

Pass-Thru Entities Revisited In Light of the New Tax Law

By John Dolgetta, Esq.

On December 24, 2017, President Trump signed the Tax Cuts and Jobs Act ([see http://bit.ly/2jZX47p](http://bit.ly/2jZX47p)) into law (hereinafter the "Tax Cuts Act"). While there has been much debate as to what effect the Tax Cuts Act will have on the real estate market in general, one thing that is certain, is that the new law will certainly have a positive impact on the tax implications on the income of many real estate agents. In August, 2017, the potential impact of the restructuring of the tax code and the benefits of setting up a limited liability entity such as an s-corporation ("S-Corp") or limited liability company ("LLC") were discussed in the Real Estate In-Depth article entitled "Agents, Associate Brokers Could Benefit from Commission Via 'Pass-Through' Biz Entities" (the "August 2017 Article") ([see http://bit.ly/2mDq45j](http://bit.ly/2mDq45j)). However, with the passage of the Tax Cuts Act, there have been additional changes to the tax code that will not, at least from a tax perspective, require many real estate agents to rush to form a S-Corp or LLC.

The Tax Cuts Act: Qualified Business Income and the "Sole Proprietor"

The Tax Cuts Act reduces the income tax due on "qualified business income" ("QBI") from a qualified trade or business that is earned not only by an estate or trust, a partnership, corporation (C-Corporation or S-Corp), or LLC, but now, even a sole proprietorship (which is the manner in which many individual real estate agents currently do business). The new law creates a new deduction (rather than a specific tax rate) of up to twenty (20%) percent of the QBI of an individual. The Tax Cuts Act also greatly reduces the existing corporate tax rate (i.e., for C Corporations) from thirty (35%) percent to twenty-one (21%) percent.

The National Association of Realtors® ("NAR") has prepared an informative publication (accompanied by a live presentation which can also be found on NAR's website) that provides a detailed outline and explanation of many aspects of the Tax Cuts Act as it pertains to the homeowner and real estate industry, in general, and, more specifically, the law's effect on the real estate brokerage business and the treatment of the real estate agent's income. ([See](#) article by NAR entitled "The Tax Cuts and Jobs Act - What It Means for Homeowners and Real Estate Professionals" at <http://bit.ly/2EIJnSq>). NAR explains that,

*"The House and Senate started out with significantly different approaches to lowering the tax rate on qualified business income for **sole proprietors** [emphasis added] and pass-through entities. The House bill featured a top rate approach while the Senate offered a deduction, which was set at 23% in the Senate bill."*

One key aspect of the new legislation, which was not specifically addressed in the summaries and literature previously released by the Trump Administration and law makers, is that a sole proprietor will be afforded the same tax benefits as pass-through entities, such as S-Corps or LLCs. The focus of the August 2017 Article was on the importance of setting up a limited liability entity, not only for the usual corporate and limited liability benefits, but because these previous proposals focused on reducing taxes on corporations (C corporations) and pass-

through entities. There was no mention of sole proprietors being afforded the benefits of a new tax law.

A “Qualified Trade or Business” and the “Specified Service Trade” Exception

Under the Tax Cuts Act a “qualified trade or business” is defined as “...any trade or business other than - (A) a specified service trade or business, or (B) the trade or business of performing services as an employee.” Basically, any trade or business, except for “a specified service trade or business” or an employee, can qualify for the deduction. It is important to note that a real estate agent would not have qualified to receive any benefit because real estate brokerage services are considered to be a “specified service trade.”

Section 1202(e)(3)(A) of the Internal Revenue Code (“IRC”) specifically excludes “...any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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 1 or more of its employees....” However, through its tireless lobbying efforts and successful calls-to-action, NAR, with the help of over 300,000 Realtors® across the nation, was able to secure an exception based on income level which will stand to benefit a large number of Realtors® and other real estate professionals.

The Tax Cuts Act exception provides that if “...the taxable income of any taxpayer is less than the sum of the threshold amount [which is \$157,500 for single filers and \$315,000 for joint filers] plus \$50,000 (\$100,000 in the case of a joint return), then – (i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business....” Basically, the deduction will be allowed but will phase out on a pro-rata basis over a range of \$50,000 over and above \$157,500 for single filers and over a range of \$100,000 over and above the \$315,000 for couples filing jointly. There will be no deduction allowed at all for qualified business income over \$207,500 and \$415,000, respectively.

All other “qualified trades or businesses” may also similarly claim the full twenty (20%) percent deduction up to the specified threshold levels. However, , unlike a “specified service trade or business,” after the threshold levels have been met, a “qualified trades or businesses” may be able to continue to claim the deduction but the deduction is subject to the “wage and capital limit exception.” This “wage and capital limit exception” allows a continued deduction that is the greater of: “(i) 50% of the W-2 wages paid by the business, or (ii) the total of 25% of the W-2 wages paid by the business plus 2.5% of the cost basis of the tangible depreciable property of the business at the end of the year.” It is also interesting to note that the Tax Cuts Act excluded “architecture” and “engineering” from the definition of a “specified service trade” and are not subject to the same limitations as the other “specified service trades or professions” under IRC 1202(e)(3)(A).

NAR’s Examples of How the Tax Cuts Act Will Benefit Agents and Brokers

NAR provides several examples (*see* <http://bit.ly/2EIJnSq>) illustrating the benefits that Realtors® and other real estate professionals will derive from the new legislation. The examples offered by NAR illustrate the calculation of the income tax due based on the prior law and what

would be due under the new law. While the examples are straightforward, the tax savings in these examples are quite significant.

In one example, a single person, who works as a real estate agent, with commission income of \$55,000, had a tax reduction of \$3,091 ($\$6,741 - \$3,650 = \$3,091$) as compared to the prior law. This represents a forty-five (45%) percent reduction. In another example, a single broker, with no dependents, had income from his brokerage firm business of \$175,000. The tax savings in that instance was \$12,927 ($\$38,861 - \$25,934 = \$12,927$), representing a thirty-three (33%) percent tax savings. In yet another example, an owner of a real estate brokerage firm, and his wife, had a total combined income of \$420,750. They did not qualify for the business income deduction because, although they filed jointly, they were over the "personal services exception" limit of \$415,000. Nevertheless, simply due to the reduction in the tax rates, the couple's taxes in this example were reduced by \$16,244 ($\$113,573 - \$97,329 = \$16,244$) - a fourteen (14%) percent savings. The examples provided by NAR illustrate that the benefits to agents and brokers are indeed substantial under the new law.

Should An Agent or Broker Still form an S-Corp or LLC?

The Tax Cuts Act extended the benefits of the legislation to most businesses, including those business ventures operated by individuals as sole proprietorships. From a tax perspective, at least, it seems that there is no immediate urgency for individuals to rush to incorporate or set up a limited liability company. There are still many legal advantages to setting up such an entity. One important factor is the limited liability that an entity such as a corporation or LLC affords an individual.

It is important to note, however, that under the real estate brokerage law, agents are deemed to be fiduciaries of their clients and will not be shielded from liability for a breach of a fiduciary duty owed to a client. Nevertheless, there are many other areas where the corporate or LLC entity can offer protection from liability arising out of general business matters (e.g., contracts, employee matters, personal injury issues, business dealings, leases, etc). It is also important to note that New York law does permit real estate licensees to set up an S-Corp or LLC and to receive commission payments through those entities. (See <http://bit.ly/2mDq45j>).

In light of the new Tax Cuts Act, one thing is certain, the legal and tax landscape has changed significantly and still remains complex. It is important that real estate professionals reach out to their accountants and attorneys in order to assess what they should be doing. The new tax law has introduced many changes and nuances and in order to take full advantage of its benefits, one must seek the necessary advice in order to structure his or her business in the most effective and advantageous manner.

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