O'Neil & Steiner, PLLC
Rental Real Estate Enterprise with QBI vs. Passive Rental Activity

Rental real estate activities are treated as passive activities by default. The 20% deduction for Qualified Business Income (QBI) made permanent by the One Big Beautiful Bill Act (OBBBA) has caused many real estate investors to reconsider whether they have a passive rental (no QBI deduction), or a Rental Real Estate Enterprise (RREE) that qualifies as a trade or business under Section 162 for the QBI deduction. The differences are detailed and should be discussed with a tax professional.

There are three ways for your rental real estate activity to be considered a trade or business eligible for the QBI deduction as follows:

1. The rental activity qualifies as a Section 162 trade or business – This is the case if you have ownership in a partnership or corporation in the business of renting properties. The entity must operate with a profit motive, involve considerable, regular, and continuous activity, and have appropriate record keeping. In addition, the business operates as a trade or business consistently in regard to other code sections. For example, it issues Forms 1099 when required, obtains a city business license, etc.

2. The rental property is rented/leased to related parties that qualify as Section 162 trades or businesses. If you own a Section 162 trade or business that rents property from yourself or a separate entity that you created, the rental activity is considered to be a Section 162 trade or business. At least 50% common ownership is required. However, renting to a related C Corporation does not satisfy this rule. An S-election may be preferable in these cases. Also, if renting to a Specified Service Trade or Business (SSTB), the rental activity will also be treated as an SSTB.

3. The rental activity satisfies the requirements of the safe harbor detailed below.

To rely on the safe harbor, the individual (or disregarded entity) must have a direct ownership interest in real property held for the production of rents and may consist of an ownership interest in multiple properties.

Taxpayers can treat and test each rental property as a separate enterprise, or all similar rental properties can be treated as a single enterprise. Commercial and residential real estate cannot be treated as part of the same enterprise. Taxpayers are not permitted to vary their treatment from year to year, unless there is a significant change in facts and circumstances which should be detailed and noted with the return for the year the change occurs.

Real estate used as a residence by the taxpayer (including the owner of a pass-through entity) for any part of a tax year is not eligible to use the safe harbor rule for Section 162 trade or business classification purposes. Real estate rented under a triple net lease (tenant is responsible to pay taxes, fees, insurance, and repairs/maintenance) is also not eligible to use the safe harbor method.

Some rental real estate generates annual losses for tax purposes due to depreciation, vacancy, etc. It is important to consider this possibility when making the decision regarding treatment of rental real estate as Section 162 trade or business. Losses generated by Section 162 trades or businesses

reduce profits from other QBI eligible activities and net losses are carried forward to the following year.

In order to qualify under the safe harbor rules the following requirements must all be met:

1. Time Test – The hours of service test states that the taxpayer must have performed 250 hours of service in the activity. For entities that have been in existence for more than five years the test can be met in any three of the previous five years. For entities in existence five years or less, the 250 hour test must be met each year. Service hours can be performed by employees, independent contractors (who receive Forms 1099 consistent with other code sections). While property management companies can be considered independent contractors the likelihood of their keeping track of their hours specific to your property is not good.

2. Separate books test – Each enterprise must maintain a separate set of accounting records to keep track of income and expenses.

3. Activity record test – Each enterprise must keep contemporaneous (maintained on an on-going basis, logged as the activities occur) records including:
    a. Time reports, logs, or similar documents to establish the hours spent on rental services,
    b. Descriptions of services performed,
    c. Date performed,
    d. Name of person or entity who performed the service.

The following types of services qualify towards the 250 hours test:

- Advertising to rent or lease real estate,
- Negotiating and executing leases,
- Verifying information contained in prospective tenant applications,
- Collecting rents,
- Managing daily operations,
- Performing routine maintenance and repairs of property,
- Purchasing materials,
- Supervising employee and independent contractors

The following types of services do not qualify towards the 250 hours test:

- Arranging financing,
- Procuring property,
- Studying and reviewing financial statements or reports of operations,
- Planning, managing, or constructing long-term capital improvements, and
- Traveling to and from properties

Taxpayers making the safe harbor election must attach a **manually signed statement** signed under penalties of perjury with their tax return indicating they have met all safe harbor requirements.

O’Neil & Steiner, PLLC
Rental Real Estate Enterprise with QBI vs. Passive Rental Activity

Taxpayers who elect to group multiple rental activities to meet the safe harbor thresholds must also file a grouping election under IRC Section 469 by the due date of their returns, including extensions for the year in which the taxpayer wishes to make the election. Once made it cannot be changed except for specific circumstances.