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## When Rental Real Estate Is a Trade or Business

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### INTRODUCTION

Section 199A allows a taxpayer other than a corporation a deduction for a taxable year that equals the lesser of (1) the taxpayer's Combined Qualified Business Income Amount (CQBIA); or (2) 20% of the amount of a taxpayer's taxable income for a taxable year in excess of the taxpayer's net capital gain (as defined in §1(h)) for that taxable year.<sup>1</sup> The CQBIA is the sum of the deductible amounts for each qualified trade or business conducted by a taxpayer plus 20% of the total of a taxpayer's qualified REIT dividends and qualified publicly traded partnership income for a taxable year.<sup>2</sup> The key concept of the CQBIA's component that consists of the deductible amount for each qualified trade or business is the trade or business notion.<sup>3</sup> The Treasury Department and the IRS have stated that a trade or business for purposes of §199A "is a trade or business under §162 (a §162 trade or business) other than the trade or business of perform-

ing services as an employee."<sup>4</sup> No concise definition of the term "trade or business" is contained in §162. Instead, various cases and administrative guidance have indicated the facts and circumstances as well as the factors necessary for an activity or group of activities to be considered a trade or business.<sup>5</sup> The definition of a trade or business that has been derived by the author from a review of this judicial and administrative guidance is that a §162 trade or business is "an activity or group of activities conducted on a regular, continuous and substantial basis for the purpose of making a profit."<sup>6</sup>

#### Example 1

In order to contribute to the physical and emotional development of youth in his hometown, Arnold sponsors a basketball team. As part of this sponsorship, Arnold pays salaries to coaches, trainers and other personnel. This team practices and plays in leagues continuously throughout the year. This group of activities is regular, continuous and substantial. However, this group of activities is not engaged in for profit. Since this group of activities is not for the purpose of making a profit, it does not constitute a §162 trade or business.

#### Example 2

Alberta owns land located in downtown Omaha. Alberta leases this land to an unrelated business. She collects \$120,000 of rent income each year and pays annual real property taxes of \$40,000. Alberta does not engage in any other activities with respect to this property. This endeavor is not a trade or business because, despite the fact that it is engaged in for the purpose of generating a profit, it does not have the regu-

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<sup>1</sup> §199A(a). All section references are to the Internal Revenue Code of 1986, as amended ("the Code"), and the regulations thereunder, unless otherwise specified.

<sup>2</sup> §199A(b).

<sup>3</sup> The definition of a trade or business was discussed extensively by James M. Kehl, *The Most Important Deduction in the 2017 Tax Act: §199A*, 34 Tax Mgmt. Real Est. J. 48 (Mar. 7, 2018); James M. Kehl, *§199A Gets an Update Three Months After Its Enactment*, 59 Tax Mgmt. Memo. 115 (Apr. 16, 2018); and James M. Kehl, *Do the §199A Proposed Regulations Provide Clarity for Business Owners?* 59 Tax Mgmt. Memo. 293 (Sept. 17, 2018).

<sup>4</sup> Reg. §1.199A-1(b)(14).

<sup>5</sup> These cases and administrative guidance were extensively discussed in the articles cited in footnote 3.

<sup>6</sup> James M. Kehl, *Do the §199A Proposed Regulations Provide Clarity for Business Owners?* 59 Tax Mgmt. Memo. 293 (Sept. 17, 2018). This definition is also supported by comments made by the IRS and Treasury Department in their comments in II.A.3.a. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

lar, continuous and substantial activity that is necessary for a §162 trade or business.

The Preamble to the final §199A regulations acknowledges that one entity can conduct more than one §162 trade or business.<sup>7</sup> Whether an entity conducts a single business or multiple businesses is a “factual determination” that is to be guided by the continuity, regularity, substantiality and profit-motive factors referred to above.<sup>8</sup> The IRS has stated that it was unlikely that an entity could have more than one trade or business if different accounting methods could not be used for each trade or business.<sup>9</sup> The IRS has also indicated that a trade or business that does not maintain a separate and complete set of books and records is not likely to be considered “separate and distinct.”<sup>10</sup>

The §199A regulations recognize that there are situations where renting or licensing property “does not rise to the level of a §162 trade or business.”<sup>11</sup> For this reason, Reg. §1.199A-1(b)(14) requires property that is rented or licensed to a trade or business conducted by that individual or to a Relevant Passthrough Entity (RPE) that is commonly controlled by the individual to be treated as a trade or business for purposes of §199A.

Rental real estate activities may be either §162 trades or businesses or §212 activities engaged in for the production of income.<sup>12</sup> The IRS and Treasury Department acknowledged this when they stated that taxpayers may have difficulties “in determining whether a taxpayer’s rental real estate activity is sufficiently regular, continuous, and considerable for the activity to constitute a §162 trade or business.”<sup>13</sup> For this reason, the IRS published Notice 2019-07<sup>14</sup> at the same time it published the §199A final regulations. Notice 2019-07 created the concept of a rental real estate enterprise and contained safe harbor conditions

whereby a rental real estate interest that satisfied this definition and met the other conditions specified in that Notice would be treated as a trade or business for purposes of §199A. The IRS received comments concerning Notice 2019-07 and its conditions. It published Rev. Proc. 2019-38<sup>15</sup> in response to those comments. Rev. Proc. 2019-38 applies to taxable years that end after December 31, 2017.<sup>16</sup> However, taxpayers and RPEs may also rely on the safe harbor rules of Notice 2019-7 for 2018.<sup>17</sup>

This article is divided into two parts. The first part is a detailed analysis of Rev. Proc. 2019-38. The second part, a case study of a typical taxpayer situation, discusses how the taxpayer may treat its rental real estate activities as a §162 trade or business without fulfilling Rev. Proc. 2019-38’s safe harbor requirements and points out the aspects of Rev. Proc. 2019-38 that may be helpful in achieving this objective.

## TRADE OR BUSINESS DISCUSSION IN PREAMBLE TO FINAL §199A REGULATIONS

In the Preamble to the final §199A regulations, the Treasury Department and the IRS rejected suggestions that a trade or business for purposes of §199A be defined by using the definitions of that term found in §469 or §1411.<sup>18</sup> Suggestions that all rental real estate activities be considered trades or businesses for purposes of §199A as well as other safe harbor rules were also rejected because the IRS believed that “providing bright line rules on whether a rental real estate activity is a §162 trade or business for purposes of §199A is beyond the scope of these regulations.”<sup>19</sup> However, the IRS did indicate some of the “relevant factors”<sup>20</sup> that should be considered by taxpayers in deciding whether a rental real estate activity is a §162 trade or business. These factors, which would form the basis for some of the safe harbor requirements of Rev. Proc. 2019-38, include, but are not limited to: (1) the type of property rented (residential rental property or commercial real estate); (2) the number of properties being rented; (3) the day-to-day involvement of

<sup>7</sup> Section II.A.3.d. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> Reg. §199A-1(b)(14).

<sup>12</sup> James M. Kehl, *The Most Important Deduction in the 2017 Tax Act: §199A*, 34 Tax Mgmt. Real Est. J., 48 (Mar. 7, 2018); James M. Kehl, *§199A Gets an Update Three Months After Its Enactment*, 59 Tax Mgmt. Memo. 115 (Apr. 16, 2018); and James M. Kehl, *Do the §199A Proposed Regulations Provide Clarity for Business Owners?* 59 Tax Mgmt. Memo. 293 (Sept. 17, 2018).

<sup>13</sup> Section II.A.3.a. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

<sup>14</sup> Notice 2019-07, 2019-9 I.R.B. 740 (Jan. 18, 2019).

<sup>15</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019).

<sup>16</sup> *Id.* at §4.

<sup>17</sup> *Id.*

<sup>18</sup> Section II.A.3.a. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

<sup>19</sup> Section II.A.3.b. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

<sup>20</sup> *Id.*

either the owner or the owner's agents; (4) the type and significance of any supplementary services provided under a lease; and (5) the type and terms of the lease (a short-term lease versus a long-term lease or a traditional lease versus a net lease).<sup>21</sup>

The IRS also elaborated on some of the definitional elements of a rental real estate enterprise that are contained in Notice 2019-07. These explanations will be discussed when the provisions of Rev. Proc. 2019-38 that pertain to rental real estate enterprises are discussed.

Finally, the IRS stated in the Preamble to the final §199A regulations that if a taxpayer is subject to other Code provisions that use a trade or business definition that is either the same as or substantially similar to the §162 trade or business definition of §199A, then the taxpayer must apply that definition consistently with respect to §199A and the other Code provisions.<sup>22</sup>

### Example 3

RB LLC is a partnership that owns a commercial building that is leased to unrelated tenants. For 2019, RB LLC has \$26 million of gross rental income, \$10 million of interest expense and \$9 million of operating expenses. RB LLC determines that it is a §162 trade or business for purposes of §199A. For purposes of the business interest limitation described in §163(j), business interest is any interest expense paid or accrued on debt that is allocable to a trade or business.<sup>23</sup> For purposes of §163(j), a trade or business is defined as a §162 trade or business.<sup>24</sup> Since RB LLC determined that its rental real estate activity was a trade or business for purposes of §199A, it must treat this activity as a trade or business for purposes of §163(j) because the trade or business definition is the same in both Code sections.

## GENERAL RULES OF REV. PROC. 2019-38

The purpose of Rev. Proc. 2019-38 is to help taxpayers "mitigate" the "uncertainty" of whether an interest in rental real estate constitutes a trade or business for §199A purposes.<sup>25</sup> Rev. Proc. 2019-38 accomplishes this task by providing a safe harbor whereby a "rental real estate enterprise" that satisfies

that revenue procedure's safe harbor requirements will be treated as a trade or business only for purposes of §199A.<sup>26</sup> If a rental real estate enterprise owned by an individual or RPE satisfies Rev. Proc. 2019-38's safe harbor conditions then, for purposes of the §199A regulations, that enterprise will be treated as a single trade or business.<sup>27</sup> Any taxpayer or RPE that desires to rely on this safe harbor must satisfy all of its requirements.<sup>28</sup> Most importantly, Rev. Proc. 2019-38 also states that "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 §199A."<sup>29</sup>

## RENTAL REAL ESTATE ENTERPRISE

A rental real estate enterprise is either an interest in a single item of real property or an interest in multiple real properties held by an individual or an RPE for the production of rents.<sup>30</sup> These real property interests must be held either directly by the individual or RPE or through a disregarded entity.

### Example 4

Karen owns Diamond Apartments through a domestic single-member limited liability company that is disregarded as an entity separate from Karen under Reg. §301.7701-3(b)(1)(ii). Karen also owns a 40% interest in Block LLC, a partnership that owns a commercial office building for the purpose of producing rents. The interest in Diamond Apartments may qualify as a rental real estate enterprise of Karen because she owns 100% of that property through an entity that is disregarded as separate from her for federal income tax purposes. The partnership interest Karen owns in Block LLC cannot be considered a rental real estate enterprise by Karen individually. However, since Block LLC is an RPE that directly owns an interest in an item of real property that is held for the production of rents, Block LLC may be eligible to treat its commercial office building as a rental real estate enterprise if certain other requirements of Rev. Proc. 2019-38 are fulfilled.

Certain interests in real property may not be rental real estate enterprises nor may those real property interests be included in a group of real properties that are part of a rental real estate enterprise. One of these types of interests is an interest in a dwelling unit, owned by the taxpayer directly or as an owner or ben-

<sup>21</sup> *Id.*

<sup>22</sup> Section II.A.3.e. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

<sup>23</sup> §163(j)(5).

<sup>24</sup> Prop. Reg. §1.163(j)-1(b)(38)(i).

<sup>25</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §2.03.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at §3.01.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at §3.02.



eficiary of an RPE, that is used by the taxpayer during a taxable year as a residence described in §280A(d).<sup>31</sup> This exclusion from the definition of a rental real estate enterprise is reasonable because the §199A deduction applies only to qualified items of income, gain, deduction and loss generated by a qualified trade or business of a taxpayer.<sup>32</sup> The Tax Court has ruled that if “a taxpayer uses a dwelling unit for rental purposes and also uses the dwelling unit for personal purposes for a number of days in excess of the number specified in §280A(d)(1). . . the taxpayer is deemed to have used the dwelling unit as a residence.”<sup>33</sup> Based on that case, if a taxpayer uses part of a dwelling unit as a residence and rents part of that unit to an unrelated person, the interest in this dwelling unit cannot be part of a rental real estate enterprise.

Real estate that is leased to a tenant under a triple net lease also cannot qualify as or be included in a rental real estate enterprise.<sup>34</sup> For purposes of Rev. Proc. 2019-38, “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.”<sup>35</sup> Under some net leases, the landlord may pay real estate taxes. If the lessor pays the real estate taxes, then the lease does not meet the definition of a triple net lease described in the preceding sentence. Net leased real estate that by virtue of the lessor paying real estate taxes and/or insurance is not excluded from that definition, however, is unlikely to satisfy the safe harbor rule’s requirement that a rental real estate enterprise provide at least 250 hours of rental services.<sup>36</sup> And because it probably lacks the regular, continuous, and substantial activity elements of a §162 trade or business, it probably wouldn’t qualify as a trade or business under that general definition.

Any real estate that is owned by the taxpayer and is leased either to a trade or business conducted by the taxpayer or to an RPE that is commonly controlled (as defined in Reg. §1.199A-4(b)(1)(i)) may not be included in a rental real estate enterprise and is thus not eligible for Rev. Proc. 2019-38’s safe harbor.<sup>37</sup> However, this type of real estate that does not rise to the level of a trade or business is mandatorily treated as a trade or business for purposes of §199A by Reg. §1.199A-1(b)(14).

<sup>31</sup> *Id.* at §3.05(A).

<sup>32</sup> §199A(c)(1).

<sup>33</sup> *Frank Shih, Jr. v. Commissioner*, T.C. Memo 1997-181 (Apr. 15, 1997).

<sup>34</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.05(B).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at §3.03(B).

<sup>37</sup> *Id.* at §3.03(C).

### Example 5

Ira individually owns a building that he leases to an S corporation in which he owns 100% of the stock. Ira collects \$70,000 of rental income from his business and incurs expenses of interest, real estate taxes, and depreciation totaling \$90,000. Ira’s leasing of his building cannot be a rental real estate enterprise, or part of one, because it is rented to an RPE that is commonly controlled by Ira as defined in Reg. §1.199A-4(b)(1)(i). The leasing of this building generates negative Qualified Business Income (QBI) to Ira of (\$20,000), which consists of income of \$70,000 minus expenses of \$90,000. Ira would like not to consider this net loss as part of QBI because it must either be offset against any other positive QBI that he has or, to the extent not offset in Ira’s current taxable year, be carried forward as negative QBI from a separate trade or business for §199A purposes in future taxable years. However, Ira is required by Reg. §1.199A(b)(14) to treat this activity as a trade or business for purposes of §199A.

The final type of rental real estate interest that cannot be part of a rental real estate enterprise is an “entire rental real estate interest if any portion of the interest is treated as an SSTB [Specified Service Trade or Business] under [Reg.] §1.199A-5(c)(2).”<sup>38</sup> Reg. §1.199A-5(c)(2)(i) states that if a trade or business provides property or services to an SSTB and there is 50% or more common ownership of the trades or businesses, that portion of the trade or business of providing property or services to the 50% or more commonly owned SSTB is treated as a separate SSTB with respect to the related parties. For purposes of this rule, 50% or more common ownership includes all direct or indirect ownership by related parties described in §267(b) or §707(b).<sup>39</sup>

### Example 6

Roberto and Marvin are two doctors who practice medicine through R&M LLC, a partnership that they own equally. Roberto and Martin also are equal partners in D&H LLC, which is a partnership that owns an office building. Approximately 50% of the office building owned by D&H LLC is leased to R&M LLC, which is an SSTB. Because D&H LLC is owned by the same people who own R&M LLC, the two trades or businesses have 50% or more common ownership. The 50% of the office building that is leased to R&M LLC is treated as a separate SSTB. The remaining portion of D&H LLC’s rental real estate activity is not treated as an SSTB.<sup>40</sup> No portion of the rental real estate interest owned by D&H LLC can be included in

<sup>38</sup> *Id.* at §3.03(D).

<sup>39</sup> Reg. §1.199A-5(c)(2)(ii).

<sup>40</sup> This portion of this example is based on Example 2 of Reg.

a rental real estate enterprise and thus is not eligible for the safe harbor rule of Rev. Proc. 2019-38. However, the portion of the building that is leased to unrelated tenants may generate QBI if the rental of the commercial office building is a trade or business under the general §162 definition.

Except for those rental real estate interests described above that are excluded from the definition of a rental real estate enterprise, a taxpayer or an RPE “may either treat each interest in similar property held for the production of rents as a separate rental real estate enterprise or treat interests in all similar properties held for the production of rents as a single rental real estate enterprise.”<sup>41</sup> The key concept in the preceding sentence is “similar property.” Rev. Proc. 2019-38 states that “properties held for the production of rents are similar if they are part of the same rental real estate category.”<sup>42</sup> The two categories for purposes of determining similar properties held for the purpose of generating rental income are (1) residential properties and (2) commercial properties.<sup>43</sup> Commercial real estate that produces rental income may be part of a rental real estate enterprise that contains only other commercial real estate held for the production of rental income. Likewise, residential real estate that produces rental income may be part of a rental real estate enterprise that contains only other residential rental real estate held for the production of rental income.<sup>44</sup> A taxpayer or RPE cannot have a rental real estate enterprise that consists of commercial real estate and residential real estate.

Rev. Proc. 2019-38 does not define residential properties or commercial properties. It is assumed that residential properties consist of properties that are dwelling units. This would include apartments, residential condominium units, single-family homes, and any other types of dwelling units where people reside. Commercial properties are presumed to include office buildings, warehouses, storage units, shopping centers, and other real estate used to house a business or a portion of a business. It seems reasonable that commercial properties would have to be categorized separately from residential properties because residential rental properties and commercial rental properties are two different types of trades or businesses. It is an underlying concept of §199A that the deductible amount component of CQBIA is to be separately determined

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§1.199A-5(c)(2)(iii)(B).

<sup>41</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.02.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

“for each trade or business”<sup>45</sup> The purpose of the Reg. §1.199A-4 aggregation rules is “to allow aggregation of what is commonly thought of as a single trade or business where the business is spread across multiple entities.”<sup>46</sup> In fact, the purpose of the two-out-of-three-factors aggregation rule of Reg. §1.199A-4(b)(1)(v) is to demonstrate that the businesses that are aggregated by either a taxpayer or an RPE are in reality “part of a larger, integrated trade or business.”<sup>47</sup> For these reasons, it is reasonable to postulate that a combination of different trades or businesses is not permitted by §199A. Since residential real estate held for the production of rents is a different type of business from commercial real estate that generates rents, combining both types of rental real estate in any manner seems contrary to the §199A principle of determining a deductible amount for each separate qualified trade or business.

Taxpayers or RPEs may own interests in a single building that produces rental income from residential units and commercial units. This is defined as “mixed-use property.”<sup>48</sup> A building that leases its first floor to a retail store and leases residential units on its higher floors would be a mixed-use property. A taxpayer or RPE that owns an interest in mixed-use property either may treat that interest as a single rental real estate enterprise or may divide it into separate residential or commercial interests.<sup>49</sup> If a mixed-use property interest is treated as a single rental real estate enterprise, it may not be treated as part of a rental real estate enterprise that consists of other residential properties, other mixed-use property, or other commercial properties.<sup>50</sup> In other words, the mixed-use property must retain its classification as a separate rental real estate enterprise.

#### Example 7

Rock LLC is an RPE that owns a six-story single building in a city. The first floor of that building is leased to two retail stores. The five floors above the first floor consist of residential units leased to individuals for the production of rents. This building is a mixed-use property. Rock LLC may treat this building as a single rental real estate enterprise. It may also combine its residential interest in this building with other residential interests that are part of a rental real

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<sup>45</sup> §199A(b)(2).

<sup>46</sup> Section V.B.3.e. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

<sup>47</sup> *Id.*

<sup>48</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.02.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

estate enterprise that consists of other residential interests and combine its commercial interests with other commercial interests that are part of a rental real estate enterprise that consists of other commercial interests. If Rock LLC elects to treat its interest in its mixed-use building as a single rental real estate enterprise, it may not be treated as part of the same rental real estate enterprise as other mixed-use property or other residential or commercial properties that it owns.

There is an irrevocable feature to a taxpayer's or RPE's elective definition of a rental real estate enterprise. Once a taxpayer or RPE elects to treat all residential properties as part of a single rental real estate enterprise, the taxpayer or RPE must treat all interests in residential properties owned or acquired in the future as part of the same rental real estate enterprise.<sup>51</sup> A comparable rule exists for commercial properties that states that once a taxpayer or RPE elects to treat all commercial properties as part of a single rental real estate enterprise, the taxpayer or RPE must treat all interests in commercial properties owned or acquired in the future as part of the same rental real estate enterprise.<sup>52</sup> However, a taxpayer or RPE that chooses to classify its interest in each of its commercial or residential properties held for the production of rents as a separate rental real estate enterprise may elect in a future year to treat all of its interests in similar residential properties or similar commercial properties as a single rental real estate enterprise.<sup>53</sup> The reason this decision to combine all similar rental estate interests as a single rental real estate enterprise must be carefully considered is the fact that this decision is effectively irrevocable once it is made. On the other hand, taxpayers or RPEs who treat each of their similar rental real estate interests as separate rental real estate enterprises retain the ability to subsequently combine those similar rental real estate interests into a single rental real estate enterprise.

## SAFE HARBOR REQUIREMENTS OF REV. PROC. 2019-38

After a taxpayer or RPE properly groups its activities in the manner required by the definition of a rental real estate enterprise, the next step under Rev. Proc. 2019-38 is to determine whether that revenue procedure's safe harbor requirements are satisfied. Whether the safe harbor conditions of Rev. Proc.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

2019-38 are satisfied is an annual determination.<sup>54</sup> All four of the following safe harbor requirements discussed below must be satisfied by any taxpayers or RPEs who desire to rely upon the safe harbor of Rev. Proc. 2019-38.<sup>55</sup>

### Requirement One: Separate Books and Records

Before discussing this requirement, it may be beneficial to review the general definition of books and records for income tax purposes. The books and records requirement for income tax purposes does not necessarily mandate that a taxpayer maintain a state-of-the-art formal set of accounting records. One definition of a record that perhaps may be discerned from the United States Code is "any memorandum, writing, entry, print, representation or combination thereof" made "in the regular course of business" by a "business, institution, member of a profession or calling or any department or agency of government" that records "any act, transaction, occurrence or event."<sup>56</sup> For income tax purposes, a taxpayer or anyone "required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information."<sup>57</sup> There are exceptions to this general rule for persons who are farmers or who earn wages.<sup>58</sup> These required records must be maintained accurately, but no prescribed form of records is required.<sup>59</sup> The only requirement is that the forms and accounting systems that are used must enable the IRS to ascertain the amount of any tax liability incurred.<sup>60</sup> Moreover, workpapers and other auxiliary records, such as depreciation schedules, may be considered a part of a taxpayer's books and records if those documents are "(1) sufficiently complete and accurate to provide a reconciling the regularly maintained books of account and the tax returns and (2) must be in the possession of the taxpayer and maintained in association with the taxpayer's regular books of account."<sup>61</sup> In one case, a cash basis taxpayer did not maintain formal journals

<sup>54</sup> *Id.* at §3.03.

<sup>55</sup> *Id.* at §3.01.

<sup>56</sup> 28 U.S.C. §1732.

<sup>57</sup> Reg. §1.6001-1 (a).

<sup>58</sup> Reg. §1.6001-1(b).

<sup>59</sup> Reg. §31.6001-1(a).

<sup>60</sup> *Id.*

<sup>61</sup> Rev. Rul. 71-333, 1971-2 C.B. 244 (Jan. 1, 1971). *Also see* Rev. Rul. 58-601, 1958-2 C.B. 81, and Rev. Rul. 68-420, 1968-2 C.B. 257.



and ledgers or use another formal bookkeeping system for her law practice. She did record fee payments supported by bank deposit slips in ledger books and retained canceled checks with notations that would explain the purpose of those checks as well as credit card receipts, statements, and other pertinent documents. The taxpayer's accountant used these records to prepare accounting workpapers that classified the taxpayer's expenses into return preparation categories and summarized the taxpayer's income and expenses. The Tax Court ruled that this informal method of bookkeeping satisfied the income tax regulations for adequate books and records.<sup>62</sup> Separate books and records are required for the income and expenses of a rental real estate enterprise, but those records may be informal as long as they enable the IRS to accurately compute a taxpayer's tax liability.

The first safe harbor requirement is that "separate books and records are maintained to reflect income and expenses for each rental real estate enterprise."<sup>63</sup> This requirement does not require the taxpayer to maintain these required separate books and records, but only requires those books and records to be "maintained." Those records could perhaps be maintained by a bookkeeping service or a real estate management company. The other interesting aspect of this rule is that the records are only required to reflect income and expenses of a rental real estate enterprise. It would seem that records that support the Unadjusted Basis Immediately After Acquisition (UBIA) of qualified property and W-2 wages should also be required.

The Preamble to the final §199A income tax regulations stated that this safe harbor would require each rental real estate enterprise to maintain separate bank accounts.<sup>64</sup> This separate bank account requirement was not adopted by Notice 2019-7 or Rev. Proc. 2019-38.

Rev. Proc. 2019-38 explained how this separate books and records requirement could be satisfied by a rental real estate enterprise that has multiple properties. The rental real estate enterprise must have separate income and expense statements for each of its properties. It must then consolidate those statements.<sup>65</sup>

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<sup>62</sup> *Ragnhild A. Westby v. Commissioner*, T.C. Memo. 2004-179 (Aug. 3, 2004).

<sup>63</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.03(A). This requirement was also in Notice 2019-7 (Jan. 18, 2019).

<sup>64</sup> Section II.A.3.b. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

<sup>65</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019),

## Example 8

Boris has three residential condominium projects that he holds for the production of rents. These three projects are managed by a real estate management company. The real estate management company maintains bank accounts for each of these projects, collects all of the rents and deposits those rents into these accounts, advertises to fill any vacant units, reviews all tenant applications, maintains the properties by providing any necessary repairs, and supervises the resident managers and other personnel who perform services for these properties. Each month, the real estate management company sends Boris monthly income and expense statements. At the end of the year, the real estate management company sends Boris an annual income and expense statement that totals the monthly amounts of income and expenses for each project. Included with this annual income and expense statement for each project is a balance sheet that includes the project's cash balances, tenant account receivables, and accounts payable. Boris sends these records to his accountant who consolidates them and uses the consolidated totals along with amounts from depreciation workpapers maintained by the accountant to develop the numbers that are entered on Boris's tax return. These books and records for Boris should satisfy the books and records requirement of Rev. Proc. 2019-38 for a rental real estate enterprise to be treated as a single trade or business.

There are many taxpayers and RPEs who maintain informal income and expense records for each of their rental real estate properties. This requirement appears to accommodate those taxpayers by not imposing rigid or overly formal record keeping systems on those entities. The flexibility allowed by this requirement and the general tax definitions of books and records should benefit those taxpayers and RPEs.

## Requirement Two: 250 or More Hours of Rental Services

One of the major clarifications of Rev. Proc. 2019-38 is the number of hours of rental services necessary for a rental real estate enterprise to satisfy its safe harbor requirements. Another major clarification is the definition of rental services.

The required number of hours of rental services with respect to a rental real estate enterprise depends upon the number of years that a rental real estate enterprise has existed. If a rental real estate enterprise has existed for less than four years, the number of hours of rental services that must be performed per year with respect to that rental real estate enterprise is

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§3.03(A).

at least 250.<sup>66</sup> Since a rental real estate enterprise concept and §199A were not part of federal tax law prior to tax years ending after December 31, 2017, this would be the criterion that would have to be met for tax years ending on December 31 of 2018, 2019, and 2020. Once a rental real estate enterprise has existed for at least four years, then 250 or more hours of rental services must be performed per year with respect to that rental real estate enterprise in any three of the five consecutive years that end with the current taxable year.<sup>67</sup>

This number of hours requirement differed slightly from the number of hours of rental services with respect to a rental real estate enterprise that was required by Notice 2019-7. That Notice required 250 or more hours of rental services to be performed per year with respect to a rental real estate enterprise for taxable years that begin before January 1, 2023.<sup>68</sup> For tax years that begin after December 31, 2022, 250 or more hours of rental services with respect to a rental real estate enterprise were required by Notice 2019-7 to be performed in any three of the five consecutive taxable years that end with the current taxable year.<sup>69</sup> The three-out-of-five-year rule of Rev. Proc. 2019-38 will be able to be applied by RPEs with fiscal years before the three-out-of-five-year rule of Notice 2019-7 would have been available to them. The three out of five consecutive taxable years rule also may allow rental real estate enterprises that have met the 250 or more hours rule for their previous years but not for a current year to be able to meet Rev. Proc. 2019-38's safe harbor requirements for that current year.

### Example 9

Nate is a calendar year taxpayer who owns a rental real estate enterprise that began on January 1, 2018 and has continued to exist through December 31, 2025. For the years 2018, 2019 and 2020, at least 250 hours of rental services would have to be performed per year with respect to Nate's rental real estate enterprise. For the years 2021, 2022, 2023, 2024, and 2025, at least 250 hours of rental services must be performed per year with respect to that rental real estate enterprise in any three of the five consecutive years that end with the current taxable year.

Rental services with respect to a rental real estate enterprise may be, but are not required to be, performed by individual owners or by owners of an

RPE.<sup>70</sup> The required rental services may also be performed by employees, agents, independent contractors or a combination of the owners and the owners' employees, agents and/or independent contractors.<sup>71</sup> This rule permits the owners of a rental real estate enterprise to be passive and perform no rental services with respect to that enterprise as long as the required rental services are performed by a management company or by employees and/or independent contractors.

### Example 10

For 2019, Mildred resides in Maryland and owns three residential apartment projects that are located in Colorado, Utah, and Arizona. Mildred treats these three projects as a single rental real estate enterprise for 2019. Mildred personally performs no rental services with respect to any of her apartment projects or with respect to this rental real estate enterprise. However, Mildred has hired three separate management companies to manage her residential apartment projects. Together, those management companies provide more than 250 hours of rental services in 2019 with respect to the residential apartment projects that comprise Mildred's rental real estate enterprise. Mildred is considered to have satisfied Rev. Proc. 2019-38's safe harbor requirement for rental services for 2019.

Rev. Proc. 2019-38 has also delineated some of the services that are considered rental services. The words "some of" are used because Rev. Proc. 2019-38 states that rental services "include, but are not limited to," the services outlined in that Revenue Procedure.<sup>72</sup> Three of the rental services specified by Rev. Proc. 2019-38 relate to obtaining tenants for real property held for the production of rents. These services include the following: (1) advertising for tenants to rent or lease the real property; (2) arranging and putting into effect leases with those tenants; and (3) verifying any information that is part of the applications of prospective tenants.<sup>73</sup> Otherservices defined as rental services by Rev. Proc. 2019-38 relate to the operation of the real estate properties. These rental services include the following: (1) collecting rents from tenants; (2) operating, maintaining and repairing the property on a daily basis, which includes purchasing necessary materials and supplies; (3) general management of the real property; and (4) supervising any independent contractors and employees.<sup>74</sup> Rental services do not include hours expended on activities or services that have nothing or very little to do with managing or op-

<sup>66</sup> *Id.* at §3.03(B).

<sup>67</sup> *Id.*

<sup>68</sup> §3.03(B) of the Form of The Proposed Revenue Procedure Section of IRS Notice 2019-7.

<sup>69</sup> *Id.*

<sup>70</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.04.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*



erating real estate. These activities or services are “financial or investment management activities” that include negotiating and obtaining financing, obtaining property, reviewing and studying financial reports or statements about operations, making additions or improvements to property as described in Reg. §1.263(a)-3(d), and traveling to and from the real property.<sup>75</sup>

### Requirement Three: Maintenance of Contemporaneous Records

The third safe harbor requirement that must be satisfied with respect to a rental real estate enterprise that wishes to be considered a single trade or business under Rev. Proc. 2019-38 is that a taxpayer, which is presumed to include an RPE, applying the provisions of Rev. Proc. 2019-38, must maintain “contemporaneous records” of all of the following: (1) number of hours spent on performing the services; (2) description of all rental and non-rental services performed; (3) the dates those services were performed; and (4) the persons or entities who performed those services.<sup>76</sup> These records may include “time reports, logs, or similar documents.”<sup>77</sup>

The first aspect of this requirement is that these records must be maintained by the taxpayer or RPE that wishes to apply the safe harbor rules of Rev. Proc. 2019-38 with respect to a rental real estate enterprise. The apparent reason these records must be maintained by the “taxpayer” [RPE] is that these “records are to be made available for inspection at the request of the IRS.”<sup>78</sup> If the taxpayer (or RPE) does not have these records available because the records are kept by someone else, the IRS may not be able to inspect those documents as part of an income tax examination.

The next aspect of this requirement is that the records must be “contemporaneous.” The dictionary definition of this word is “existing, occurring or originating during the same time.”<sup>79</sup> A literal application of this adjective would mean that these required records must be created at the same time as the rental services are performed with respect to the rental real estate enterprise. Contemporaneous records required by some areas of the federal income tax laws are not required to be created at the exact same time as the event those records are recording or acknowledging. A required acknowledgement of a charitable contribu-

tions is considered contemporaneous by §170(f)(8)(C) if a taxpayer obtains it on or before the earlier of: (1) the date the taxpayer files his income tax return for the year the contribution was made; or (2) the due date (including extensions) of the taxpayer’s tax return for the year of the contribution. Reg. §1.482-7(k)(1) requires a Cost Sharing Arrangement (CSA) to be recorded in writing in a contract that is contemporaneous with that CSA’s formation and any revision. A written contractual agreement is considered as satisfying this contemporaneous requirement only if the CSA is recorded in its entirety in a document that is signed and dated by the CSA’s controlled participants no later than 60 days after the first occurrence of any Intangible Development Cost.<sup>80</sup> Since the contemporaneous records requirement does not apply to taxable years that begin before January 1, 2020,<sup>81</sup> it is possible that further guidance may be published concerning the meaning of “contemporaneous record.” Until that occurs, it is probably wise that the records of the required rental services be prepared as closely as possible to the time that the rental services are performed. In any event, those records must exist prior to the date the tax return of the taxpayer or RPE relying upon the safe harbor of Rev. Proc. 2019-38 files its tax return.

As discussed above, Rev. Proc. 2019-38 contemplates that a taxpayer or RPE may have rental services performed by the taxpayer’s or RPE’s own employees or by independent contractors. For instance, a taxpayer or RPE that operates an apartment project may have trash removal services performed by a waste management company and may employ a resident building manager and maintenance people. A taxpayer or RPE that operates a commercial building may have security services provided by its own employees or by a security company, may have janitorial services provided to its tenants by its own employees or by a company that provides cleaning services, and may have elevator maintenance services provided by its employees or by an elevator maintenance company. A taxpayer’s or RPE’s residential or commercial properties may be managed by a real estate management company. Taxpayers or RPEs who utilize employees or independent contractors to perform rental services may satisfy the contemporaneous records requirement of Rev. Proc. 2019-38 by providing a description of the rental services performed by those employees or independent contractors and by providing time, payroll or payment records that indicate the amount of time those employees or independent contractors ex-

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at §3.03(C).

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> <https://www.merriam-webster.com/dictionary>.

<sup>80</sup> Reg. §1.482-7(k)(1)(iii).

<sup>81</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §4.

pending in providing the rental services for the rental real estate enterprise.<sup>82</sup>

### Example 11

Block LLC is an RPE that owns Randallstown Garden Apartments, which is an apartment project that leases 200 residential units to its tenants. Block LLC's managing member provides overall supervision of the full-time resident manager and maintenance personnel employed by the project as well as any independent personnel that provide trash removal and grounds maintenance services. Block LLC uses a payroll service to issue paychecks to its employees. Block LLC's managing member should maintain logs and time reports that do the following: (1) describe the services the managing member performs; (2) indicate the dates he performs those services; and (3) indicate the number of hours he expends on performing those services. He also should prepare these diaries, logs, and other documentation as close to the dates he performs these services as possible. Block LLC's managing member should also request that the invoices the apartment project receives from contractors that provide the trash removal and grounds maintenance services indicate the dates those services are performed, who performed those services, the number of hours spent performing those services, and a description of the services performed. Block LLC should retain copies of the cancelled checks and bank statements in order to prove payment of these invoices. Block LLC should prepare and retain a description of the rental services performed by the resident manager and maintenance personnel. The payroll records supplied to Block LLC by the payroll service should indicate the number of hours those employees expended in performing those services as well as providing the necessary wage and payment records.

As indicated above, this requirement of maintaining contemporaneous records is not applicable to taxable years that begin prior to January 1, 2020.<sup>83</sup> Even though this requirement is not effective for years that begin in 2019, it may be prudent for rental real estate enterprises who desire to rely upon the safe harbor of Rev. Proc. 2019-38 to begin keeping these records for all taxable years.

### Requirement Four: Statement to Be Attached to Tax Return

Notice 2019-7 required a taxpayer who claimed a §199A deduction or an RPE that passed through §199A information to its owners and desired to rely upon its safe harbor for a rental real estate enterprise

to attach a statement signed either by the eligible taxpayer or an authorized representative of that eligible taxpayer or RPE that read: "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."<sup>84</sup> Fortunately, Rev. Proc. 2019-38 does not contain this requirement.

Rev. Proc. 2019-38 does require a taxpayer or RPE who wants to rely on its safe harbor for purposes of §199A to attach a statement to either 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. That statement must contain the following information for each rental real estate enterprise: (1) an address, description and rental category (residential, commercial or mixed-use) of all rental real estate properties contained in each rental real estate enterprise; (2) an address, description and rental category of all rental real estate properties that were either acquired or disposed of during the taxable year; and (3) a statement that the requirements of Rev. Proc. 2019-38 have been satisfied.<sup>85</sup> An individual or RPE that has more than one rental real estate enterprise and wants to rely upon Rev. Proc. 2019-38's safe harbor is permitted to submit a single statement as long as that statement contains the information described in the preceding sentence for each rental real estate enterprise.<sup>86</sup>

## RENTAL REAL ESTATE AS A §162 TRADE OR BUSINESS WITHOUT APPLYING REV. PROC. 2019-38

Rev. Proc. 2019-38 defines a rental real estate enterprise and outlines the conditions of a safe harbor whereby a rental real estate enterprise described in that revenue procedure may be treated as a §162 trade or business. Many taxpayers or RPEs either may not desire to apply Rev. Proc. 2019-38 or may fail to satisfy Rev. Proc. 2019-38's safe harbor requirements. The rental activities of those taxpayers or RPEs will have to qualify as §162 trades or businesses under the general definition of Reg. §1.199A-1(b)(14) if those activities are to generate QBI.

The author contends that taxpayers or RPEs that do not fulfill all of the conditions of the safe harbor contained in Rev. Proc. 2019-38 may still have their in-

<sup>84</sup> Section 3.06 of the Form of The Proposed Revenue Procedure Section of IRS Notice 2019-7.

<sup>85</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.03(D).

<sup>86</sup> *Id.*

<sup>82</sup> *Id.* at §3.03(C).

<sup>83</sup> *Id.* at §4.

terests in rental real estate treated as §162 trades or businesses for purposes of §199A under the general §162 trade or business guidelines. To accomplish the objective of having its interests in rental real estate treated as a trade or business, a taxpayer or RPE must establish that its real estate rental operations are for the purpose of making a profit and that those rental real estate operations possess the regular, continuous and substantial activity characteristics of a §162 trade or business. Taxpayers or RPEs can achieve this objective without complying with all of the conditions of Rev. Proc. 2019-38. However, Rev. Proc. 2019-38 may be instructive for those taxpayers or RPEs who do not comply with its safe harbor requirements but who desire that their rental real estate interests be considered a trade or business. This is because Rev. Proc. 2019-38 may contain indications about the IRS's attitude toward certain aspects of a §162 rental real estate business. The remainder of this article will discuss those possible indications and their application to a case study that may represent a typical situation for many taxpayers or RPEs.

## CASE STUDY

Ed is a dermatologist who works 40 hours per week at a hospital and devotes additional time to reading and attending training seminars. Ed also owns three residential condominiums: two townhouses and one single-family dwelling. Ed holds these properties for the purpose of producing rental income and hopes that they will continue to provide him with a source of income when he retires. Ed personally manages these six residential rental properties. Some of these regular, continuous, and substantial management activities are finding new tenants, preparing the units for those new tenants and supplying furnishings.

The facts in this case study are the facts of *Edwin R. Curphey v. Commissioner*.<sup>87</sup> The Tax Court held that the taxpayer's "activities were sufficiently systematic and continuous to place him in the business of real estate rental."<sup>88</sup> For purposes of §199A, the Tax Court's holding in the *Curphey* case can be cited to support an assertion that all of a taxpayer's or RPE's residential rental properties may, when combined and viewed in totality, comprise a §162 trade or business. A taxpayer or RPE making this contention would have to demonstrate the similarity of its situation to the facts of this case. Since the primary issue of the *Curphey* case related to a §280A home office deduction, the Tax Court's opinion did not contain an elaborate discussion of how it arrived at its conclusion that

the taxpayer was in a real estate business. The discussion of this case study will talk about the actual and implied factors the Tax Court considered in reaching its decision, apply those factors to the case study, and then discuss how Rev. Proc. 2019-38 illuminates the current attitude of the IRS concerning those factors.

The first observation about the *Curphey* case is that the rental real estate interests of the taxpayer that comprised his trade or business consisted solely of residential rental properties directly owned by the taxpayer. Partnership interests or interests in other pass-through entities that held rental properties were not part of this trade or business. The attitude of the IRS toward this factor is indicated by Rev. Proc. 2019-38's mandate that all interests in a taxpayer's or an RPE's rental real estate properties that are to be part of a rental real estate enterprise must be either directly owned or owned through an entity that is disregarded for federal income tax purposes. Partnership interests or other interests in pass-through entities owned by a taxpayer or RPE may not be part of this grouping or combination of rental real estate interests. The combined interests must be interests in properties. When attempting to combine interests for purposes of showing that the combined interests are part of a single §162 trade or business, taxpayers or RPEs should not attempt to combine interests held through investments in pass-through entities.

Another observation is that Rev. Proc. 2019-38 indicates the IRS's belief that a taxpayer or RPE may not combine or group commercial rental real estate properties with residential rental real estate properties into one §162 trade or business. Rev. Proc. 2019-38 states that residential rental real estate and commercial rental real estate are two separate categories for purposes of determining a taxpayer's or RPE's rental real estate enterprises. The inference to be drawn is that the Treasury Department and the IRS believe residential real estate and commercial real estate are different trades or businesses. Treating an office building that is rented and a shopping center that is rented as part of the same rental real estate enterprise is apparently permitted by Rev. Proc. 2019-38. Whether an office building and a shopping center can be part of one §162 trade or business is not known. But it seems reasonable that Rev. Proc. 2019-38's permitting only residential rental properties to be part of the same rental real estate enterprise as other residential rental real estate and only commercial rental real estate properties to be part of the same rental real estate enterprise as other commercial real estate supports the assertion that the IRS and Treasury believe residential rental real estate properties and commercial rental real estate properties cannot be part of the same §162 trade or business.

An inference that must be drawn from the *Curphey* case is that the taxpayer had satisfactory records to

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<sup>87</sup> *Edwin R. Curphey v. Commissioner*, 73 T.C. 766 (Feb. 4, 1980).

<sup>88</sup> *Id.*



document the amounts of his gross rental income, negative cash flow and net loss from his six units. These amounts were not challenged by the IRS. Income tax regulations and other administrative guidance has traditionally indicated that one of the characteristics of an activity with an objective of making a profit is maintaining “complete and accurate books and records.”<sup>89</sup> The income tax regulations for accounting methods discuss how taxable income is to be calculated using the “method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books.”<sup>90</sup> The syllabus of the *Curphey* case did not discuss the taxpayer’s books and records. However, the summary of that case did indicate that the records maintained by the taxpayer reflected the income and expenses from his properties. It can be discerned from this case that the records a taxpayer or RPE would need to support a contention that several rental properties comprise a §162 trade or business would be records of the income and expenses of each property. Rev. Proc. 2019-38 reinforces this inference with its safe harbor requirement that books and records must be “maintained to reflect income and expenses for each rental real estate enterprise.”<sup>91</sup>

The taxpayer in the *Curphey* case computed his net loss and negative cash flow for his six rental properties by combining his income and expenses from each of his properties to arrive at total amounts. Following the methodology of the *Curphey* case, a taxpayer with several rental properties that are each part of a §162 trade or business would combine and consolidate the income and expenses of each of those properties to determine the income and expenses of the rental real estate business. Rev. Proc. 2019-38 would seem to support this methodology with its declaration that a rental real estate enterprise with more than one property may satisfy the safe harbor’s books and records requirement “if income and expense information statements for each property are maintained and then consolidated.”<sup>92</sup> It also seems reasonable that a taxpayer with several rental properties that are components of a §162 trade or business should determine the W-2 wages and UBIA for that trade or business by combining and consolidating the amounts of W-2 wages and UBIA of each rental property.

Prior articles have discussed how rental income could be considered §162 trade or business income only if significant services were provided to tenants in

a regular, continuous, and substantial manner.<sup>93</sup> Those articles speculated on the question of what types of significant services had to be provided. The *Curphey* case indicated that significant services for residential rental properties included “seeking new tenants ..., supplying furnishings and ... cleaning and otherwise preparing the units for new tenants.”<sup>94</sup> Rev. Proc. 2019-38 created the concept of “rental services” and described some of the services this term encompasses.<sup>95</sup> Rev. Proc. 2019-38’s list of rental services is an indication of the types of services the IRS believes are rental services. At the same time, Rev. Proc. 2019-38 also indicates the IRS’s belief as to the “financial or investment management activities” that would not be considered significant services.<sup>96</sup> A taxpayer or RPE who is seeking to demonstrate that multiple rental properties are part of a §162 trade or business must, based on the *Curphey* case and other authoritative guidance, show that significant rental services to tenants are provided by this rental trade or business. Rev. Proc. 2019-38’s discussion of the types of services that are included in the definition of rental services should provide a reference point as to the nature of these significant rental services.

Some tax professionals believed that an individual owner of rental real estate properties had to be actively involved in the management of those properties in order for those properties to be a §162 trade or business. Other tax professionals held an opinion that a §162 trade or business could have an objective of making a profit and possess the required characteristics of regular, continuous and substantial activity without the active involvement of the owner if these required characteristics were demonstrated by the regular, continuous and substantial involvement of the owner’s employees or a real estate management company engaged by the owner to manage the properties. Rev. Proc. 2019-38 appears to indicate that the IRS agrees with the latter view because it allows rental services performed with respect to a rental real estate enterprise to “be performed by owners, including

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<sup>93</sup> See James M. Kehl, *The Most Important Deduction in the 2017 Tax Act: §199A*, 34 Tax Mgmt. Real Est. J. 48 (Mar. 7, 2018); James M. Kehl, *§199A Gets an Update Three Months After Its Enactment*, 59 Tax Mgmt. Memo. 115 (Apr. 16, 2018); and James M. Kehl, *Do the §199A Proposed Regulations Provide Clarity for Business Owners?* 59 Tax Mgmt. Memo. 293 (Sept. 17, 2018).

<sup>94</sup> *Edwin R. Curphey v. Commissioner*, 73 T.C. 766 (Feb. 2, 1980).

<sup>95</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.04.

<sup>96</sup> *Id.*

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<sup>89</sup> Reg. §1.183-2(b)(1).

<sup>90</sup> Reg. §1.446-1(a)(1).

<sup>91</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.03(A).

<sup>92</sup> *Id.*

owners of an RPE, or by employees, agents, and/or independent contractors of the owners.”<sup>97</sup>

One of the problems with determining whether a group of rental real estate properties constituted a §162 trade or business was determining how many hours of significant services had to be performed on a regular, continuous, and substantial basis. There was no indication of the number of hours of services performed in the *Curphey* case or in other guidance. Some professionals felt at least 500 hours of significant services had to be performed annually because this was one of the tests of material participation contained in the income tax regulations defining material participation for purposes of the passive loss rules.<sup>98</sup> However, that was a subjective determination. As mentioned in the Preamble to the §199A regulations, the §469 regulations are tests for determining “whether an individual materially participates in a rental real estate activity. They cannot be used to determine whether the activity itself is a trade or business.”<sup>99</sup> On the other hand, the purpose of Rev. Proc. 2019-38 is to determine whether a rental real estate enterprise is a §162 trade or business. For this reason, Rev. Proc. 2019-38 seems to provide taxpayers with some basis for asserting that the required number of hours of significant rental services for a §162 trade or business may be 250 or more based on Rev. Proc. 2019-38’s requirement that 250 or more hours of rental services would have to be performed with respect to rental real estate enterprises that have not existed for four years.<sup>100</sup> This is a subjective opinion. The counter view is that the standard of 250 or more hours is only for purposes of the safe harbor requirements for a rental real estate enterprise.

Finally, Rev. Proc. 2019-38 emphasizes the importance of contemporaneous documentation, such as logs and time reports, concerning hours of rental ser-

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<sup>97</sup> *Id.*

<sup>98</sup> Reg. §1.469-5T(a)(1).

<sup>99</sup> Section II.A.3.b. of the Summary of Comments and Explanation of Revisions in the Preamble to the Final Code Section 199A regulations that was in T.D. 9847, filed with the Federal Register on February 4, 2019.

<sup>100</sup> Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (Sept. 24, 2019), §3.03(B).

vices provided with respect to a rental real estate enterprise.<sup>101</sup> A taxpayer or RPE contending that the entity’s rental real estate properties constitute a §162 trade or business will need to document the necessary regular, continuous, and substantial activity. These records should be prepared as close to the time the rental services are provided as possible in order to be contemporaneous. Post-fact reconstructions that are estimates of the services provided during a year are likely to be unsatisfactory. This has proven to be true for taxpayers who were unsuccessful in litigation concerning §469.<sup>102</sup> On the other hand, taxpayers that provided reliable contemporaneous records that were supplemented with credible testimony were successful in cases that involved §469.<sup>103</sup> Rev. Proc. 2019-38 reinforces the necessity of keeping and maintaining good records if a taxpayer or RPE desires to have its rental real estate activities considered a §162 trade or business for purposes of §199A.

## CONCLUSION

Since rental real estate activities may be §162 trade or business activities or §212 activities held for the production of income, the issue of whether these rental real estate activities are qualified §199A trades or businesses will continue to bedevil taxpayers and their advisors. Rev. Proc. 2019-38 resolves this issue for rental real estate enterprises that satisfy its safe harbor requirements. However, Rev. Proc. 2019-38 is also illuminating for those taxpayers or RPEs who desire to be accorded §162 trade or business standing without fulfilling Rev. Proc. 2019-38’s safe harbor requirements.

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<sup>101</sup> *Id.* at §3.03(C).

<sup>102</sup> See *Merino v. Commissioner*, T.C. Memo 2013-167 (July 16, 2013); *Flores v. Commissioner*, T.C. Memo 2015-9 (Jan. 12, 2015); *Coastal Heart Med. Grp., Inc. v. Commissioner*, T.C. Memo 2015-84 (May 4, 2015); and *Almquist v. Commissioner*, T.C. Memo 2014-40 (Mar. 10, 2014). There are several other cases that could be cited where a taxpayer’s lack of timely-prepared records had adverse consequences for a taxpayer.

<sup>103</sup> *Zarrinnegar and Dini v. Commissioner*, T.C. Memo 2017-034 (Feb. 13, 2017); *Windham v. Commissioner*, T.C. Memo 2017-068 (Apr. 24, 2017).