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New Deduction for Pass-Through Income: Good, But Not So Simple

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On Dec. 22, 2017, P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act) was signed into law, enacting the biggest set of changes to the Internal Revenue Code since 1986. One of the most important provisions of the act for real estate owners is new Section 199A, which (subject to certain important limitations) allows individuals, trusts, and estates a deduction equal to up to 20 percent of certain qualified business income. This effectively reduces the top marginal tax rate on qualified business income from 37 percent to approximately 30 percent. Although this is a very favorable provision for the real estate industry, there are several areas of uncertainty.

In general, Section 199A provides that ordinary income from a trade or business is eligible for the deduction, whether it is derived from a partnership, LLC, S corporation, or sole proprietorship. However, income from certain types of businesses generally do not qualify for the deduction. Among these non-qualifying businesses are service businesses such as health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business "where the principal asset of such trade or business is the reputation or skill" of one or more of its owners or employees. Also excluded are businesses involving "the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities."

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Hurdles to Overcome to Qualify for Deduction

Certain types of income do not qualify for the deduction, such as capital gain, interest income (if it is not allocable to a trade or business), dividends, royalties, and annuity income. Employee wages, and guaranteed payments made by a partnership to a partner for services rendered to a trade or business, are also excluded. In addition, only income that is effectively connected with the conduct of a U.S. trade or business may qualify for the deduction.

Even if a taxpayer has the right kind of income from a qualifying trade or business, there is yet another hurdle that must be overcome in order to claim a deduction under Section 199A. The deduction, which cannot exceed 20 percent of business income, is generally capped at the *higher* of two alternative limitations: (i) a wage limitation and (ii) a wage plus depreciable basis limitation.

The first of these limitations is relatively simple: a taxpayer's deduction for income from a trade or business is capped at 50 percent of the wages paid by that trade or business to its employees as shown on Forms W-2. The alternative limitation is equal to 25 percent of wages paid plus 2.5 percent of the business's "unadjusted basis" in its depreciable property. The business's unadjusted basis in its depreciable property is generally equal to its cost of purchasing depreciable property, without taking into account prior depreciation deductions. However, property that has been fully depreciated for tax purposes is generally not taken into account. Furthermore, because the property must be depreciable in order for its unadjusted basis to count toward this limitation, land and property held for sale (such as residential condominium projects) are not taken into account in calculating the limitation. Note that for businesses conducted through partnerships and S corporations, the limitations are calculated at the partner or shareholder level based on the partner's or shareholder's share of wages and unadjusted basis. A partner's share of a partnership's wages is equal to its share of the deduction for wage expenses, and a partner's share of a partnership's unadjusted basis is equal to its share of the partnership's depreciation deductions.

Taxpayers with taxable incomes below $157,500 (or $315,000 for married couples filing joint returns) are eligible for the full 20 percent deduction on business income, regardless of whether the income is from a qualifying trade or business and regardless of the wage and basis limitations. For taxpayers with incomes between $157,500 and $207,500 (or between $315,000 and $415,000 for married couples filing joint returns), (i)

the deduction for income from non-qualifying businesses is phased out and (ii) the wage and basis limitations are phased in.

REIT dividends (other than capital gain dividends) qualify for the deduction without regard to any of these limitations, which may put REITs at an advantage compared to real estate held by partnerships.

Some Clarification Needed

Several crucial questions regarding the application of Section 199A so far remain unanswered. For example, it is unclear what types of businesses qualify for the deduction. The statute excludes businesses involving "the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities." It is unclear whether "investing, investment management, or trading" relate only to "securities, partnership interests, or commodities." "Brokerage services" are also excluded, but the intent may only have been to exclude stockbrokers, not real estate brokers.

In addition, the wage and basis limitations apply separately for each trade or business, so if a taxpayer owns multiple trades or business, wages and depreciable basis from one business cannot be used to allow a deduction on income from another business. However, neither the statute nor the legislative history indicates what constitutes a separate trade or business. This question is not necessarily defined by legal entities or even by taxpayer entities. For example, assume a taxpayer owns several pieces of rental real estate, and each property is owned by a separate partnership. Does the taxpayer have a single trade or business, or does each property constitute a separate trade or business (each with its own wage and basis limitations)? If an individual owns real estate through one taxpayer and has a management business in a separate taxpayer, is the management business a separate trade or business from the real estate? At least one government official has indicated that the IRS may define a trade or business using principles similar to those of the activity grouping regulations under the passive loss rules of Section 469. However, until the Treasury Department or the IRS promulgates regulations or other guidance, there will be much uncertainty in this area.

Conclusion

Section 199A has the potential to greatly benefit real estate investors. However, the provision is very complicated and there is uncertainty regarding key questions. In light of these issues, real estate businesses should reconsider their organizational structures to make sure they are maximizing their tax benefits.