Current Federal Tax Developments

Week of September 30, 2019

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SECTION: 199A
SAFE HARBOR §199A RENTAL RULES FINALIZED BY IRS

Citation: Revenue Procedure 2019-38, 9/24/19

Sometimes the worst thing that happens is when you get what you ask for. Arguably, CPAs who were asking for guidance on whether a client's rental was a trade or business for purposes of §199A's qualified business income deduction ended up in that situation when the IRS released Notice 2019-07 in January 2019 with a draft revenue procedure. The draft procedure provided a safe harbor test for when the IRS would not challenge the taxpayer's position that their rental undertaking was a trade or business.

In Revenue Procedure 2019-38[1] the IRS has now finalized that procedure, making some adjustments to the draft procedure but still, arguably, have issued a procedure that only protects rentals that the case law indicates were clearly trades or businesses anyway.

An undertaking is included in the calculation of qualified business income under IRC §199A only if it is incurred in a trade or business as defined in IRC §162.[2] Whether a rental activity rises to the level of a trade or business is one of the many "it depends" issues under the tax law, but case law going back decades suggests that, in most cases, a rental will rise to a level of a trade or business.

In the case of *Fackler v. Commissioner*, 133 F.2d 509 (1943) a taxpayer was found to have a trade or business in rental with just a single commercial property. Similarly, in the case of *Hazard v. Commissioner*, 7 TC 372 (1946), a single-family residence was all the taxpayer possessed—but renting that out was again held to be a trade or business. While the Second Circuit Court of Appeals, in the case of *Grier v. United States*, 120 F.Supp. 395 (1954), *affd*, CA2 218 F. 2d 603 (1955) refused to go as far as the courts in *Hazard* and *Fackler* with a single rental, the Circuit has pretty much stood alone on this issue.

The types of rentals that have traditionally not been held to be a trade or business have been a single triple net lease (see Revenue Ruling 73-522). But even triple-net leases, if a taxpayer has enough of them, can rise to a trade or business as was discussed on our website early in 2019.[3]

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[1] Revenue Procedure 2019-38, September 24, 2019, https://www.irs.gov/pub/irs-drop/rp-19-38.pdf (retrieved September 24, 2019)

[2] Reg. §1.199A-1(b)(14)

[3] Edward K. Zollars, "Can an LLC Operating a Shopping Center with Triple Net Leases for All Tenants Give Rise to Qualified Business Income?" *Current Federal Tax Developments* website, February 23, 2019,

The proposed, and now final, Revenue Procedure was issued in response to complaints that taxpayers were finding it confusing to determine if their rental was a trade or business. So, the IRS issued a safe harbor that was intended to address only the most obvious cases where a taxpayer had a trade or business in his/her rental undertaking.

The procedure is merely a safe harbor, not a bright line test that divides trade or business activities from those that are not such. The IRS added language to the final revenue procedure to make it clear this was never meant to be used to give the final answer:

> Failure to satisfy the requirements of this safe harbor does not preclude a taxpayer or the Service from otherwise establishing that an interest in rental real estate is a trade or business for purposes of section 199A.[4]

That line saying that the Service is not precluded from arguing the rental is a trade or business if the taxpayer fails this test is a warning—since gains treated as capital gains are not part of QBI (such as §1231 gains if such gains are in excess of losses and there's no recapture of prior §1231 losses)[5] but the carried over post-2017 passive losses released on the sale of a trade or business are, the IRS clearly will often be ahead by arguing a rental is a trade or business—and arranging a taxpayer's affairs to barely fail the safe harbor will almost certainly fail to protect the taxpayer from the IRS treating the rental activity as a trade or business, using the released loss to reduce the taxpayer's QBI from profitable trades or businesses.

One significant change in the final revenue procedure involves the issue of "mixed-use" rental properties. Generally, under the Revenue Procedure, the taxpayer tests rental *enterprises* for meeting the requirements of the safe harbor. Taxpayer can treat each rental as an enterprise on its own, or the taxpayer can combine similar properties into an enterprise. Under the Revenue Procedure *similar properties* generally must be all commercial properties or all residential properties. As well, commercial properties cannot be combined with residential properties normally into a single enterprise[6]

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https://www.currentfederaltaxdevelopments.com/blog/2019/2/23/can-an-llc-operating-a-shopping-center-with-triple-net-leases-for-all-tenants-give-rise-to-qualified-business-income, retrieved September 24, 2019.

[4] Revenue Procedure 2019-38, Section 3.01

[5] Reg. §1.199A-3(b)(2)(ii)

[6] Revenue Procedure 2019-38, Section 3.02

EXAMPLE

Greg owns four single family homes and three office buildings that he rents. Greg can treat all the single-family homes as a single enterprise and all the office buildings as a second enterprise under the Revenue Procedure.

However, Greg is not allowed to combine all seven properties into a single enterprise for purposes of the Revenue Procedure.

Several commentators noted that there are numerous buildings, especially in urban downtown areas, where a building has both commercial properties (often on the ground floor) and residential properties (normally on the upper floors). In such a case, it wasn't clear if the draft revenue procedure required the taxpayer to split the single property into two components, or if that property could be a single enterprise.

The final procedure provides some clarification and choice, indicating:

> An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. For purposes of this revenue procedure, mixed-use property is defined as a single building that combines residential and commercial units. An interest in mixed-use property, if treated as a single rental real estate enterprise, may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property.[7]

If a taxpayer decides to combine like properties into a single enterprise, the taxpayer must combine all such like properties. Once the taxpayer chooses to treat the properties as a single enterprise, the taxpayer must continue to do so under the Revenue Procedure in future years, as well as add any new properties of that type to the enterprise in future years. However, if a taxpayer does not initially combine the like properties into a single enterprise, the taxpayer may elect to combine all similar properties in a later year.[8]

EXAMPLE

Greg does not treat the four residential properties as a single enterprise on his 2018 return. Even though he did not combine them into a single enterprise on his 2018 return, he can decide to treat them as one enterprise on his 2019 return.

But if Greg had treated the residential properties as a single enterprise on the 2018 return, he cannot decide to treat them as separate enterprises in 2019 or any later year. As well, if he acquires a new residential rental in 2019 or later years, he will be required to add that rental to the enterprise.

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[7] Revenue Procedure 2019-38, Section 3.02

[8] Revenue Procedure 2019-38, Section 3.02

As with the draft revenue procedure, under the final procedure the determination for qualification under the revenue procedure is made annually. If all the following requirements are met, the IRS will not challenge the taxpayer treating the rental enterprise as a trade or business:

- Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise. Note, the final procedure added the following: if a rental real estate enterprise contains more than one property, this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated;

- For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive taxable years that end with the taxable year, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise; and

- The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i)hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of the IRS.[9]

If the taxpayer qualifies and wishes to take advantage of the safe harbor, the revenue procedure requires attaching the following to the tax return:

> The taxpayer or RPE attaches a statement to a timely filed original return (or an amended return for the 2018 taxable year only) for each taxable year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement but the statement must list the required information separately for each rental

[9] Revenue Procedure 2019-38, Section 3.03

> real estate enterprise. The statement must include the following information:
>
> (1) A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise;
>
> (2) A description (including the address and rental category) of rental real estate properties acquired and disposed of during the taxable year; and
>
> (3) A representation that the requirements of this revenue procedure have been satisfied.[10]

Rental services for purposes of the 250-hour test include, but are not limited to, the following items:

- 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 the property, including the purchase of materials and supplies;
- Management of the real estate; and
- Supervision of employees and independent contractors.[11]

However, such rental services do not include financial or investment management activities. The procedure provides the following example of such services that cannot be used to meet the 250-hour test:

- Arranging financing; procuring property;
- Studying and reviewing financial statements or reports on operations;
- Improving property under § 1.263(a)-3(d); or

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[10] Revenue Procedure 2019-38, Section 3.03(D)

[11] Revenue Procedure 2019-38, Section 3.04

- Hours spent traveling to and from the real estate.[12]

The procedure also bars taxpayers from including the following rentals in an enterprise, and thus they cannot qualify to use the safe harbor as only enterprises are tested under the safe harbor:

- Real estate used by the taxpayer (including an owner or beneficiary of an RPE) as a residence under section 280A(d);

- Real estate rented or leased under a triple net lease. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to pay for maintenance activities for a property in addition to rent and utilities;

- Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled under Reg. §1.199A-4(b)(1)(i);

- The entire rental real estate interest if any portion of the interest is treated as a specified service business (SSTB) under Reg. §1.199A-5(c)(2) (the anti-crack and pack rules which would apply if the property is leased to a controlled SSTB).

The procedure is effective for tax years beginning after December 31, 2017, though for 2018 taxpayers may rely on the draft revenue procedure found in Notice 2019-07 if they prefer.[13]

The procedure also extends the limited relief from the strict contemporaneous records requirement for the 250-hour rule for one more year, first applying to years beginning on or after January 1, 2020. However, the ruling contains following caution regarding this break:

> …[T]axpayers are reminded that they bear the burden of showing the right to any claimed deductions in all taxable years. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84; 112 S.Ct. 1039, 1043) (1992); *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281 (1943). See also I.R.C. § 6001; Treas. Reg. § 1.6001-1(a) and (e).[14]

Again, advisers must remember *this is only a safe harbor* and that a large number, arguably the majority, of rentals that cannot pass this test will nevertheless be a §162 trade or business subject to the §199A rules, for better or worse.

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[12] Revenue Procedure 2019-38, Section 3.04

[13] Revenue Procedure 2019-38, Section 4

[14] Revenue Procedure 2019-38, Section 4

SECTION: 274
HIGH-LOW AND OTHER SPECIAL PER DIEM RATES FOR 2019/2020 FISCAL YEAR PUBLISHED BY THE IRS

Citation: Notice 2019-55, 9/25/19

The special per-diem rates for the fiscal year running from October 1, 2019 to September 30, 2020 has been released in Notice 2019-55.[15] The special rates governed by this Notice are:

- The special transportation industry meal and incidental expenses (M&IE) rates,
- The rate for the incidental expenses only deduction, and
- The rates and list of high-cost localities for purposes of the high-low substantiation method.[16]

The special meals and incidental expense rates for the transportation industry for the period from October 1, 2019 to September 30, 2020 are $66 for any locality of travel in the continental United States (CONUS) and $71 for any locality outside the continental United States (OCONUS).[17]

The rate for incidental expenses for the period from October 1, 2019 to September 30, 2020 for the incidental expenses only deduction is $5 per day.[18]

For those using the high-low substantiation method, the rates will be $297 for any high cost locality and $200 to any other location within CONUS. Of that amount, $71 is treated as paid for meals and incidentals to a high cost locality and $60 for travel to any other locality within CONUS.[19]

The list of high cost localities can be found at Section 5.2 of the Notice.

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[15] Notice 2019-55, September 25, 2019, https://www.irs.gov/pub/irs-drop/n-19-55.pdf, retrieved September 26, 2019

[16] Notice 2019-55, Section 1

[17] Notice 2019-55, Section 3

[18] Notice 2019-55, Section 4

[19] Notice 2019-55, Section 5.1

The notice indicates that the following localities have been added to the list for the 2019/2020 fiscal year:

> Mill Valley/San Rafael/Novato, California; Crested Butte/Gunnison, Colorado; Petoskey, Michigan; Big Sky/West Yellowstone/Gardiner, Montana; Carlsbad, New Mexico; Nashville, Tennessee; Midland/Odessa, Texas.[20]

As well, the following locations are having modifications made to the portion of the year they qualify for high cost status for the 2019/2020 fiscal year:

> Napa, California; Santa Barbara, California; Denver, Colorado; Vail, Colorado; Washington D.C., District of Columbia; Key West, Florida; Jekyll Island/Brunswick, Georgia; New York City, New York; Portland, Oregon; Philadelphia, Pennsylvania; Pecos, Texas; Vancouver, Washington; Jackson/Pinedale, Wyoming.[21]

Finally, the following localities have been removed from the high cost list for 2019/2020:

> Los Angeles, California; San Diego, California; Duluth, Minnesota; Moab, Utah; Virginia Beach, Virginia.[22]

SECTION: 6651
IMPRISIONMENT AND LACK OF ACCESS TO POTENTIAL DEDUCTION DOCUMENTS ARE NOT REASONABLE CAUSE FOR FAILURE TO FILE RETURNS OR TIMELY PAY TAXES

Citation: George v. Commissioner, TC Memo 2019-128, 9/25/19

Taxpayers faced with a penalty for failure to file a return and failure to timely pay the tax can attempt to escape either or both penalties by arguing they had reasonable cause for the failure under §6651(a)(1) and (2). But in the case of *George v. Commissioner*,

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[20] Notice 2019-55, Section 5.3.a

[21] Notice 2019-55, Section 5.3.b

[22] Notice 2019-55, Section 5.3.c

TC Memo 2019-128,[23] the taxpayer was unable to persuade the Court that such reasonable cause included being in prison after being convicted of wire fraud for running a real estate Ponzi scheme.

The relevant penalties and the reasonable cause defense is found at IRC §6651(a)(1) and (2) which provide:

> (a)Addition to the tax
>
> In case of failure—
>
> (1)to file any return required under authority of subchapter A of chapter 61 (other than part III thereof), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), or of subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), or of subchapter A of chapter 53 (relating to machine guns and certain other firearms), on the date prescribed therefor (determined with regard to any extension of time for filing), *unless it is shown that such failure is due to reasonable cause and not due to willful neglect*, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;
>
> (2)to pay the amount shown as tax on any return specified in paragraph (1) on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), *unless it is shown that such failure is due to reasonable cause and not due to willful neglect*, there shall be added to the amount shown as tax on such return 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;

The Court found that there was no disputing the taxpayer had received a pension distribution of $208,111 during the year and, that being age 45 at the time of the distribution, was also subject to the 10% additional tax on premature distributions.

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[23] *George v. Commissioner*, TC Memo 2019-128, September 25, 2019, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12062, retrieved September 26, 2019

The Court also accepted the IRS's calculation of an overall deficiency, after giving account for taxes withheld from the distribution, of $70,318.[24]

So now we turn to the penalties, both for his failure to file a return (the IRS eventually filed a substitute for return that lead to the deficiency the agency sought to collect) and the failure to pay the tax when due. The taxpayer argued he had reasonable cause for this failure, noting:

> Petitioner's principal defense to respondent's additions to tax is that he has been incarcerated, so that documents evidencing deductible expenditures are unavailable to him, and it would be inadvisable for him to file a 2013 return until he obtains documents that might evidence those deductible expenditures.

The taxpayer's lack of access that documents that may have been relevant to his return was not found to create reasonable cause for the failure either to file the return or pay the tax due timely. The opinion points out:

> The regulations provide that a taxpayer has reasonable cause for failure to timely pay a tax if "the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship * * * if he paid on the due date." Sec. 301.6651-1(c)(1), Proced. & Admin. Regs. The regulations further state:
>
> > In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax. * * * [Id.][25]

The Court, in applying these rules to this case notes:

> Even if it were true that there is evidence of deductible amounts not available to petitioner, that would not necessarily establish reasonable cause and a lack of willful neglect for not filing or paying. The mere fact that petitioner was incarcerated when his return was due is not

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[24] *George*, p. 8-9

[25] *George,* p. 11

> reasonable cause for his failure to file timely. *Llorente v. Commissioner*, 74 T.C. 260, 268-269 (1980), aff'd in part, rev'd in part on other grounds, and remanded, 649 F.2d 152 (2d Cir. 1981); *Thrower v. Commissioner*, T.C. Memo. 2003-139, 2003 WL 21107675, at *5. Nor is the unavailability of records generally reasonable cause for failure to file a timely return. *Thrower v. Commissioner*, 2003 WL 21107675, at *5.[26]

The Court first notes that he didn't even attempt to file timely or compute or pay the tax due:

> Nothing in the record suggests that petitioner applied for an extension of time to file his 2013 return. Nor has he shown specific facts raising a genuine dispute for trial that he could not have prepared a timely 2013 return with a reasonable degree of accuracy on the basis of the information available to him as of the due date of that return.[27]

The Court also notes that the taxpayer never described any sort of expenditure that might have been part of his missing records that could have given rise to a deductible expense that would have impacted his income tax return.[28]

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[26] *George,* pp. 9-10

[27] *George*, p. 10

[28] *George*, p. 10