Summary

Entity choice rules allow U.S. businesses to choose how they will be taxed, and real estate generally is owned and operated through "pass-through" entities—partnerships, LLCs, S corporations, and REITs. These pass-through entities allow income and often deductions to pass through to individual investors. Pass-through entities give investors greater flexibility in how they allocate the risks and rewards of these capital-intensive and relatively illiquid businesses. Our partnership tax rules facilitate the ability of differently situated parties, such as entrepreneurs and capital providers, to come together for productive activities that create jobs and strengthen communities.

Despite the economic benefits of our pass-through tax regime, pass-through rules are often challenged by certain lawmakers who claim that the rules: (1) disproportionately benefit upper-income taxpayers and large corporations, (2) give taxpayers too much ability to pick and choose how and when to pay tax, and (3) are too complicated for the IRS to enforce.

Several proposals in recent years would significantly restrict pass-through taxation or raise tax rates on pass-through income, effectively raising the tax burden on real estate investment. These proposals include:

- Extending the 3.8 percent net investment income tax to all pass-through business income,
- Capping or phasing out the 20% deduction for pass-through business income (section 199A) for taxpayers with incomes exceeding certain levels (see, e.g., Equal Tax Act, H.R. 5336),
- Repealing REIT dividends' eligibility for the 20% pass-through business income deduction (sec. 199A),
- Limiting taxpayers' ability to deduct state and local taxes (SALT) paid by pass-through entities under state laws enacted in response to the Tax Cuts and Jobs Act,
- Requiring partnership liabilities (including recourse debt) to be allocated based on the partners' shares of partnership profits, rather than actual economic liability,
- Restricting how taxpayers account for built-in gains and losses on appreciated or depreciated property when it is contributed to a partnership, and
- Recharacterizing all partnership profits interests (carried interest) as ordinary income.

Support for proposals to raise revenue on the backs of pass-through businesses may grow in the months and years ahead as pressure increases for Congress to address rising debt and deficits. For example, Senate Finance Ranking Democrat Ron Wyden (D-OR) has claimed that his PARTNERSHIPS Act (S. 2095) to reform partnership tax rules would raise over $725 billion.

Key Takeaways

- Our pass-through regime is a competitive strength of the U.S. tax system. Most countries rely on inflexible corporate regimes that provide little ability for an entrepreneur to tailor the capital and ownership structure to meet the needs of the business and its investors.
- Pass-through businesses account for roughly 95% of all U.S. businesses, and these businesses are the drivers of job growth, innovation, and productive risk-taking.
- Half of the 4 million partnerships in the U.S. are real estate partnerships, and real estate activity constitutes a large share of pass-through business activity.
- Publicly traded REITs allow small investors to invest in diversified, commercial real estate using the same single tax system available to partners and partnerships.
- Small and closely held businesses drive job growth and entrepreneurial activity in the U.S. Entity choice is a differentiator that contributes to our entrepreneurial culture.