



IRS Issues New Rules and “Safe Harbors” for Pass-Through Deductions

By Jackie Himes, CPA

Thanks to the Tax Cuts and Jobs Act (TCJA) of 2017, real estate investors and other professionals may qualify to take up to a 20% deduction on income from pass-through entities. The IRS released [Notice 2019-07](#) which created a safe harbor and more clearly defines the types of rental real estate that qualifies for the Section 199A deduction.

[InvestingAnswers](#) defines a pass-through entity as a special business structure that is used to reduce the effects of double taxation. Pass-through entities don't pay income taxes at the corporate level. Instead, corporate income is allocated among the owners, and income taxes are only levied at the individual owners' level.

Pass-through entities include the following business structures:

- Sole proprietorship
- Partnership
- Limited Liability Company (LLC)
- Single Member Limited Liability Company
- C corporation
- Professional or Personal Service Corporation
- S Corporation

Taxpayers who own a stake in any one of the above-mentioned entities, may be able to take

a qualified business income (QBI) deduction from the pass-through. Taxpayers in the top federal tax bracket of 37% that qualify for the full deduction could effectively reduce their tax rate to 29% on this category of income.

The intention of the pass-through deduction was to create parity between pass-through entities and corporations, which saw a decrease in their tax rate from 35% to a flat 21%,

Real Estate Investment Trusts (REIT) generally qualify for the full 20% deduction for dividend income, with no limitation for publicly-traded and non-listed REITs.

The IRS wants to use this deduction for QBI instead of other types of income to weed out some passive investors. The original intent of TCJA was to create deductions for individuals or businesses that would result in job growth, as well as business or real estate reinvestment.

Taxpayers who are under the cap for personal income (\$315,000 for married couples filing jointly and \$157,500 for individuals) may also qualify for this deduction. These taxpayers are generally eligible to take the full 20% deduction if they receive QBI for rental property from an approved trade or business.

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Solely for the purposes of section 199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

- Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
- For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed (as described in Notice 2019-07) per year with respect to the rental enterprise.
- For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described in Notice 2019-07) per year with respect to the rental real estate enterprise; and
- The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: hours of all services performed; description of all services performed; dates on which such services were performed; and who performed the services. Such records are to be made available for inspection at the request of the IRS.

The safe harbor is not the only way to qualify for the 20% QBI deduction. Pass-through entities involving rental real estate that are recognized as a trade or business (Section 162 trade or business), may also be eligible for the 20% deduction (limitations apply). Rental services for purpose of this revenue procedure include:

- Advertising to rent or lease the real estate,
- Negotiating and executing leases,
- Verifying information contained in prospective tenant applications,

- Collection of rent,
- Daily operation, maintenance and repair of the property,
- Management of the real estate,
- Purchase of materials,
- Supervision of employees and independent contractors.

Page | 2

There is a higher “phase-out” level and more limitations for individuals above the income threshold (\$315,000 for married couples and \$157,500 for individuals).

We expect that the IRS might issue further guidance on who qualifies for the 20% pass-through deduction and the safe harbor. We will let you know when more information is available.

About the Author

Jackie Himes, CPA, director - tax services, prides herself on being attentive, responsive, and proactive. As a result, her clients are confident that she has their best interests in mind and know that their taxes are being handled by a professional who knows what she is doing. Jackie is solutions-focused while also being transparent.



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