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Special Tax Alert: The New Pass-through Deduction Explained

The recently enacted Tax Cuts and Jobs Act introduced a completely new concept to the Internal Revenue Code. IRC Section 199A for the first time provides a 20 percent deduction to lower the effective rate at which certain business income earned by noncorporate taxpayers is taxed. The deduction of 20 percent of a taxpayer's "qualified business income," coupled with the new maximum individual tax rate of 37 percent, results in a maximum effective tax rate on qualified business income of 29.6 percent. This alert explains how the new deduction works and highlights some uncertainties that we hope the IRS will try to clarify.

<u>Which Taxpayers Can Claim the Deduction?</u> The deduction is available to all taxpayers other than C corporations. Individuals, trusts and estates that earn qualified business income can claim the deduction. It is available for business income earned directly by the taxpayer (Schedule C income) or business income earned through pass-through entities (such as S corporations, partnerships and limited liability companies), and reported to the individual, trust or estate on a Schedule K-1.

<u>What Is a Qualified Business?</u> A qualified business is defined as any trade or business *other than* a specified service business or a trade or a business of performing services as an employee. A specified service business is any business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, trading or dealing in securities, partnership interests or commodities, or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its owners or employees. Specifically excluded from the definition of a specified service business are architecture and engineering services.

The report of the Senate Finance Committee on this provision makes reference to regulations promulgated under other IRC sections that further expand on what is meant by certain of the fields listed above. For example, the referenced regulations provide that performing arts means the services of actors, actresses, singers, musicians, entertainers and similar artists in their capacity as such. It does not include the provision of services by persons who themselves are not performing artists (e.g., persons who may manage or promote these artists, and other persons in a trade or business that relates to the performing arts). Similarly, it does not include the provision of services by persons who broadcast or otherwise disseminate the performances of artists to members of the public (e.g., employees of a radio station that broadcasts the performances of musicians and singers).

These regulations also clarify what is meant by the performance of services in the field of health. The regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists and other similar healthcare professionals. It does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the operation of health clubs or health spas that provide physical exercise or conditioning to their customers is not considered a business performing services in the field of health and therefore can qualify for the deduction.

The regulations provide that the performance of services in the field of consulting means the provision of advice and counsel. Other services, such as sales or brokerage services, or economically similar services, are not included (however, certain brokerage services are separately listed as a specified service in IRC Section 199A).

The catchall category, “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,” unfortunately, will inevitably lead to considerable confusion and uncertainty. Identifying these businesses will require a very subjective determination and will almost certainly lead to a multitude of disputes between taxpayers and the IRS, some of which will end up being resolved through litigation. The language “any trade or business” raises the question of whether this category is limited to service-based businesses. The language is broad enough to include any kind of business; however, the business that Section 199A excludes is referred to as “specified service trade or business.” We hope this will be clarified and its application limited to service-based businesses.

This language comes from IRC Section 1202(e)(3), where these businesses are among those that do not qualify for the capital gain exclusion provided by that section. The principal asset issue has been addressed once, in 2012, by the Tax Court in *Owens v. Commissioner*. The IRS argued that the principal asset of a successful insurance agency that had been sold was the skill of one of its owners. The court disagreed, finding that the principal reason for the success of the business was its training and organizational structure, as it was the independent agents that sold the policies that led to the success of the company. There is not much in the court’s opinion that would shed light on how other situations might be addressed.

In *PLR 201436001*, the IRS addressed this provision in the context of a company that assisted drug companies in bringing new drugs to market. In addressing whether the principal asset of the firm was the skill or reputation of its employees, the IRS noted: “this [provision] works to exclude, for example, consulting firms, law firms, and financial asset management firms. Thus, the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners). Company is not in the business of offering service in the form of individual expertise. Instead, Company’s activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers.”

An immediate issue that arises, for example, is the classification of a handful of world-famous architects. Are they eligible for the deduction because architectural services are specifically excluded from the definition of specified services, or is this handful of world-famous architects denied the deduction because their work results from their reputation? What about Henry Petroski, the engineering professor at Duke University who became known around the world for his books on structural design failures? If he is hired as a consultant, it may well be because of the reputation he developed through his books. It seems unlikely that Congress intended to exclude these professions as a whole and then carve out (and deny the deduction to) a handful of their most famous practitioners. At some level every architect or engineer gets work due to having a positive reputation, at least in some sector. If the IRS thinks the provision excludes lawyers who offer their expertise to clients, it would certainly think it also excludes architects, unless the specific exclusion of architecture and engineering prevails. Whatever the reason that Congress decided to allow the deduction for architects and engineers, we hope the IRS will not attempt to deny the deduction to a handful of famous ones.

Certain businesses may have aspects to them that are service businesses and other aspects that are not. For example, assume Mary has become a well-known photographer in her community. Assuming she is sufficiently well-known that the principal asset of her business is her skill or reputation, then to the extent her business is a service business, her income will not qualify for the pass-through deduction. Some of her income comes from photographing weddings and other special family events. This may be viewed as a service business as she is specifically hired to photograph the event. The balance of her income comes from the sales of prints of images she has taken in galleries and at art shows. She decides what she will photograph, and at the time she takes the photographs, she has no advance commitment from anyone to buy her images. There is good argument that this portion of income is considered to have come not from a service business but instead from the sale of prints of her photographs. People might buy the image because Mary took it, or they might buy the image simply because they like it. Does the buyer's motive matter? In the case of her wedding work, can Mary take the position that she is just selling her images rather than performing a service? What if in addition to her basic fee for photographing the wedding, she charges a specified amount for each print or video the family purchases from her? Does her income from these sales qualify? These questions cannot be definitively answered today and will require clarification. Of course, these distinctions will not make any difference if the skill or reputation criteria is interpreted as not limited to service-based businesses.

Another potential issue arises around the question of what level of activity is necessary to constitute a "trade or business." For example, with respect to real properties that are subject to triple net leases, where the owner does little more than collect the rent each month, a variety of court cases that have held this level of activity does not give rise to a trade or business but is instead treated as investment activity. While the term "trade or business" is used many times in the Internal Revenue Code, it is never defined. In addition, courts have reached differing results in some of the different contexts in which the term is used. The better answer here appears to be that any income-producing real property should be treated as a trade or business for purposes of qualifying it for the pass-through deduction. In this case, Congress does appear to have given us a clue as to what it intended, providing specifically that REIT dividends qualify for the 20 percent deduction. The Code prohibits REITs from engaging in the kinds of real property rental activities where significant services are provided to tenants. REITs essentially must generate the kind of passive rental income that results from a property subject to a triple net lease. This should be taken to mean that, in the case of a property owned outside of a REIT, the rental income also qualifies for the deduction.

<u>What Types of Income From a Qualified Business Are Taken Into Account?</u> Not all income of a qualified business is eligible for the deduction. The income must be earned by the business within the United States or in some cases, Puerto Rico. In addition, investment income is excluded. This includes:

- short- and long-term capital gains.
- dividends, income equivalent to dividends and payments in lieu of dividends.
- interest income other than income generated as a part of the business.
- income from an annuity not related to the business.
- gains from commodities transactions, including futures, forward and similar transactions except if used in connection with hedging by the business, or if selling commodities is the business of the taxpayer.
- foreign currency gains.
- net income from notional principal contracts.

Also excluded is any reasonable compensation paid to the taxpayer by a qualified business for services rendered with respect to the business, and any guaranteed payment or payment to a partner for services with respect to the trade or business. There is no specific exclusion for rental income of any kind or for royalties, which further bolsters the argument that any type of rental income should be eligible.

<u>How Is the Deduction Computed?</u> The starting point of the computation is the determination of the net business income for each qualified business of the taxpayer. Net income is simply the net of the qualifying income items of the business and the deduction or loss items of the business, and may be a negative number (i.e., a loss). This amount is multiplied by 20 percent. The amount derived from the above computation is subject to several limitations in many cases. Discussed in more detail, below. these limitations are generally based on the amount of W-2 wages paid by the business or a combination of the amount of W-2 wages and the original cost of depreciable property owned and used by the business. The amounts computed above for each business of the taxpayer are then added together. If the net amount resulting from combining all of the individual amounts from the taxpayer's businesses is a loss, the loss carries over indefinitely and reduces qualified business income in subsequent years.

The amount of the deduction determined above for qualified business income is increased by 20 percent of the taxpayer's qualified REIT dividends, qualified publicly traded partnership income and cooperative dividends. Qualified REIT dividends are dividends from a REIT other than capital gain dividends and dividends that qualify for the 20 percent tax rate on qualified dividend income. Qualified publicly traded partnership income is the net of the income and deduction items allocated to the taxpayer from a qualified business conducted by a publicly traded partnership and any gain on the disposition of the taxpayer's interest in the partnership that is treated as ordinary income under IRC Section 751.

The deduction amount cannot exceed 20 percent of the taxpayer's taxable income before the deduction reduced by the amount of any net capital gain. This limitation will come into play for taxpayers who have more itemized and other nonbusiness deductions than they have nonbusiness income. For example, if a taxpayer's income is made up entirely of qualified business income and the taxpayer has deductions for home mortgage interest, state and local taxes (limited to $10,000), and charitable contributions, 20 percent of his taxable income will be less than 20 percent of his qualified business income. This limitation prevents the deduction from creating an overall loss for the year. The provision also explicitly states that the deduction cannot cause the taxpayer's taxable income to be negative.

<u>The W-2 Wage and Depreciable Property Limitations.</u> For many taxpayers, with certain income level-based exceptions discussed below, the amount of the deduction with respect to any qualified business cannot exceed the greater of 50 percent of the W-2 wages paid with respect to the business, or the sum of 25 percent of the W-2 wages paid with respect to the business and 2.5 percent of the unadjusted basis of tangible depreciable property owned and used by the business. Only assets whose depreciation life has not expired can be taken into account. For this purpose, the depreciation life of an item of tangible property is the greater of its depreciable life determined under IRC Section 168 or 10 years.

Both of these limitation benchmarks have questions around them. With respect to W-2 wages, many types of businesses utilize affiliated service companies that provide the services of its employees to various related business. This is very common in the real estate industry in particular. Will the W-2 wages paid by the affiliated service company be counted as W-2 wages of the related business? Some point to the language of the Code that says, "W-2 wages paid with respect to the business," and have expressed hope that the phrase "with respect to" will be considered broad enough to include W-2 wages paid by a related service company.

The unadjusted basis of depreciable property is determined "immediately after acquisition." Clearly, this would include the purchase price and related capitalized costs before the basis is subsequently reduced by depreciation deductions. This raises the question of whether the cost of subsequent capitalized improvements can be included. For example, the owner of a commercial building may after a period of years spend a considerable sum to renovate or refurbish the building. Will these expenditures be added to the unadjusted basis? The phrase "immediately after acquisition" may cast some doubt on this; however, it may also be the case that subsequent improvements are treated as a separate new asset just acquired by the business and therefore will qualify. Support for this position can be found in IRC Section 168(i)(6), which provides that an improvement to a depreciable asset is treated as a new asset and depreciated using the same depreciation period as the original asset but beginning when the improvement is placed in service. Subsequent capital improvements should add to the unadjusted basis of depreciable property.

Exceptions for Taxpayers With Income Below Certain Levels. There is an exception to both the prohibition against claiming the deduction with respect to service businesses, and also the limitation on the deduction based on the W-2 wages and/or cost of depreciable property used in the business for taxpayers whose income falls below certain thresholds. The exception applies if taxable income determined before the deduction is not more than $315,000 for taxpayers filing a joint return, or not more than $157,500 for single taxpayers. On a joint return the benefit obtained from this exclusion is phased out between $315,000 and $415,000 of taxable income, and on the return of a single taxpayer the benefit is phased out between $157,500 and $207,500 of taxable income.

S Corporations, Partnerships and Limited Liability Companies. Where a taxpayer has qualified business income passed through from an entity such as an S corporation or partnership-type entity, the individual takes that income into account in computing his pass-through deduction. He also takes into account his allocable share of W-2 wages paid by the entity and of the unadjusted basis of the entities' assets.

Trusts and Estates. In the case of trusts and estates, the W-2 wages and asset basis of any qualified business are apportioned between the trust or estate and its beneficiaries in proportion to the amount of income retained by the trust or estate and the amount passed through to it beneficiaries.

Assessing the Benefit of the Deduction. In order for the owners of most businesses to benefit from the deduction, the business must either pay significant wages or have a significant investment in depreciable property. For example, assume a qualifying business generates $5 million of net income per year before the pass-through deduction. Twenty percent of this amount is $1 million. In order to be able to deduct the full $1 million, the business could, for example, either pay at least $2 million in W-2 wages or pay $1 million in W-2 wages and have depreciable property of at least $20 million that is still within its depreciation life. Alternatively, if the business paid no W-2 wages, it would need to have at least $40 million of original cost of depreciable property that is still within its depreciation life in order to be eligible for the full $1 million deduction.

Many real property businesses pay very little or no W-2 wages, especially if the management of the property is contracted to a third-party service provider. Assume a new commercial building is purchased for $40 million and produces net operating income of $2 million per year, which means the building was purchased at a capitalization rate of 5 percent. Assuming $32 million of the purchase price (80 percent) is depreciable over 39 years, the annual depreciation deduction would be $820,000. If the building was purchased without debt, the net income would be $1,180,000, of which 20 percent is $236,000. Two and one-half percent of the purchase price of $32 million (the depreciable portion) is $800,000, so the deduction is allowable in full. Any amount of financing on the property would result in some level of interest deduction that will further reduce net income and correspondingly reduce the 20 percent deduction.

If you assume a precipitous drop in prices and the building is purchased at a cap rate of 10 percent, the purchase price would be $20 million. If 80 percent of the price is depreciable ($16 million), the annual depreciation would be $410,000 and net income (assuming no debt) would be $1.59 million. Twenty percent of this amount is $318,000. Two and one-half percent of the $16 million depreciable cost is $400,000, so the full deduction would still be allowable.

In most cases, it appears that the full 20 percent of net income deduction should be available for income produced by rental real property. There may be extreme cases where buildings purchased many years previously at much lower prices now produce net operating income that is a high enough percentage of the original cost of the building that a limitation may become applicable.