Comments on Proposed Revenue Procedure in Notice 2019-07 Regarding Section 199A and Rental Real Estate Enterprises

AMERICAN BAR ASSOCIATION SECTION OF TAXATION

June 27, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on the Proposed Revenue Procedure in Notice 2019-07 Regarding Section 199A and Rental Real Estate Enterprises

Dear Commissioner Rettig:

Enclosed please find comments on the proposed revenue procedure in Notice 2019- 07 regarding section 199A of the Internal Revenue Code. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,
Eric Solomon
Chair, Section of Taxation
Enclosure

cc:
Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury

Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Audrey W. Ellis, Attorney-Advisor, Department of the Treasury
Hon. Michael Desmond, Chief Counsel, Internal Revenue Service
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Frank J. Fisher, Office of Associate Chief Counsel, (Passthroughs & Special Industries), Internal Revenue Service

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These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by John Sikora. Substantial contributions were made by Todd Keator, Bryan Keith, and Thomas Phillips. These comments have been reviewed by Grace Kim and Jennifer Alexander of the Partnerships & LLCs Committee, Gary Huffman of the Committee on Government Submissions, and Eric B. Sloan, Vice Chair for Government Relations for the Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments, or has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section's diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: June 27, 2019

Executive Summary

Section 199A was added to the Code by An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, commonly referred to as the Tax Cuts and Jobs Act (the "Act").[1] Final regulations under section 199A were issued on January 18, 2019 (the "Final Regulations"). Notice 2019-07, [2019-09 I.R.B. 740,] issued simultaneously with the Final Regulations, contains a proposed revenue procedure (the "Proposed Revenue Procedure") detailing a proposed safe harbor pursuant to which a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A (the "Safe Harbor").

We commend the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") for providing expedited guidance under section 199A. We respectfully request that Treasury and the Service consider the following recommendations with respect to the Proposed Revenue Procedure.

1. We recommend that taxpayers be allowed to include commercial and residential real estate (and real estate that may include both uses) in the same enterprise.

2. We recommend that the word "similar" be eliminated from the description of properties that are to be included in the same enterprise if the taxpayer does not treat each property as a separate enterprise or, if not eliminated, that the meaning of the word be clarified.

3. We recommend that the requirement of the proposed Safe Harbor regarding the performance of 250 or more hours of "rental services" for the year with respect to each "rental enterprise" be reduced to 120 hours. In addition, we recommend that "planning, managing, or constructing long-term capital improvements" be removed from the list of excluded activities under the definition of "rental services" if tenants of the taxpayer have previously occupied and paid rent for more than fifty percent (50%) of the available rental space in a property for more than three consecutive months.

[1] P[ub]. L. [No.] 115-97, 131 Stat. 2054 (Dec. 22, 2017). Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended.

4. We recommend that the exclusion of real estate used by the taxpayer as a residence be replaced with (or clarified by) a rule providing that a taxpayer may not apply the proposed Safe Harbor to any portion of any real estate that is a dwelling unit within the meaning of section 280A used by the taxpayer during any part of the taxable year as a residence.

5. If our fourth recommendation (regarding real estate used by the taxpayer as a residence) is adopted, we recommend that the hourly requirement be eliminated for taxpayers using not more than fifty percent (50%) of the real estate as a principal residence for the entire year if the taxpayer treats that real estate as a separate enterprise.

6. We recommend that the provision in the proposed Safe Harbor that requires separate books and records be maintained for each rental real estate enterprise be modified to state that if the enterprise includes more than one property, the requirement may be satisfied if the taxpayer maintains income and expense information statements for each property, which then are consolidated.

7. We recommend the following general modifications regarding the definition of triple net lease: that it be comprehensive (and not one that refers merely to what the term "includes"); that the references to tenant obligations to pay taxes, fees, and insurance be replaced with references to tenant obligations to pay all of the real estate taxes, operating expenses and casualty insurance allocable to the portion of the property leased by the tenant; and that responsibility for maintenance be clarified to mean that the tenant is responsible for providing or engaging all maintenance, repair, and replacement services and work, with the exception of repairs and replacements to foundations, exterior walls or roofs, in addition to paying for or reimbursing the lessor for the services and work. We also recommend that the exclusion not apply unless more than fifty percent (50%) of the square footage of the improvements on the real estate is subject to triple net leases at any time in the applicable taxable year.

Discussion

These Comments address the proposed Safe Harbor included in the Proposed Revenue Procedure pursuant to which a "rental real estate enterprise" may be treated as a "trade or business" for purposes of section 199A. We appreciate the acknowledgement that whether a rental real estate pursuit is a trade or business under section 199A is the subject of uncertainty for some taxpayers and the decision to propose a safe harbor.

Regulation section 1.199A-1(b)(14) defines "trade or business" for purposes of section 199A as a trade or business under section 162. The preamble to Treasury Decision 9847 (the "Preamble") refers to *Commissioner v.*

Groetzinger, 480 U.S. 23 (1987), as the seminal case regarding the definition of "trade or business" under section 162, and interprets the decision and others to require, in addition to a profit motive, "considerable, regular, and continuous activity."

1. *Definition of Rental Real Estate Enterprise – Interests in Commercial and Residential Real Estate*

a. *Background*

The proposed Safe Harbor states that a rental real estate enterprise that satisfies certain requirements will be treated as a trade or business for purposes of section 199A. It provides that a rental real estate enterprise may consist of an interest in multiple similar properties, but that commercial and residential real estate may not be part of the same enterprise.[2]

b. *Recommendation*

We recommend that taxpayers be allowed to include commercial and residential real estate (and real estate that may include both uses) in the same enterprise.

c. *Explanation*

The ownership and rental of different kinds of properties, such as a multifamily residential development and an office building, by a single taxpayer is not uncommon. A taxpayer might also own mixed-use properties, such as, for example, one with both retail and apartment space. It is possible that taxpayers holding commercial, residential and mixed-use properties would not meet the proposed Safe Harbor requirements with respect to any of the properties separately, but would meet the requirements with respect to all of the properties if viewed as a single enterprise.

We appreciate the decision to allow taxpayers to treat interests in multiple rental properties as a single enterprise and, in turn, a trade or business, under the proposed Safe Harbor. However, we do not believe a taxpayer's rental real estate holdings should be separated based on the use of the property.[3]

The fundamental activities carried on by a taxpayer holding rental properties, whether commercial, residential, or mixed-use, are essentially the same. Similar rental services, skill, and activities are provided, applied and occur as to each. The nature of revenue and expense items is the same. The essential

[2] Section 3.02 of the Proposed Revenue Procedure[, Notice 2019-07, 2019-09, I.R.B. at 741].

[3] The Preamble states that "relevant factors" for determining whether a rental real estate activity is a section 162 trade or business "might" include the "type of rented property (commercial real property versus residential)." [Notice 2019-07, 2019-09 I.R.B. at 740.] Consistent with current law, the quoted text does not state or imply that commercial, residential and mixed-use properties cannot be considered a single activity for purposes of determining whether a trade or business exists.

aspects of contracts (leases) and laws governing rental activities address similar issues. The same vendors and employees used or employed by taxpayers holding more than one type of property frequently service all the taxpayer's properties. In addition, in our experience, mixed-use property is common and demonstrates the compatibility and unity that often exists among a taxpayer's commercial and residential holdings. We believe that there is nothing inconsistent with the policies underlying section 199A with treating the operation of all rental properties as one enterprise for purposes of determining whether the taxpayer is engaged in a trade or business. Moreover, such an approach would provide a sound and useful safe harbor.

2. *Inclusion of Similar Properties in Single Enterprise*

a. *Background*

In addition to stating that commercial and residential real estate may not be part of the same enterprise, the proposed Safe Harbor states that if a taxpayer does not treat each property held for the production of rents as a separate enterprise, then the taxpayer is to treat all "similar" properties held for the production of rents as a single enterprise.[4]

b. *Recommendation*

We recommend that the word "similar" be eliminated from the description of properties that are to be included in the same enterprise if the taxpayer does not treat each property as a separate enterprise or, if not eliminated, that the meaning of the word be clarified.

c. *Explanation*

The term "similar" is not defined. Taxpayers will be uncertain what properties must be combined in a single enterprise.

The meaning of the third and fourth sentences of Section 3.02 of the proposed Safe Harbor (which require combining similar properties, but prohibit combining commercial and residential properties, in a single enterprise, respectively) is not entirely clear. It is possible that these sentences indicate that only commercial and residential properties are not similar. It is also possible that they require an assessment of degrees of similarity within these two categories. For example, taxpayers may ask if a medical office property and a warehouse facility for medical products, both commercial, are similar, or whether apartments and condominiums, both residential, are similar. Regardless of which interpretation is correct, taxpayers will have difficulty categorizing mixed-use properties.

For the reasons stated above, we believe the Safe Harbor should be modified to allow taxpayers to include all real estate rental properties, whether

[4] Section 3.02 of the Proposed Revenue Procedure[, Notice 2019-07, 2019-09 I.R.B. at 741].

commercial, residential or mixed-use, in a single enterprise. But, if that recommendation is not adopted, then for the same reasons we believe the specification that it is "similar" properties that must, if the taxpayer does not treat each property held for the production of rents as a separate enterprise, be included in a single enterprise should be eliminated. The result would be that, if the taxpayer does not opt to treat each property as a separate enterprise, all commercial properties would be included in a single enterprise and all residential properties would be included in a single enterprise. If that suggestion is not adopted, then the meaning of the word "similar" should be clarified. Regardless of whether any of these recommendations are adopted, the treatment of mixed-use property should be clarified, perhaps by a rule that bifurcates the evaluation of such properties.

3. *250 Hour Safe Harbor Requirement*

a. *Background*

Qualification for the proposed Safe Harbor for a taxable year depends in part on the performance of 250 or more hours of "rental services" for the year with respect to each "rental enterprise."[5] For years after 2022, the 250 hour requirement need only be satisfied in any three of five taxable years ending with the year for which the Safe Harbor is sought.

"Rental services" include certain listed items and may be performed by owners and certain others.[6] It excludes certain financial or investment management activities; "planning, managing, or constructing long-term capital improvements" is on the list of excluded services.

b. *Recommendations*

We recommend that the 250 hour standard be reduced to 120 hours. In addition, while the exclusion of financial or investment management activities is generally appropriate, we recommend that "planning, managing, or constructing long-term capital improvements" be removed from the list of excluded activities if tenants of the taxpayer have previously occupied and paid rent for more than fifty percent (50%) of the available rental space in a property for more than three consecutive months.

c. *Explanation*

We are not aware of authority holding that any specific hourly commitment is sufficient or required to establish trade or business status. To the

[5] Section 3.03(B) of the Proposed Revenue Procedure[, Notice 2019-07, 2019-09 I.R.B. at 741].

[6] Section 3.04 of the Proposed Revenue Procedure[, Notice 2019-07, 2019-09 I.R.B. at 741].

contrary, rental of even a single house, which presumably requires less than 250 hours of taxpayer time each year, has been held to constitute a trade or business regularly carried on.[7]

We acknowledge and agree that objective standards are helpful to a properly functioning safe harbor. In that regard, the announced purpose of the proposed Safe Harbor is to mitigate uncertainty. We believe that a 250 hour annual requirement is so high that relatively few taxpayers who use the Safe Harbor will actually need its protection. In other words, a taxpayer who devotes that much time to a rental enterprise likely would conclude with a high degree of comfort that the considerable, regular and continuous activity referred to in the Preamble had occurred. Those taxpayers are not the taxpayers who need the protection of the Safe Harbor.

Instead, we believe that, to achieve the objectives of the Safe Harbor, the 250 hour requirement should be reduced to a level at which some uncertainty may commence. We believe that is at 120 hours per year.

In addition, we agree that, if an hourly test is to be included, certain financial or investment management activities should be excluded from the count. Some financial or investment management activities may not differentiate a trade or business under section 162 from ventures or pursuits described in section 212, or may be more prone to precede the commencement of a trade or business.

However, we believe that once a trade or business has commenced, then planning, managing, or constructing long-term capital improvements should be included in the count. Building out space for new tenants, replacing mechanicals, upgrading real estate infrastructure and common areas, expanding existing structures or developments, and the like, are common. For this reason, we respectfully recommend that, if a trade or business already exists, planning, managing, or constructing long-term capital improvements should be considered in evaluating whether the taxpayer is continuing to pursue profit through considerable, regular and continuous activity.

We think that, in determining whether a rental real estate trade or business has commenced for this purpose, it would be appropriate to require that a taxpayer show occupancy has commenced and rental income has been received. Consistent with the overall purpose of reducing uncertainty, we recommend a bright-line test that commencement of a trade or business, for purposes of allowing such planning, managing or constructing to be included in the hour count, is sufficiently demonstrated if there has been significant occupancy and payment of rent for at least three consecutive months.

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[7] *See Anders I. Lagreide*, 23 T.C. 508 (1954), and discussion of similar cases in *Curphey v. Commissioner*, 73 T.C. 766 (1976 [1980]).

4. *Exclusion of Real Estate Used by Taxpayer as Residence from Eligibility for Safe Harbor*

a. *Background*

The Proposed Revenue Procedure states that "[r]eal estate used by the taxpayer … as a residence for any part of the year under section 280A is not eligible for the safe harbor."[8] It is not clear whether the rule means that a taxpayer who uses only part of the real estate as a residence cannot enjoy the safe harbor with respect to the part the taxpayer does not use.

b. *Recommendation*

We recommend that the rule excluding real estate used by the taxpayer as a residence be replaced with (or clarified by) a rule providing that a taxpayer may not apply the proposed Safe Harbor to any portion of the real estate that is a dwelling unit within the meaning of section 280A used by the taxpayer during any part of the taxable year.

c. *Explanation*

Taxpayers commonly lease parts of real estate in which they reside. We believe the rental of portions of real estate not used by the taxpayer as a residence during any part of the taxable year may constitute a trade or business, and that expressly extending the protection of the Safe Harbor to that rental (or, if the proposed Safe Harbor text is intended to extend that protection, clarifying the text of the Safe Harbor) is therefore appropriate.

5. *Hourly Test for Real Estate Used by Taxpayer as Residence*

a. *Background and Recommendation*

If our fourth recommendation, above, is adopted, we also recommend that the hourly requirement of the Safe Harbor be eliminated for taxpayers using not more than fifty percent (50%) of the real estate as a principal residence for the entire year if the taxpayer treats that real estate as a separate enterprise.

b. *Explanation*

Taxpayers commonly reside in multi-family structures or developments owned by them. If the purpose of the hourly requirement is to show sufficient "considerable, regular and continuous activity" at the rental property, as may be required by Groetzinger, we believe it is reasonable to presume, at least in establishing a safe harbor, that taxpayers residing in multi-family structures or developments owned by them easily satisfy that standard. Such taxpayers are at the location regularly, which results in continual inspection

[8] Section 3.05 of the Proposed Revenue Procedure[, Notice 2019-07, 2019-09 I.R.B. at 741].

and review of property conditions and tenant circumstances, and makes them readily available to render assistance to tenants.

We recognize that, even if this recommendation is adopted, a taxpayer may still want to combine time devoted to the taxpayer-occupied property and other properties in order to satisfy the hourly requirement of the Safe Harbor as to all properties. To eliminate the confusion and potential for abuse that could follow from combining, in the same enterprise, a property for which an hourly minimum applies and one for which it does not, we think that eliminating the hourly minimum for a taxpayer-occupied property should be conditioned on the taxpayer also electing to treat the property as a single enterprise (i.e., not part of an enterprise including any other property).

We also believe additional "guardrails" are appropriate. Thus, we recommend that this suggested exception be available only if the property is used for the entire year as a principal residence, as that will provide a high degree of confidence in the stated presumption. In addition, we recommended a fifty percent (50%) cap on residential use because the presumption that a taxpayer devotes regular and considerable effort and time to the business portion of the property and to serving tenants may be overly generous if the taxpayer occupies the majority of the real estate as a principal residence.

6. *Maintaining of Separate Books and Records*

a. *Background*

The proposed Safe Harbor requires separate books and records be maintained to reflect income and expenses for each rental real estate enterprise.[9]

b. *Recommendation*

We recommend that the provision be modified to require that if the enterprise includes more than one property, the requirement may be satisfied if the taxpayer maintains income and expense information statements for each property, which then are consolidated.

c. *Explanation*

The Proposed Revenue Procedure permits treatment of all similar properties as a single enterprise. Taxpayers usually maintain books and records on a property-by-property basis, as this facilitates tax reporting (e.g., Schedule E reporting), lender reporting, valuation work, municipal assessment reporting, potential property sale negotiations and other business objectives. Maintaining books and records on a "rental real estate enterprise" basis, if more than one property is included in the enterprise, would be inconsistent with the manner in which taxpayers typically maintain their records. Thus, it would

[9] Section 3.03(A) of the Proposed Revenue Procedure[, Notice 2019-07, 2019-09 I.R.B. at 741].

be helpful if the Safe Harbor were to permit the separate books and records requirement to be satisfied by maintaining income and expense information or statements for each property, which then are consolidated to satisfy the requirement for an enterprise containing multiple properties.

This would not adversely affect the interests of the Service. All income of the enterprise would be reported separately on a property-by-property basis. And, all financial data would be combined, as required in the proposed Safe Harbor, for the single enterprise deemed to be a trade or business for section 199A purposes.

7. *Triple Net Leased Property*

a. *Background*

The Proposed Revenue Procedure states that real estate rented or leased under a triple net lease is not eligible for the proposed Safe Harbor.[10] For purposes of the Proposed Revenue Procedure, a "triple net lease" includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities, or a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

b. *Recommendation*

We recommend that the definition of triple net lease be changed so it is comprehensive (and not one that refers merely to what the term "includes"). Alternatively, we recommend the definition be modified to describe what a triple net lease is <u>not</u>.

In that regard, we suggest that the reference to tenant obligations to pay taxes, "fees" and insurance be replaced with a reference to tenant obligations to pay all of the real estate taxes, operating expenses and casualty insurance allocable to the portion of the property leased by the tenant, and that responsibility for maintenance referred to in the proposed Safe Harbor be clarified to mean that the tenant is responsible for providing or engaging all maintenance, repair and replacement services and work, with the exception of repairs and replacements to foundations, exterior walls or roofs, in addition to paying for or reimbursing the lessor for the services and work.

Finally, we also recommend that the exclusion not apply unless more than half the square footage of the improvements on the real estate is subject to triple net leases at any time in the applicable taxable year.

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[10] Section 3.05 of the Proposed Revenue Procedure[, Notice 2019-07, 2019-09 I.R.B. at 741].

c. *Explanation*

Real estate leased under a "triple net lease" is not eligible for the proposed Safe Harbor. We think that many aspects of this part of the Safe Harbor will create new, rather than mitigate existing, uncertainty.

Not all real estate professionals, tax advisors and others have a common understanding of what constitutes a triple net lease, and terms such as absolute triple net, absolute net, fully net, and others, are sometimes used interchangeably. Thus, a statement in the Proposed Revenue Procedure as to what the term triple net lease "includes," as distinguished from a statement of what a triple net lease "is," will in many cases jeopardize a sure, confident use of the Safe Harbor.

The proposed Safe Harbor refers to a tenant or lessee obligation to "pay taxes, fees, and insurance," which might be misinterpreted by some to mean any portion of those amounts. Also, "fees" is not the all-encompassing term commonly used in defining tenant payment responsibilities in most triple net leases. It could be interpreted to mean a category or subset of the operating expenses, all of which are what a triple net tenant typically pays.

We also recommend that the reference to being "responsible" for "maintenance activities" be clarified. For example, it is not clear whether the term refers to the person "who provides or engages the services" or "who ultimately pays for the services." If, as it appears, the basis for excluding real estate subject to triple net leases is that such property is less likely to require considerable, regular and continuous activity, we think a lease should be considered "triple net" for purposes of the safe harbor only if the tenant is the person required to do both.

Lessors are commonly obligated to maintain structural components under leases that many would consider triple net leases. Thus, we think that a lease that obligates a lessor to repair and replace only foundations, exterior walls and roofs could properly be considered a triple net lease under a revised Safe Harbor, assuming the tenant has responsibility for all other maintenance, repairs and replacements, and all taxes, insurance and operating expenses, as previously described.

Finally, under any definition of a triple net lease, some space in a building may be rented on a triple net basis and some not. We recommend that the proposed Safe Harbor clearly provide whether the presence of any triple net leasing in a property excludes the entire property from the potential protection of the Safe Harbor. We recommend that real estate should be ineligible for the safe harbor only if it is used predominantly (i.e., more than 50%, determined on a square foot basis) by triple net tenants.