectively connected and is eligible for the 20 percent deduction, and the $30,000 passive loss carryover does not offset this amount for purposes of determining the 20 percent deduction.

Example 4 – Two Rental Properties, Carryover Rental Loss, Rental Sold at Loss

Assume the same facts as in Example 3, except that during 2018 Bob and Susan sold one of the rental houses, resulting in a $20,000 loss.

Qualified business income includes a recognized gain or loss attributable to the qualified business.[29] The $20,000 loss is included in qualified business income and offsets the $6,000 in net rental income. Net business income is <$14,000>, and as a result, Bob and Susan are not eligible for the 20 percent deduction.

Conclusion

The new 20 percent deduction for qualified business income allowed under IRC §199A can be a great benefit to many of our small business clients, and it is likely to generate a lot of controversy for clients who have net rental income. This new provision will present us with many challenging questions as we try to apply it to our clients' specific facts and circumstances. **EA**

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Ed note: This article was published on CSEA's website in January. It has been updated to reflect current guidance. As of press time, we have reason to believe IRS will issue further guidance by the end of the year.

For Your Review

1. Which of the following is true?

A. A taxpayer with net business income but whose taxable income (computed without the deduction) is zero may claim the 20 percent deduction.

B. A taxpayer with a net business loss but whose taxable income (computed without the deduction) is above zero may claim the 20 percent deduction.

C. A taxpayer with net business income and a loss from the sale of business equipment that exceeds the net business income may claim the 20 percent deduction.

D. None of the above

2. Which of the following service-type businesses is not a specified service trade or business?

A. Doctor

B. Architect

C. Lawyer

D. Enrolled agent

*See page 39 for the answers.

About the Author

David M. Fogel, EA, CPA, USTCP, is a self-employed tax consultant. He provides tax-consulting services to other tax practitioners and represents clients before the various tax agencies. David has more than 43 years of experience in tax controversies, including 26 years working for the IRS, and six years as a tax advisor for law firms in Sacramento. Email him at dfogel@surewest.net or visit his webpage at www.fogelcpa.com.

ENDNOTES

1. IRC §§199A(a), (f)(1)(A), (f)(1)(B).
2. IRC §199A(a).
3. IRC §199A(b)(2)(B). To qualify as W-2 wages, W-2 forms must be filed with the Social Security Administration no later than the sixtieth day after the due date (including extensions) for filing the forms. See IRC §199A(b)(4)(C).
4. IRC §199A(b)(2)(B).
5. IRC §199A(b)(3)(A). These amounts are indexed for inflation beginning in 2019. See IRC §199A(e)(2)(B).
6. IRC §199A(b)(3)(B).
7. IRC §199A(b)(6)(A).
8. IRC §199A(b)(6)(B).
9. IRC §199A(c)(1).
10. IRC §199A(c)(2).
11. IRC §199A(c)(3)(A).
12. IRC §§199A(c)(1), (c)(3)(B).
13. IRC §199A(b)(1)(B).
14. IRC §§199A(b)(7), (g).
15. IRC §§199A(c)(4), (d)(1)(B).
16. IRC §199A(d)(2)(A), citing IRC §1202(e)(3)(A).
17. IRC §199A(d)(2)(A).
18. IRC §199A(d)(3). These amounts are indexed for inflation beginning in 2019.
19. *Id*.
20. IRC §871(d).
21. See *Neill v. Commissioner*, 46 B.T.A. 197 (1942) (nonresident alien was not in the trade or business of renting a single building where the rents were collected by her attorney and the taxpayer was not involved in the rental activity); *Herbert v. Commissioner*, 30 T.C. 26 (1958) (nonresident alien was not in the business of renting a single building in Washington, D.C., to a men's clothing store where the building was rented on a net lease basis, the tenant was responsible for all repairs, and all the taxpayer did was to collect the rent, pay the mortgage, real estate taxes, and insurance premiums); Rev. Rul. 73-522, 1973-2 C.B. 226 (nonresident alien was not in the trade or business of renting real estate where the leases were net leases in which all expenses, including the mortgage payments, real estate taxes, operating expenses, insurance, and repairs, were paid by the tenant).
22. See *Taiyo Hawaii Company, Ltd. v. Commissioner*, 108 T.C. 590, 611 (1997) (Japanese corporation that held real property in Hawaii that it intended to develop into residential subdivisions was engaged in a real estate business); *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (nonresident alien who held an interest in eleven buildings in New York City, which he managed for himself and his two brothers, and which required regular and continuous activity, hiring of personnel, purchase of materials, making of contracts, was engaged in a real estate business); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), aff'd. per curiam 221 F.2d 227 (9th Cir. 1955) (nonresident alien who managed four commercial and residential properties in Northern California by directing all actions of a licensed real estate broker, was engaged in a real estate business); *De Amodio v. Commissioner*, 34 T.C. 894 (1960) (nonresident alien who owned two properties in Dallas, Texas, and managed them by directing all actions of local real estate agents was engaged in a real estate business).
23. *Curphey v. Commissioner*, 73 T.C. 766 (1980).
24. See, e.g., *Hazard v. Commissioner*, 7 T.C. 372 (1946, Acq. 1946-2 C.B. 3); *Fackler v. Commissioner*, 45 B.T.A. 708 (1941), aff'd. 133 F.2d 509 (6th Cir. 1943); *Post v. Commissioner*, 26 T.C. 1055 (1956, Acq. 1958-2 C.B. 7); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955, Acq. 1956-1 C.B. 5); *Elek v. Commissioner*, 30 T.C. 731 (1958, Acq., 1958-2 C.B. 5); *Fegan v. Commissioner*, 71 T.C. 791 (1979), aff'd. 81-1 USTC (CCH) ¶9436 (10th Cir. 1981).
25. See S. Rept. 99-313 (1986), 1986-3 C.B. (Vol. 3) 1, 737-738. See also *Madler v. Commissioner*, T.C. Memo. 1998-112.
26. IRC §199A(c)(2).
27. *Id*.
28. §11011(e), Tax Cuts and Jobs Act of 2017 (P.L. 215-97).
29. IRC §199A(c)(1).