October 1, 2018

CC:PA:LPD:PR (REG–107892–18)
Room 5203
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

RE: Comments on Section 199A [REG-107892-18]

On behalf of our more than 23,000 NATP members and the thousands of others who work in the tax preparation industry, we are submitting this commentary to address our concerns with certain ambiguity in the regulations under §199A that were released Aug. 8, 2018.

We are submitting commentary on three specific areas.

- Clarity on the definition of a trade or business specific to rental activities.
- Definition of what is included in taxable income and how to calculate.
- Determination of due diligence requirements regarding reasonable compensation.

Rentals and the Definition of Trade or Business

Since the proposed regulations (REG-107892-18) were issued, there has been much confusion surrounding rental activities and whether the rental income qualified for the §199A deduction. The regulations state that rental income is qualified business income provided the activity "rises to the level of a trade or business" as defined in §162. While the definition of a trade or business relies on such standards as "regular and continuous" and "profit motive", tax professionals emphasize that these standards are not an example of clarity for owners of rental property, specifically residential rental property owners, over the years. Some taxpayers are also worried that because they might not actively participate in the management of their rental properties, they could lose out on the deduction.

The reality is that neither §162, nor any other code section or regulation, define trade or business. Rather the code and regs go to great lengths to describe what a trade or business is not. Take for instance the sharing economy. To what degree of regularity and continuity must a taxpayer participate before his Airbnb or Über service is not considered a trade or business? In these circumstances, practitioners are left to interpret a large amount of existing case law and administrative guidance in the context of a broad range of industries before they can adequately advise their clients. Practitioners must also rely on the overtly nebulous facts and circumstances test.

To exacerbate the situation, Congress and the courts have, over the years, sent mixed signals when interpreting the law. Take for example *Levy, Trustee, v. U.S. 215 F. Supp. 631 (1963)* where the court ruled that the plaintiffs were engaged in a trade or business because they managed several rental properties though agents on a regular and continuous basis. But a rental activity isn't always a trade or business. Another example in case law include *Neill v. Commissioner, 46 B.T.A. 197 (1942).* In this case, a nonresident alien was not in the trade or business of renting a single building because the rents were collected by her attorney and the taxpayer was not involved in the rental activity at any substantial level; a total contradiction from the *Levy* ruling.

Today, when real estate professionals claim to be in a “trade or business” to avoid the limitations under the passive loss rules under §469, several more hurdles must be cleared. Primarily, to qualify as a real property trade or business under §469(c)(7)(C) there must be material participation – more than 50 percent of all services performed and more than 750 hours during the year must be in real property trades or businesses where there is material participation. A real property trade or business is broadly defined to include real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage. There is no connection to §469 when determining whether a rental activity is a trade or business for purposes of §199A.

Another example of inconsistent guidance is in information return reporting. There is a law requiring “persons engaged in a trade or business” to satisfy information document reporting requirements when payments are made to service providers in excess of $600. The confusion arrived in 2010 when Congress enacted the *Small Business Jobs Act* which added §6041(h) indicating that “a person receiving rental income from real estate shall be considered to be engaged in a trade or business of renting property” and thus were required to issue Form 1099-Misc.

After additional consideration, President Obama signed into law the *Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011*, striking §6041(h) in its entirety, effective for payments made after Dec. 31, 2010, and therefore placing individuals who receive rental income in the same position as if the expanded information reporting requirements had never been enacted. Under the provision, recipients of rental income from real estate who are not otherwise considered to be engaged in a trade or business of renting property are not subject to the same information reporting requirements as taxpayers who are considered to be engaged in a trade or business. Again, a clear definition of trade or business is conspicuously absent.

Adding to the confusion, since 2011, Part I of Schedule E, *Supplemental Income and Loss,* includes two questions that ask, a) “Did you make any payments that would require you to file Form(s) 1099?” and b) “If yes, did you or will you file all required Forms 1099?” It should be noted that the instructions are less than helpful with answering these questions. The lack of clarity makes even answering the questions on the form difficult. A request for the information needed to answer the questions may constitute a disclosure necessary for a complete return or to avoid penalties. There are potential consequences associated with how IRS may choose to administer its position once it is determined. The IRS has the benefit of hindsight since the challenge to positions taken always occur many months after the return has been filed.

Clearly, the proposed regulations do not go far enough to describe the circumstances under which a rental activity will constitute a §162 trade or business for purposes of the §199A deduction. The criteria that must be present before a landlord can claim the deduction is the

most important issue that hasn't been addressed. Prop. Reg. §1.199A-1(d)(4) provides two examples that involve a rental activity. Example 1 describes an individual who leases several parcels of land to suburban airports for parking lots for $1,000,000. The proposed regulations state that the rental activity is a business. It is difficult to surmise how a conclusion was reached that this activity rises to the level of a trade of business when there is no active participation or qualifying property owned by taxpayer. Example 2 describes the same individual who builds parking structures on the land and who receives $4,000,000 in rental income. The proposed regulations state that the rental activity is also a business. Neither of these examples is particularly helpful to most taxpayers who own residential or small commercial rental properties.

We suggest adding language to the definitions section along with additional examples to make it clear that residential rentals qualify as a trade or business and to amend the qualified business income definition to explicitly include residential rental income. Specifically, examples are needed that bring clarity to when a taxpayer is engaged in the trade or business of renting property when there is active participation, material participation or neither.

<u>Definition of Taxable Income</u>

Section 199A(c)(3)(B)(i) provides that qualified business income (QBI) does not include any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss. However there remains some uncertainty on the extent to which gains and losses subject to §1231 may be taken into account in calculating QBI.

Section 199A(f)(1) provides that in the case of a partnership or S corporation, §199A is applied at the partner or shareholder level. The proposed regulations provide that the §199A deduction has no effect on the adjusted basis of the partner's interest in the partnership. With respect to S corporations, the §199A deduction has no effect on the adjusted basis of a shareholder's stock in an S corporation or the S corporation's accumulated adjustments account.

If §199A is to be applied at the entity level and then passed through to the shareholder or partner on Schedule K-1, what happens when certain items that went into the calculation of QBI are not allowed or by election not claimed on the individual return? For example, this can occur when there is a §179 deduction passed through from the entity. There are other deductions for retirement plan contributions, one-half of self-employment tax or some other adjustment to taxable income that is taken at the individual level that affects taxable income. The regs do not address how these situations should be handled. The primary question is whether these items affect the calculation of QBI.

<u>Due Diligence Regarding Reasonable Compensation</u>

Determining reasonable compensation has been a challenge for the courts and the IRS as evidenced by the number of cases tried and IRS research projects undertaken over the years. The proposed regulations did little to clarify reasonable compensation in a manner that is consistent. The proposed regulations state, "The rule for reasonable compensation is merely a clarification that, even if an S corporation fails to pay a reasonable wage to its shareholder-employees, the shareholder-employees are nonetheless prevented from including an amount equal to reasonable compensation in QBI." Ten different preparers could interpret this rule ten different ways.

It is impossible to make a general statement as to what amount of compensation is reasonable because reasonableness must be determined based on the surrounding facts and

circumstances. What happens when a preparer of the shareholder's individual Form 1040 believes the compensation is unreasonable? Is that preparer then obligated to increase the compensation then calculate the §199A deduction based on the change? How, if at all, is this change reported to the IRS? What are the due diligence requirements in this situation, and if the preparer does nothing, would that subject the preparer to penalties?

Thank you for this opportunity to submit our comments on these regulations. While there is more work to be done, our members and others in the tax preparation community appreciate the efforts the IRS has taken to provide guidance on this complicated topic.

If you would like to discuss this further, please contact us at govtrelations@natptax.com. Thank you again for your time and consideration.

Sincerely,

Gerard Cannito, CPA
NATP President
president@natptax.com

Scott Artman, CPA
NATP Executive Director
sartman@natptax.com