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# Final pass-through rules mostly favors middle market and real estate

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For many in the middle market or the real estate industry, the most eagerly awaited details of the final tax bill are the new rules applicable to qualified business income of pass-through entities and sole proprietors – including partners in partnerships, members of LLCs taxed as partnerships, shareholders of S corporations, owners of single-member LLCs and sole proprietors not operating through any legal entity. The pass-through specific provisions of the conference agreement discussed below can be found beginning on page 23 of the House and Senate conference committee report, and beginning on page 37 of the conference committee's Explanatory Statement.

The House and Senate conference committee report (legislative text and Joint Committee on Taxation estimate) and the conference committee's Explanatory Statement that explains the bill are both available for download.

Here are the basic rules, several examples of how they operate, and observations about the unresolved technical or policy problems that still remain.

## Summary of the new pass-through rules

1. A new exclusion or deduction of 20 percent of 'qualified business income' will effectively reduce the tax rate on such income by 20 percent. Thus, qualified income otherwise taxed at the top rate of 37 percent will be taxed at 29.6 percent. Income otherwise taxed at 24 percent, for example, will be taxed at 19.2 percent. Self-employment or net investment income taxes, where applicable, would be in addition to these amounts.

2. Qualified business income would generally include the ordinary, operating income of a trade or business, excluding certain financially oriented businesses like those that trade financial instruments, commodities, etc.

3. The new rules are the same for 'active' and 'passive' investors – and contain no changes to the rules governing net investment income taxes or self employment taxes. Accordingly, many investors will want to be 'active' in order to maximize their ability to avoid the 3.8 percent net investment income tax – and where possible avoid the 3.8 percent self-employment tax, such as by organizing as a traditional limited partnership, or qualifying an LLC under the proposed regulations by holding an 'investor' class of securities along with a 'manager' class. Since active/passive is not an issue, one cannot expect an opportunity to 'regroup.'

4. For joint filers with taxable income below $315,000 (and lower amounts for single filers), there will be no restrictions on enjoying the benefit, other than the requirement that the income be bona fide 'trade or business' income and not disguised 'wages.' However, those benefits will be phased-out as joint taxable income increases from $315,000 to $415,000, or as single filer taxable income increases from $157,500 to $207,500.

   1. At one time, the conference committee was considering a proposal to require that a qualified trade or business receive no more than 20 percent of its income from any customer or client, but that I limitation was not included in the final bill. That provision would have limited the ability of salaried workers to convert their status to that of an independent contractor. Because there is no mechanical test of this nature, the question of whether

a service provider is an employee or independent contractor will be a serious concern for taxpayers and the IRS.

2. In addition, even if the income is bona fide 'trade or business' income of an S corporation, there appears to be no change to the requirement that 'reasonable compensation' be paid as wages to shareholders providing substantial services. As a result, a personal service business operating through an S corporation may effectively be ineligible for benefits.

3. That problem does not appear to exist with sole proprietorships (including single-member LLCs) or partnerships, for whom there is apparently no current law requirement to pay'reasonable compensation' – and the statute does not appear to require an allocation of net partnership income to be recast as if reasonable compensation were paid as a guaranteed payment.

5. For higher-income taxpayers, there are three requirements to qualify for the deduction. The most restrictive of which is the list of forbidden 'service' businesses.

1. The business may not be a 'specified service business.' That unequivocally – and not unexpectedly – includes law firms, accounting firms, medical practices, and any other firms involved in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services. A reference to engineering and architecture was deleted, but those fields might face difficulties with other provisions discussed below.

2. Specified service businesses would also include any business, "which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2))."

3. However, the language goes much farther. It appears that such 'service' businesses are defined as including any service business, whether it is listed or not, that does not have a substantial investment in fixed assets — such as a construction company that leases its offices and all of its construction equipment, or a plumbing contractor that leases its trucks and other equipment. That is because the final bill excludes "any trade or business where the principle asset of such trade or business is the reputation or skill of one or more of its employees [or owners]." There is some ambiguity as to whether that language applies to non-service businesses — such as a manufacturer of hand-made guitars — but event if it applied only to service businesses, firms engaged in the fields of construction, remodeling, plumbing, HVAC, electrical work, maintenance, repair and similar 'service' activities would appear to be generally included as 'specified service businesses,' unless their 'principal asset' was something other than the skill or reputation of their owners or employees. Indeed, it is difficult to know how one would even measure, as an 'asset,' the reputation or skill of employees or owners. This may be a technical drafting error, since this language was excluded from both the Senate and House bills. But other language — expanding the exclusion to cover the reputation and skill of 'owners' as well as 'employees' suggests that its inclusion was intentional.

4. Ironically, although 'engineers and architects' were taken out of the specific list of forbidden fields, they may be brought back in by this 'catch-all' language relating to the reputation and skill of the business owners or employees.

5. It is also possible that the 'skill or reputation' language also applies to non-service businesses, such as a manufacturer of hand-made guitars or motorcycles.
6. These points will evidently need to be clarified quickly by the IRS

6. For businesses not excluded by the service business blacklist, the rules require either that the business pay a specified amount of W-2 wages (generally twice the amount of the claimed deduction), or that it have a specified amount of investments in tangible, depreciable property (generally, an original cost equal to 40 times the amount of the annual deduction) such as buildings, structures, vehicles, or other machinery or equipment. Note also that the taxpayer is allowed to use, as a limit, a combination consisting of the sum of 2.5 percent of such assets and 25 percent of wages. The rules may be easier to understand with some examples, provided immediately below. Generally speaking, the rules appear to work effectively to limit perceived abuses of the type the drafters were trying to avoid, although they are somewhat too restrictive in certain cases.

1. Assume a purely passive investor with $1 million of other income who invested $10 million in a parking lot that was leased to a local mall for use by its customers, with no wages paid and no depreciable property. Assume that the business generates $1 million of net rental income from the mall. No benefits would be provided under the tax bill because no wages were paid and the investor did not have an investment in depreciable assets.

2. If instead of a parking lot the investment were in a fully depreciable, high-rise parking garage (i.e., ignoring the land), a 20 percent deduction of $200,000 would be allowed because it did not exceed a specified fraction of the investor's original $10 million cost for the structure. (Expressed differently, $10 million is more than 40 times the $200,000 annual deduction, and therefore the deduction is allowable.) Expressed as an annual fraction the annual limitation is 2.5 percent of $10 million or $250,000 in this case. That 2.5 percent or $250,000 allowance would continue without regard to any actual depreciation of the structure, for the longer of 10 years or the actual useful life of the structure, as long as it was used in the business. Another way of looking at this is that the bill assumes that the 'normal' or 'reasonable' return on a tangible asset would be 12.5 percent – since 20 percent of 12.5 percent would be 2.5 percent.

3. It is unclear how these rules would be applied when real property – used to establish a base for the 2.5 percent rule – is exchanged on a tax-free basis in a like-kind-exchange. The conferees indicated their expectation that Treasury would address this issue in regulations.

4. Alternatively, assuming an investment in the parking lot instead of the structure, if the business had gross revenues of $1.4 million and had incurred wages for parking attendants and security guards of $400,000, the $200,000 deduction would be fully allowable because it would not exceed 50 percent of the taxpayer's wages.

5. However, again assuming an investment in the parking lot instead of the structure, if the taxpayer had $1.4 million of gross rents and paid $400,000 to a management company to provide those services with its own employees, no benefits would be allowable. Wages count, but payments to contractors do not, even if the contractor is providing personal services performed by its employees.

6. In that case, or in the original parking lot case with no wages or service-related payments at all, it is possible that the owner could pay himself (or a

spouse) wages of, say, $300,000, reducing his qualified business income to $700,000. That might allow him to claim a deduction or 20 percent of $700,000 or $140,000. It would be the equivalent of a 14 percent deduction applied to $1 million. Again, this appears to be allowed by the statutory language but it is unclear whether it was intended and will be a viable position.

7. Finally, if the parking garage provided parking mainly for a nearby medical center – perhaps for a flat fee paid by the center to provide free parking for its patients and visitors – an aggressive IRS agent might argue that the taxpayer should be denied all benefits as a business providing services in the field of 'health.' Note that the 'health' restriction does not depend on any person's skill or reputation being the 'principal asset' of the business – which it would clearly not be in the case of a $10 million parking structure. The 'principal asset' test applies only in the catchall provision – not in the 'listing' of forbidden fields. This may be an extreme hypothetical, but the issue would certainly arise for an investment in a string of urgent care clinics, even if they were owned by a passive investor who himself was not a physician or health expert and whose own personal services were clearly not being provided or offered. As a policy matter, it is difficult to understand disallowing the benefits for passive investments in clinics designed to discover or treat skin cancer, for example, while allowing them without restriction, say, for passive investments in tanning salons or tattoo parlors.

## Implications and Analysis

The overarching economic policy of the TCJA was to reduce the relative income tax burden on business income – as compared to the taxes imposed on wages and salaries or portfolio income. In the case of income inuring to individuals through 'C' corporations the effective tax burden on individual shareholders was essentially reduced by 25 percent. (That is, the combined top income tax rate of approximately 36 percent under the new bill, assuming current payment of all aftercorporate-tax income as qualified dividends to top rate individual shareholders, is 75 percent of the current law top combined rate of 48 percent making the same assumptions). In the case of passthrough businesses, the policy decision was to make a comparable reduction in their tax burden by excluding approximately 20 percent of such income from tax. A 20 percent exclusion – with a generally applicable top individual tax rate set at 37 percent – would result in a top rate of 29.6 percent. Of course, potential net investment income taxes would be additive to these rates.

To preserve perfect parity between the pass-through benefits and the corporate benefits, it would seem that the pass-through benefits would need to apply fully, and perhaps only, to income representing a return on purely passive investments – as is the case with corporate income representing a return on the passive capital invested by shareholders. Indeed, both the Unified Framework – and the House bill – purported to favor such an approach. And at least one private sector proposal advanced several ideas of how to accomplish that. In the final analysis, the effort to strictly distinguish returns to capital from returns to labor proved too difficult, or perhaps not that popular, and a different approach was adopted.

Nevertheless, the bill seems to accomplish very similar results to a pure labor/capital split in many if not all cases and could prove workable. As described above, there are a few significant unanswered questions and areas for potential improvement.

First, the idea of a list of forbidden businesses may need to be reconsidered and replaced with another approach.

Second, it seems to be disruptive and potentially destructive of economic value to require independent contractors receiving Forms 1099 to be replaced with employees receiving wages – or to require companies to merge or reconstitute themselves to meet the wage requirement in borderline cases.

Note should also be taken that there are also new restrictions on 'active losses' of pass-through investors – some of which are contained in the new pass-through rules described above and some of which are contained elsewhere in the bill – that may inappropriately inhibit capital formation in the pass-through sector. Those rules are quite complex and it is still far from clear how they will operate in conjunction with the existing passive loss rules and the new NOL restrictions.

Please see our additional tax alerts for details regarding the individual, domestic business, and international aspects of the conference agreement on the final proposed legislation.

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