



FREQUENTLY ASKED QUESTIONS ON PASS-THROUGH DEDUCTION

The following are some FAQs regarding the operation of the pass-through deduction. **Please note that these FAQs are preliminary and do not constitute tax advice.**

Who qualifies for the 20 percent pass-through deduction?

The 20 percent deduction is fully available for pass-through (e.g., sole proprietorship, partnership, S Corporation, estate and trust) trade or business income of single filers and married taxpayers earning under \$157,500 and \$315,000, respectively.

While the final regulations generally require an enterprise to be a trade or business to qualify for the 20 percent pass-through deduction, the Treasury Department and Internal Revenue Service provide for a safe harbor in concurrently released guidance (Notice 2019-07) to benefit smaller operators of rental real estate whose holdings may not be considered a trade or business. Under the safe harbor, a rental real estate enterprise may be treated as a trade or business solely for purposes of the pass-through deduction if at least 250 hours of services (e.g., maintenance, repairs, collection of rent, payment of expenses, and efforts to rent the property) are performed with respect to the property by any person. Time spent in the capacity of an investor does not count toward the 250-hour threshold.

How is the 20 percent pass-through deduction limited?

Once taxpayers earn over the thresholds, the deduction is limited to the greater of: (1) 50 percent of W-2 wages paid by the taxpayer; or (2) 25 percent of W-2 wages paid by the taxpayer plus 2.5 percent of the unadjusted basis of the taxpayer's property. This unadjusted basis is available for up to 27.5 years for a multifamily structure and at least 10 years for other types of property. This second prong of the test should be beneficial to multifamily owners who have substantial property holdings relative to wages paid.

Do all kinds of business income qualify for the pass-through deduction?

Once a taxpayer's income exceeds the threshold amount, certain types of business income do not qualify. These so-called Specified Services include: brokerage services; 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 or owners; and any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Do any of the Specified Service Limitations Impact the Multifamily Industry

Upon first read, NMHC/NAA believe that these types of Specified Services should not generally prevent developers and managers of multifamily real estate from qualifying for the 20 percent deduction. The

proposed regulations provide several clarifications regarding Specified Services that bolster this conclusion, including:

- Investing and investment management services does NOT include directly managing real property.
- Brokerage services do NOT include services provided by real estate agents and brokers.
- The “reputation or skill” clause is limited to taxpayers engaged in the trade or business of: (1) receiving income for endorsing products or services; (2) licensing or receiving income for the use of an individual’s image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual’s identity; or (3) receiving appearance fees or income.

How is the deduction calculated if I own several buildings?

The amount of business income qualifying for the deduction is calculated separately with regard to each trade or business of the taxpayer. As many multifamily firms today file a separate tax return for each partnership, the deduction is calculated separately for each such entity. However, if a multifamily entity owns several properties within a single entity, the activities of all properties within that entity may be combined for purposes of calculating the deduction. This could potentially mean that taxpayers could receive a deduction for income flowing from older buildings that no longer have qualifying adjusted basis if the taxpayer also holds newer buildings with significant unadjusted basis within a portfolio.

Can taxpayers with multiple trades or businesses aggregate those activities?

The final regulations enable certain individuals to aggregate multiple trades or businesses. To qualify, among other conditions, the same person, or group of persons, must directly or indirectly, own a majority interest in each of the businesses to be aggregated. The required ownership threshold may, in some cases, make it challenging to aggregate real estate activities conducted as part of separate entities. Assuming the ownership requirement can be met, the final regulations also require that the trades or businesses being aggregated meet two of the three of the following: (1) they offer the same products; (2) they share centralized business elements; and (3) they are operated in conjunction or in reliance upon one or more businesses in the group (e.g., supply chain interdependencies).

What happens if the employees at a property are paid from an entity that is separate from the partnership owning the property?

A special rule allows wages paid by an entity separate from the entity claiming the deduction to be considered qualifying wages for purposes of the deduction. Specifically, the final regulations provide that a person may take into account any W-2 wages paid by another person provided that the wages were paid to common law employees or officers.

How are like-kind exchanges treated?

The final regulations allow a taxpayer to retain the unadjusted basis of a relinquished property following a like-kind exchange. However, such basis must be adjusted downward by the amount of any money or property received as part of the transaction that is not of like-kind to the property exchanged. Basis may be adjusted upward by any additional money or property reflecting additional taxpayer investment.

The proposed regulations would have required that depreciation deductions be taken into account with regard to a relinquished property when calculating the unadjusted basis of the acquired property. NMHC/NAA successfully requested that the Treasury Department and IRS amend the proposed regulations to avoid penalizing taxpayers who engage in like-kind exchanges.

How are REIT Dividends treated for the deduction?

The deduction is applicable to REIT dividends without regard to a taxpayer's income or any other limitations. In conjunction with the final pass-through regulations, Treasury Department and Internal Revenue Service proposed regulations that clarify that REIT dividends held as part of a mutual fund (as opposed to those derived from directly held REIT stock) qualify for the deduction.

How do the regulations treat improvements to property?

The final regulations allow improvements to qualified property to serve as additional unadjusted basis for purposes of the deduction. For example, if a taxpayer placed in service a multifamily building on March 26, 2018, and then incurred additional capital expenditures to improve that building on May 27, 2020, the taxpayer has two qualified properties: the building placed in service on March 26, 2018, and the improvements to the building incurred on May 27, 2020.