

NAR Committee:

Federal Taxation Committee

What is the fundamental issue?

The centerpiece of the 2017 Tax Cuts and Jobs Act (TCJA) was to lower significantly (from 35% to 21%) the income tax rate paid by regular corporations. However, most businesses in the U.S. are not regular C corporations but are organized as limited liability companies, S corporations, partnerships, or as sole-proprietorships. These entities all “pass through” their income or losses to the owners of the business who pay any tax due on their own tax returns.

The authors of TCJA knew that if they limited the tax cut only to regular corporations, many constituents with pass-through businesses would be upset to miss out on the tax cut and also could decide to change their entities to C corporations to cut themselves in on the tax cut action.

Therefore, to deliver a similarly significant tax cut to pass-through businesses, the TCJA provided a new kind of tax deduction for pass-through businesses. Unlike normal tax deductions, this new idea (called the “Qualified Business Income Deduction” or the “199A Deduction”) is not based on an expenditure but equals up to 20 percent of the net business income of the entity after all other business expenses have been deducted.

Unfortunately, this new business deduction is somewhat complex, both in concept and in its application. Most of this complexity comes from concerns of Congress that the deduction be available only for businesses, including bona fide independent contractors, but not those who are employees who decide to try to talk their employers into making them independent contractors. Thus, the new law puts a number of so-called “guardrails” around the deduction, which adds complexity.

Further, Congress was concerned that enterprises in certain types of personal service businesses not be able to claim the deduction if their income is above certain thresholds. These restricted types of businesses are referred to by the new law as “non-specified service businesses” and include those in the following fields:

“any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing or investment managing, trading, dealing in certain assets, 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 employees.”

When this language first appeared in the draft legislation, it appeared to be very bad news for real estate professionals, for two reasons. First, the term “brokerage services” appears to rule out the use of the deduction by real estate agents and brokers. And second, it seemed that the threshold would be a fairly low dollar amount.

Two separate events occurred that mitigated these concerns and ended up making the new deduction available to a great many, if not most, real estate professionals who are in business for themselves as independent contractors or through another kind of pass-through business. First, the final legislation included threshold limits that are quite high - \$157,500 of taxable income for single tax filers and \$315,000 for those who file a joint tax return. Below these limits, the specified services restriction does not apply. And even for a range above these limits, a partial deduction is available on a phased-out basis.

Even better, the second event clarified that “brokerage services” does not include real estate brokerage, but only brokerage for intangible assets, such as stocks and bonds. This came from favorable regulations

promulgated by the Treasury Department and the Internal Revenue Service at the behest of NAR and others.

However, there is further complexity in the issue in that those with incomes above the same thresholds listed above cannot take a straight 20% deduction off their net income but must use a separate formula that depends on the amount of wages and/or business investment the entity has for the tax year. Specifically, the deduction for those businesses whose owners have taxable income higher than the applicable threshold is limited to the greater of 1) 50% of the W-2 wages paid by the business, or 2) the total of 25% of the W-2 wages paid by the business plus 2.5% of the original cost basis of the tangible depreciable property of the business at year end.

I am a real estate professional. What does this mean for my business?

The new qualified business deduction is a huge boost for most real estate professionals who are in business for themselves or who own an S corporation, limited liability company, or partnership. The deduction essentially means that not only are the regular C corporations qualified to get a significant tax cut on their business income but so are independent contractors and others who do business in one of these “pass-through” forms. This deduction can be as high as 20% of the net income from the business. As indicated above, however, having taxable income above the thresholds can greatly complicate the computation or result (in some cases) with a much smaller deduction. For example, a real estate agent or broker with income above the threshold who does not have a lot of business assets will get little or no deduction.

NAR Policy:

NAR strongly supported the new deduction for qualified business income and urged Members of Congress to include the self-employed and owners of pass-through businesses in the tax cut bill as it would have been highly inequitable for only regular corporations to get this kind of tax relief. And NAR also pushed for high thresholds.

In addition, NAR worked with Treasury and the IRS to exclude real estate brokerage activities from the definition of “brokerage services” as a prohibited category for business owners earning over the threshold amounts.

Opposition Arguments:

Some Members of Congress believe all of the tax cut provisions of the TCJA were ill-advised and they may be looking for opportunities to overturn them legislatively. In addition, because many of the provisions of the new law are temporary, including the qualified business income deduction, and are in effect only through December 31, 2025, some opponents of the tax relief are opposed to extending them beyond this time.

Legislative/Regulatory Status/Outlook

Federal Tax / Section 199A Qualified Business Income Deduction

While the regulations issued by Treasury and IRS have been finalized, the new tax deduction itself is temporary and is scheduled to end at the end of 2025. Some groups, including NAR, are already advocating for a permanent extension of the deduction. However, some opponents of the tax cuts passed in 2017 are advocating a cut-back of those tax cuts for those making over certain amounts of income. President Biden has indicated that he does not support tax increases for anyone making less than \$400,000 per year. Thus, both the long-term and the shorter-term prospects for this deduction are somewhat in doubt, and especially for those with higher incomes.

Current Legislation/Regulation (bill number or regulation)

S. 480/H.R. 1381– Main Street Certainty Act (to make permanent the tax deduction for qualified business income)

S. 2387 – Small Business Tax Fairness Act (limits the full tax deduction for qualified business income to those making less than \$400,000 and entirely phases out the deduction at \$500,000)

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