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Subject: Alan Gassman & Kelsey Weiss - Is it Possible for a Triple Net Lease to be Considered a "Trade or Business" for Section 199A Purposes

"The 2017 Tax Cuts and Jobs Act introduced the new, and problematic, Section 199A to the Internal Revenue Code. Section 199A was designed to provide taxpayers with a 20% deduction for qualified business income earned through qualifying trades or business. This deduction for business owners was added, most likely, in response to the significant tax cut the Act created for large corporations. Unfortunately, the Internal Revenue Code has yet to specifically define 'trades or businesses,' leaving some taxpayers in limbo as to whether they qualify for this deduction.

Instead of supplying taxpayers with a definition, the Proposed Regulations state that a qualifying 'trade or business' must meet the requirements of the Internal Revenue Code Section 162. However, Section 162 does not provide a clear definition either. Section 162 states that expenses can be deducted when they are incurred for a legitimate and active trade or business. Section 199A of the Act simply defines 'trades and businesses' by exclusion. The term excludes 'the trade or business of performing services as an employee and 'specified service' trades or businesses: those involving the performance of services in law, accounting, financial services, and several other enumerated fields, or where the business's principal asset is the reputation or skill of one or more owners or employees.' This definition begs the question: who actually qualifies for the 199A deduction, and where do real estate investors fall into this?

This newsletter will focus on using previous court decisions to define the term 'trade or business' for purposes of determining whether a real estate investor with a triple net lease can qualify for the 199A deduction under the Proposed Regulations."

We close the week with important commentary by **Alan Gassman** and **Kelsey Weiss** that examines whether a triple net lease can be considered a "trade or business" for Section 199A purposes.

Alan Gassman, JD, LL.M is the founding partner of the law firm of **Gassman, Crotty & Denicolo, P.A**. in Clearwater, Florida. Alan is a frequent contributor to **LISI** and has authored several books and many articles on Estate and Estate Tax Planning, Trust Planning, Creditor Protection Planning, and associated topics. Most recently, Alan is the co-author of The Section 199A (and 1202) Handbook: The Advisor's Guide to Saving Taxes on Business and Investment, with **Brandon Ketron**, **Martin Shenkman**, **Jonathan Blattmachr**, and **Robert Schenck**.

Kelsey Weiss is a law clerk for **Gassman, Crotty & Denicolo, P.A**. and is a student at Stetson College of Law.

Here is their commentary:

EXECUTIVE SUMMARY:

The 2017 Tax Cuts and Jobs Act introduced the new, and problematic, Section 199A to the Internal Revenue Code. Section 199A was designed to provide taxpayers with a 20% deduction for qualified business income earned through qualifying trades or business. This deduction for business owners was added, most likely, in response to the significant tax cut the Act created for large corporations.[i] Unfortunately, the Internal Revenue Code has yet to specifically define "trades or businesses," leaving some taxpayers in limbo as to whether they qualify for this deduction.

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principal asset is the reputation or skill of one or more owners or employees." This definition begs the question: who actually qualifies for the 199A deduction? And where do real estate investors fall into this?

This newsletter will focus primarily on using previous court decisions to define the term "trade or business" for purposes of determining whether a real estate investor with a triple net lease can qualify for the 199A deduction under the Proposed Regulations.

FACTS:

The Supreme Court has been faced with the task of defining a "trade or business" in the tax context multiple times over the last century. Going back to 1911, the Court in *Flint v. Stone Tracey* used the Bouvier Dictionary to broadly define a business as, "that which occupies the time, attention and labor of men for the purpose of a livelihood or profit."[ii] Then, in 1935 the Supreme Court provided a limitation to the definition by distinguishing between an active trader and an investor.[iii] In *Snyder v. Commissioner*, the Court determined that an investor seeking to merely increase his personal holdings was not engaged in a trade or business.[iv] However, Justice Brandeis also stated that a taxpayer who made his livelihood from buying and selling on the stock exchange would be a trade or business.[v] This was the first of many instances where the activity level of the taxpayer is a deciding factor in whether the definition of a "trade or business" applies.

Not long after *Snyder*, the Court was faced with two "trade or business" cases in one year centered on estate preservation. In the 1941 *Higgins v. Commissioner* case, the Court determined that a taxpayer managing and preserving his own estate did not qualify as carrying on a business.[vi] Next, in *City Bank Farmers Trust v. Helvering*, the Court decided that asset conservation and maintenance by way of estate or trust efforts is not a trade or business.[vii]

These cases highlight the struggle of the Supreme Court in deciding whether a certain activity qualifies as a trade or business without a succinct definition from Congress or its agencies. In its 1987 sentinel case *Commissioner v. Groetzinger*, the Court laid out a definition for what qualifies as a trade or business that is still good law.[viii] In *Groetzinger*, the Court determined that a full-time gambler who wagered for himself alone

was engaged in a “trade or business” within the meaning of the applicable Internal Revenue Code.[ix] The Court rejected the previously used ‘goods and services’ test reasoning that almost every activity could potentially satisfy the test leading to litigation over the meaning.[x]

The Court held that to be an engaged in a trade or business: (1) the taxpayer’s involvement must be continuous and regular; and (2) the primary purpose of the activity must be for income or profit.[xi] The Court then cautioned future courts to examine the facts of each case as this is not a test for all situations and highlighted that it is the responsibility of Congress to make changes or revisions to this Court’s interpretation of the definition.[xii] While it is true that Congress has the ultimate responsibility to define “trade or business” as used in its rules and proposed regulations, they have not done so. Therefore, the best definition available still comes from the Supreme Court in *Groetzinger*.

The Supreme Court, however, only hears a select number of cases, and the majority of disputes related to tax matters are heard by the Tax Court. The Tax Court has held that, beyond the definition provided in *Groetzinger*, the threshold test for deduction of income expenses under Section 162 is whether the primary purpose and intention of the taxpayer was to make a profit.[xiii] In other words, if a taxpayer loses money by participating in a hobby, the taxpayer cannot receive benefits of income tax deductions by calling the hobby a trade or business.

For example, in *Seebold v. Commissioner*, a married couple decided to breed horses to add to their retirement income.[xiv] In this case, the court explicitly placed greater weight on the objective factors showing the couple’s intent to profit rather than simply their statement of intent.[xv] For example, they worked hard to learn the subject area, sought advice from experts in the field, used a veterinarian for the purpose of breeding, and consulted an accountant.[xvi] Additionally, Mrs. Seebold eventually quit her job to work on the breeding farm full time.[xvii]

The Tax Court determined that this level of activity met the threshold showing that the primary purpose and intention of the Seebolds was to incur a profit, regardless of the loss they sustained when they first started and the Seebold’s horse breeding qualified as a trade or business.[xviii] Therefore, in addition to the *Groetzinger* test, taxpayers must also be able to show that the primary purpose and intent of the activity is to incur a

profit. According to the court in *Seebold*, the petitioner bears the burden of proving they meet the threshold. Therefore, a taxpayer must prove that they meet this burden before benefitting from the 199A deduction.

Application to Real Estate

The issue of whether a taxpayer is engaging in a trade or business is an issue of fact that involves analyzing the scope of activities the taxpayer is engaged in, either personally or through an agent. Passive ownership of a rental property will not be enough to qualify as a trade or business, however, active management of such a property historically has been viewed as a trade or business. Because qualifying as a trade or business is based on a question of fact, the line distinguishing passive ownership and active ownership can become blurry.

A typical court, when considering whether a real estate venture qualifies as a trade or business, will evaluate four factors.[xix] First, the court will consider the type of property owned and/or managed by the taxpayer (i.e. commercial, residential, condominium, or personal).[xx] Second, the court will consider the number of properties rented out by the taxpayer.[xxi] Third, and what seems to be most importantly, the court will consider the day to day involvement of the owner or agent.[xxii] And finally, the court will consider the type of rental (i.e. triple net lease, traditional lease, short term lease, or long-term lease).[xxiii]

The Tax Court, in the 1946 case *Hazard v. Commissioner,* ruled that even one single family rental was a trade or business.[xxiv] The Internal Revenue Service has since adopted the same reasoning and the rule still stands in most jurisdictions.[xxv] Therefore, it would be reasonable for the IRS to continue to follow the *Hazard* standard with regard to 199A deductions and allow single family, or single property, rentals to qualify as a trade or business. However, much case law has shown that simply renting the property alone is not enough.

In *Neill v. Commissioner*, the 1942 Tax Court ruled that the mere collection of rent without any other activity was not enough to constitute a trade or business.[xxvi] Additionally, in *Hendrickson v. Commissioner*, the Tax Court ruled that a passive investment in an oil gas well where the owner simply purchased the lease and collected income from it did not qualify as a trade or business.[xxvii] Therefore, while it is possible for a rental business to

constitute a “trade or business” for the purpose of deductions under Section 162, simply owning the business and collecting money is not enough.

Based on the relevant case law, in order to qualify as engaging in a trade or business, the taxpayer must have some active role in running the rental. For example, in *Schwarcz v. Commissioner*, the Tax Court determined that a landlord owning, managing, and operating apartment buildings was engaging in a trade or business.[xxviii] Interestingly, the owner could do so through an agent and would still qualify.[xxix]

In some tax cases not related to the 199A deduction, taxpayers may want to avoid being labeled as a tax or business in order to avoid paying additional taxes as a trade or business. In *Bennett v. Commissioner*, two partners leased equipment to site organizations allowing people to play a form of lottery called Keno under the company name of Lucky Keno.[xxx] The partners both reported their business income from Lucky but did not report self-employment tax.[xxxi] The partners argued that they did not have to pay the self-employment tax because Lucky was a passive owner of the equipment and not actively engaged in trade or business.[xxxii] However, the Tax Court disagreed stating that the partners oversimplified their role.[xxxiii] Lucky’s name was on all of the Keno advertisements and Lucky controlled the funds and distributed them to the winners, municipalities, the state, and the site organizations.[xxxiv] Therefore, Lucky was not a passive owner and the partners were required to pay the self-employment tax because they owned a trade or business.[xxxv]

Application Specifically to Triple Net Leases

In a triple net lease, the tenant is mostly responsible, and the lessor does very little by way of managing the rental. The tenant usually agrees to pay the normal fees like rent and utilities plus the three “nets” – real estate taxes, building insurance, and maintenance. Using the *Groetzinger* test, a triple net leaseholder will most likely not qualify as having a trade or business because, while owning the property for the purpose of making a profit would meet the second prong of the test, the involvement of the leaseholder is not continuous and regular enough to meet the first prong.

The Proposed Regulations themselves offer two examples of real estate initiatives qualifying as a trade or business. In the first example, an individual who owns and manages leased land to airports for parking lots

qualified as a Section 162 business. The management aspect of the owner is the likely reason why this example qualified as a trade or business. It is unclear, however, how this example could apply practically because if the land is leased to airports, there isn't much management left for the owner to handle. In the second example, the owner developed the same land to build parking structures and then leased the parking structures to the airports. This example appears to allow for a triple net lease to qualify as a trade or business. However, relevant case law would suggest that this example would not qualify as a trade or business.

While case law is scant regarding whether a triple net lease specifically qualifies as a trade or business, one Revenue Ruling has addressed the issue. Under Section 871, there are special rules for the taxation of nonresident aliens who are engaged in trade and business in the United States. Revenue Ruling 73-522, 1973-2 C.B. 226 stated, however, that a rental under a net lease is not considered a trade or business for the purposes of Section 871.

The question of whether a triple net lease can constitute a trade or business was also raised with regard to withdrawal liability under the Multiemployer Pension Plan Amendments Act (MPPAA) in *Central States, Southeast and Southwest Areas Pension Fund v. Fulkerson*.[xxxvi] Thomas and Dolly Fulkerson owned several triple net leases and were also shareholders of Holmes Freight Lines, Inc. (Holmes) when it became bankrupt.[xxxvii] As a creditor, Central States used the MPPAA of 1980 to calculate the withdrawal liability of Holmes.[xxxviii] Under the MPPAA, all "trades or businesses" are treated as one employer.[xxxix] Under that theory, the Fulkerson's leasing business and Holmes were under the common control of the Fulkersons and the leasing business was thereby pulled in to help pay the remainder of what was owed to Central States.[xl] Because the leasing business was unincorporated, the Fulkersons became personally liable.[xli]

The MPPAA, like the IRC, uses the term "trade or business" but does not define it.[xlii] Therefore, the appellate court affirmed the Supreme Court's test in Groetzinger reasoning that the test comports with the common meaning and can be used generally.[xliii] In order to meet the first prong of the Groetzinger test, the taxpayer's involvement must be continuous and regular. However, because the leases were triple net leases, Mr. Fulkerson only spent about five hours per year involved with the properties.[xliv] The

properties were purchased with the intent of pure investment. The court therefore held that the “mere holding of leases for ten years by shareholder was not such continuous and regular activity as to constitute a trade or business, for purpose of imputing withdrawal liability to company.”[xlv]

In *Central States v. Personnel*, the court reached the opposite decision with similar facts as *Fulkerson*.[xlvi] In *Personnel*, the defendant was held responsible for withdrawal of liability because the defendant was much more frequently engaged in activities related to leasing such as buying and selling multiple properties annually and advertising.[xlvii] The court concluded that this conduct was both regular and continuous.[xlviii]

Based on the reasoning in these cases, it is clear that: (1) the *Groetzinger* test is still applicable and used by courts to determine whether an activity is a trade or business, and (2) courts truly use activity level of the taxpayer as a deciding factor. Based on the relevant case law, it seems as though the courts are really looking for some degree of activity or legal responsibility of risk on behalf of the taxpayer. In order to show that, an owner of a triple net lease could do a number of things to increase their level of activity with the rental such as: take on responsibility for maintenance, participate in tenant management, participate in advertisement initiatives, or be more active in pursuing new leases or selling leases.

Conclusion

Under the Proposed Regulations, being classified as a “trade or business” can provide a taxpayer with a significant tax reduction on business income. In order to be classified as a “trade or business,” an owner must show that he or she is regularly and continuously involved with the property. Therefore, under the classic definition of a triple net lease, the lessor would not qualify for the 199A deduction.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman
Kelsey Weiss

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CITATIONS:

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[i] Tony Nitti, *Understanding the New Section 199A Business Income Deduction*, THE TAX ADVISOR (April 1, 2018). I

[ii] *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

[iii] *Snyder v. Commissioner*, 295 U.S. 134 (1935).

[iv] *Id.*

[v] *Id.*

[vi] *Higgins v. Commissioner*, 312 U.S. 212 (1941).

[vii] *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941).

[viii] *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

[ix] *Id.*

[x] *Id.*

[xi] *Id.*

[xii] *Id.*

[xiii] *Seebold v. Commissioner*, 55 T.C.M. 723 (1988).

[xiv] *Id.*

[xv] *Id.*

[xvi] *Id.*

[xvii] *Id.*

[xviii] *Id.*

[xix] Tony Nitti, *IRS Provides Guidance On 20% Pass-Through Deduction, But Questions Remain*, FORBES (Aug. 9, 2018), https://www.forbes.com/sites/anthonynitti/2018/08/09/irs-provides-guidance-on-20-pass-through-deduction-but-questions-remain/#7cf566562ff8.

[xx] *Id.*

[xxi] *Id.*

[xxii] *Id.*

[xxiii] *Id.*

[xxiv] *Hazard v. Commissioner*, 7 T.C. 372 (T.C. 1946).

[xxv] The Second Circuit decided in *Grier v. US* that “broader activity” on the part of the owner was needed in order for a rental to constitute a trade or business.

[xxvi] *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

[xxvii] *Hendrickson v. Commissioner*, 78 T.C.M. 322 (1999).

[xxviii] *Schwarcz v. Commissioner*, 24 T.C. 733 (1955).

[xxix] *Id.* See also *Elek v. Commissioner* showing that having an agent actively manage and maintain the rental property does not disqualify the owner from engaging in a trade or business.

[xxx] *Bennett v. Commissioner*, 83 T.C.M. 1429 (2002).

[xxxi] *Id.*

[xxxii] *Id.*

[xxxiii] *Id.*

[xxxiv] *Id.*

[xxxv] *Id.*

[xxxvi] *C. States, S.E. and S.W. Areas Pension Fund v. Fulkerson*, 238 F.3d 891 (7th Cir. 2001).

[xxxvii] *Id.*

[xxxviii] *Id.*

[xxxix] *Id.*

[xl] *Id.*

[xli] *Id.*

[xlii] *Supra* note xvi.

[xliii] *Id.*

[xliv] *Id.*

[xlv] *Id.*

[xlvi] C*. States, S.E. and S.W. Pension Fund v. Personnel, Inc.*, 974 F.2d 789 (7th Cir. 1992).

[xlvii] *Id.*

[xlviii] *Id.*