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Section 199A for Trusts and Estates: Planning Techniques for Counsel, Optimizing QBI Deductions, Multiple Trusts

TUESDAY, MARCH 12, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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SECTION 199A FOR TRUSTS AND ESTATE

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CURRENT GUIDANCE

- Final regulations (released January 18, 2019)
 - Apply for tax years ending after 2/8/19
- Proposed Regulations (issued August 16, 2018)
 - Taxpayers may rely on proposed regulations in their entirety for taxable years ending in calendar year 2018
- Notice 2019-7
 - Provides safe-harbor under which a rental real estate business will be treated as a trade or business for purposes of section 199A
- Rev. Proc. 2019-11
 - Provides methods for computing W-2 wages
 - Applies for tax years ending after December 31, 2017

SECTION 199A – QUALIFIED BUSINESS INCOME DEDUCTION, IN GENERAL

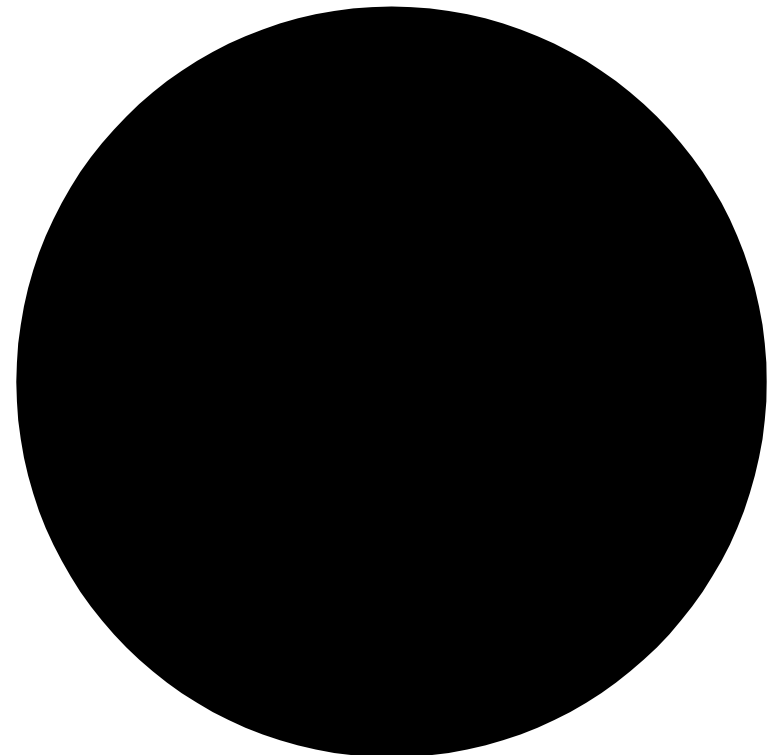
- Deduction generally equals 20% of “qualified business income” through 2025, with some limitations.
 - Includes REIT dividends and PTP income.
- QBI generally is taxable income (*i.e.*, the net amount of items of income, gain, deduction and loss) with respect to a US trade or business.
- For taxpayers with income in excess of threshold, limited to the greater of:
 - 50% of the taxpayer’s share of W-2 wages, or
 - 25% of the taxpayer’s share (a) of W-2 wages and (b) 2.5% of the taxpayer’s share of the unadjusted basis of qualified property.
- Specified personal service businesses (SSTB) not eligible, except for taxpayers with taxable income below \$315,000 for MFJ or \$157,500 for other taxpayers.
 - Deduction phased out over next \$50k/\$100k.
- Income exceeding the threshold amounts stated above that is from a SSTB is not eligible for the section 199A deduction because a SSTB is not a “qualified” trade or business under section 199A.

DEFINITION OF TRADE OR BUSINESS

- “Trade or business” is a key term in section 199A
 - only amounts earned in a qualified *trade* or *business* are eligible for the full benefit of the deduction.
- Code: Neither section 199A nor its legislative history defines trade or business.
- Proposed regulations:
 - Adopt the definition of trade or business in section 162, with modifications.
 - The proposed regulations also aggregate certain related entities into a single trade or business. This extension of the trade or business definition allows more than one legal entity to be treated as conducting a single trade or business for purposes of the section 199A deduction, potentially increasing the amount of a taxpayer’s deductible QBI.

DEFINITION OF TRADE OR BUSINESS (CONTINUED)

- Final regulations: retain section 162 definition of trade or business.
 - Preamble summarizes case law that applies for purposes of determining whether a taxpayer is engaged in a trade or business under section 162.
 - Requirements mentioned in preamble:
 - Good faith intention to make a profit; and
 - Considerable, regular, and continuous activity.



DEFINITION OF TRADE OR BUSINESS (CONTINUED)

- Rental or Licensing Exception.

- Reg. 1.199A-1(b)(14): “rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under §1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under §1.199A-4(b)(1)).”
- Not available where commonly controlled entity is a C corporation.

DEFINITION OF TRADE OR BUSINESS (CONTINUED)

● Multiple Trades or Businesses

– Identifying Separate Businesses

- The regulations do not provide bright-line test for identifying trades or businesses conducted by a single entity.
 - Preamble states that a single entity generally will not be treated as conducting multiple trades or businesses unless different methods of accounting could be used for each trade or business under Reg. § 1.1446-1(d).
 - Entity must maintain a “complete and separable set of books and records” for each trade or business.
 - Consistency requirement: “In cases in which other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, taxpayers should report such items consistently.”

– Allocating Items

- Reg. § 1.199A-3(b)(5) requires allocation of all qualified items of income, gain, loss and deduction among multiple trades or businesses.
 - Method: any “reasonable method based on all the facts and circumstances”
 - Must be consistently applied from year to year and must clearly reflect income and expenses from each trade or business.

DEFINITION OF TRADE OR BUSINESS (CONTINUED)

● Real Estate Trade or Business

- Preamble has separate discussion regarding whether real estate activities qualify as a section 199A trade or business.
- Preamble discusses the following factors:
 - Type of rented property (commercial vs residential property);
 - The number of properties rented;
 - The owner's or agent's day-to-day involvement;
 - The types and significance of ancillary services provided under the lease; and
 - The terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus and long-term lease).

DEFINITION OF TRADE OR BUSINESS (CONTINUED)

● Real Estate Trade or Business (continued)

– Notice 2019-7

- Applies to “real estate enterprise,” defined as “an interest in real property held for the production of rents”
- Rental real estate enterprise will be treated as a trade or business if:
 - Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
 - 250 or more hours of rental services are performed (for taxable years beginning prior to January 1, 2023); and
 - Taxpayer complies with documentation requirements related to hours of work and work performed.
- Triple Net Lease Excluded
 - Real estate rented or leased under a triple net lease is not eligible for the safe-harbor

SPECIFIED SERVICE TRADE OR BUSINESS

- Specifically identified SSTBs:

- Health
- Athletics
- Trading
- Investing and Investment Management
- Consulting
- Financial Services
- Dealing in Securities

- Catch-All

- Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.
- The regulations provide that a business is an SSTB if it is a business in which a person receives compensation for: (a) endorsing products or services; (b) the use of a person's image, likeness, name, signature, voice, trademark or any other symbols associated with the individual's identity; or (c) appearing on radio, television or another media format.

SSTB RELATED PARTY RULES

SSTB Related Party Rules:

- 80% Rule

- Proposed Regulations: Any trade or business that provides 80 percent or more of its property or services to a related SSTB is itself treated as an SSTB (if less than 80%, proportionate amount treated as SSTB).
- Final Regulations: 80% rule is eliminated. Only portion of non-SSTB providing property or services to related SSTB is treated as an SSTB.

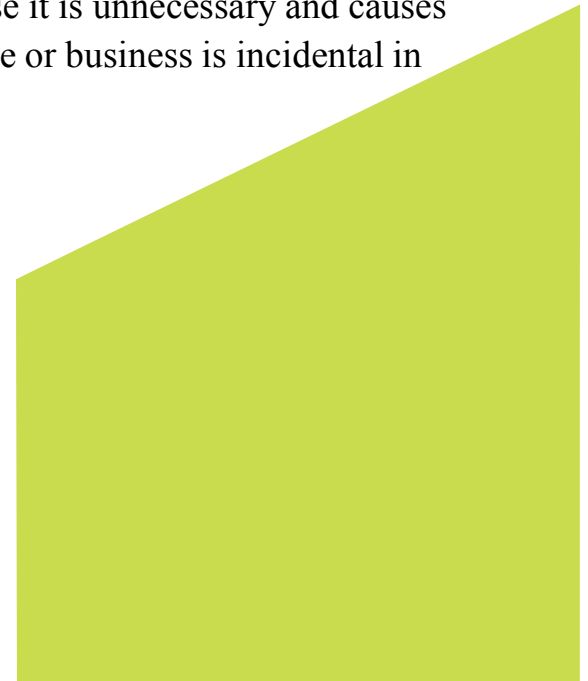
- Related SSTB Defined

- Related party rules apply only if an SSTB and an otherwise qualifying trade or business are “related.” Businesses are related for this purpose if they share 50 percent or more common ownership.
- Ownership is determined under sections 267(b) & 707(b).

SSTB RELATED PARTY RULES (CONTINUED)

- 5% Rule (“Incidental Trade or Business”)

- Proposed Rule: A trade or business is treated as an SSTB if (1) it shares expenses (including wages or overhead) with a related SSTB and (2) the trade or business’s gross receipts represent 5 percent or less of the total combined gross receipts of the trade or business and the related SSTB during a taxable year.
 - Example: vet that also sold small amount of pet food.
- Final Regulations: Removed. Taxpayers may now benefit from identifying small non-SSTB businesses.
 - Preamble: “One commenter recommended that this rule be removed because it is unnecessary and causes administrative difficulties for taxpayers who must determine whether a trade or business is incidental in order to apply the rule.”



EXCEPTION FOR *DE MINIMIS* SSTB

- The proposed regulations added a *de minimis* exception to the definition of SSTB, which was not included in section 199A.
- Small Business *De Minimis* Exception
 - Under the exception, a business that generates **\$25 million or less** gross receipts for a taxable year will not be an SSTB if less than **10 percent** of its gross receipts are attributable to the performance of services in the fields that are SSTBs.
 - Final regulations adopt this rule.
- Large Business De Minimis Exception
 - A business that generates **more than \$25 million** of gross receipts for a taxable year will not be an SSTB if **less than 5 percent** of its gross receipts are attributable to the performance of services in the fields that are SSTBs.
 - Final regulations adopt this rule.

UNADJUSTED BASIS IMMEDIATELY AFTER ACQUISITION

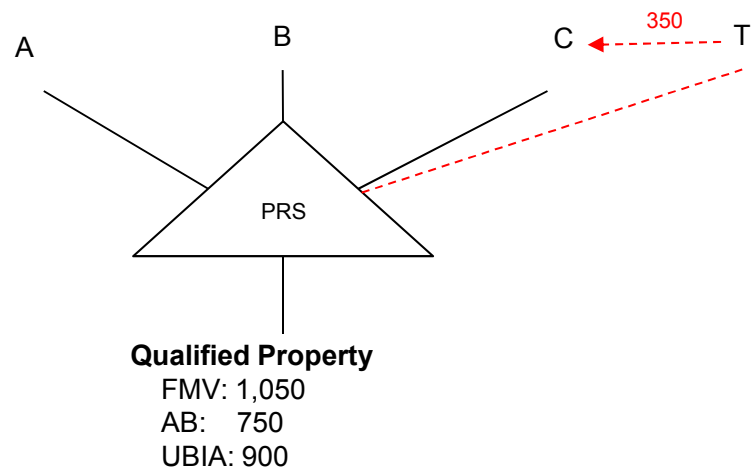
- Unadjusted Basis Immediately After Acquisition (UBIA)
 - Applies for purposes of determining 2.5% portion of deduction limitation.
- Non-Recognition Transactions (e.g., sections 351 and 721)
 - Proposed regulations: UBIA equals adjusted basis on date property is placed in service by the recipient
 - Final regulations: UBIA carries over from the contributor (i.e., adjusted basis on date property placed in service by the contributor).

UNADJUSTED BASIS IMMEDIATELY AFTER ACQUISITION (CONTINUED)


- Proposed regulations: Section 743(b) adjustments are ignored in calculating UBIA.
- Corrected final regulations:
 - Section 743(b) adjustments are treated as separate items of qualified property.
 - Partners can take into account the UBIA with respect to a section 743(b) adjustment to the extent it qualifies as an “excess section 743(b) basis adjustment”:
 - An amount that would represent the partner's section 743(b) basis adjustment as determined under Reg. §§ 1.743-1(b) and 1.755-1, but calculated as if the adjusted basis of all of the partnership's property was equal to its UBIA.
 - The absolute value of the excess section 743(b) basis adjustment cannot exceed the absolute value of the total section 743(b) basis adjustment with respect to qualified property.

UNADJUSTED BASIS IMMEDIATELY AFTER ACQUISITION (CONTINUED)

Reg. § 1.199A-2(a)(3)(D), Ex. 1



- Regular section 743(b) adjustment
 - Amount Paid: 350
 - Inside AB: (250)
 - Section 734(b) Adj: 100
- “Excess section 743(b) adjustment”
 - Amount Paid: 350
 - Inside UBIA AB: (300)
 - UBIA 734(b) Adj: 50
- Absolute value of “excess section 743(b) adjustment” [50] is smaller than absolute value of regular section 743(b) adjustment [100].



Section 199A for Trusts and Estates

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March 12, 2019

Holland & Knight

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Final Regulations

- » Entity-Level Aggregation
- » Trust-Level Deduction for Distributions

New Proposed Regulations

- » Treatment of Charitable Remainder Trusts
- » Confirmation on treatment of Charitable Lead Trusts

IRS Notice 2019-07 | Rental Property Safe Harbor

- » Rental Real Estate Enterprises (RREE)
- » Three Prongs: (1) books & records, (2) 250 hours, (3) rental services substantiation
- » Exclusions & Procedure

Opportunities for Business Owners (especially SSTBs)

» Anatomy of a 199A Prospect

- TBs, SSTBs, and potential for restructuring
- Non-tax reasons for business structures
- Third-party customers for side businesses
- Employees and stuff: the wage/UBIA limitation

» Entity Structuring and Restructuring

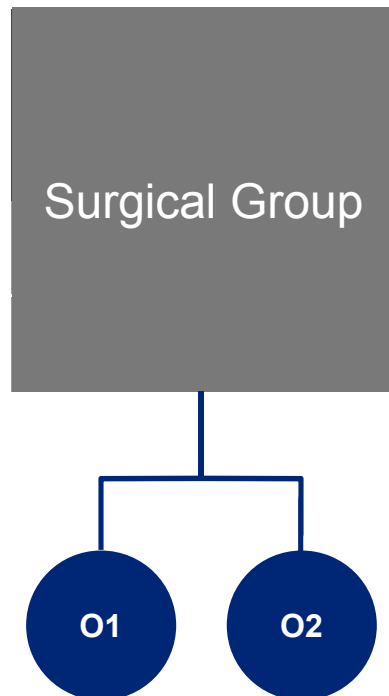
- Anti-Crack & Pack Regs.
- A word about dogs & tails
- December 31, 2025

» Aggregation

» Threshold Income Issues

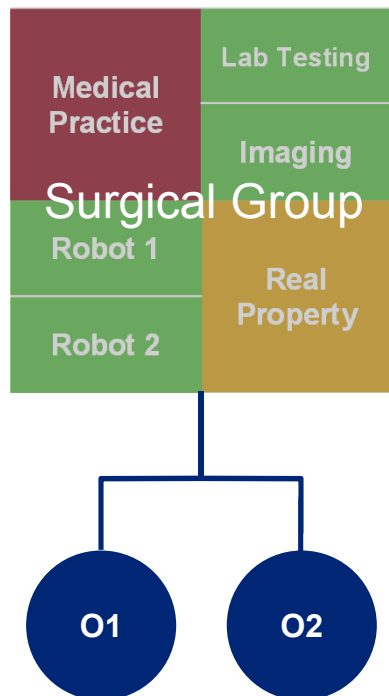
WHAT IS THE BUSINESS?

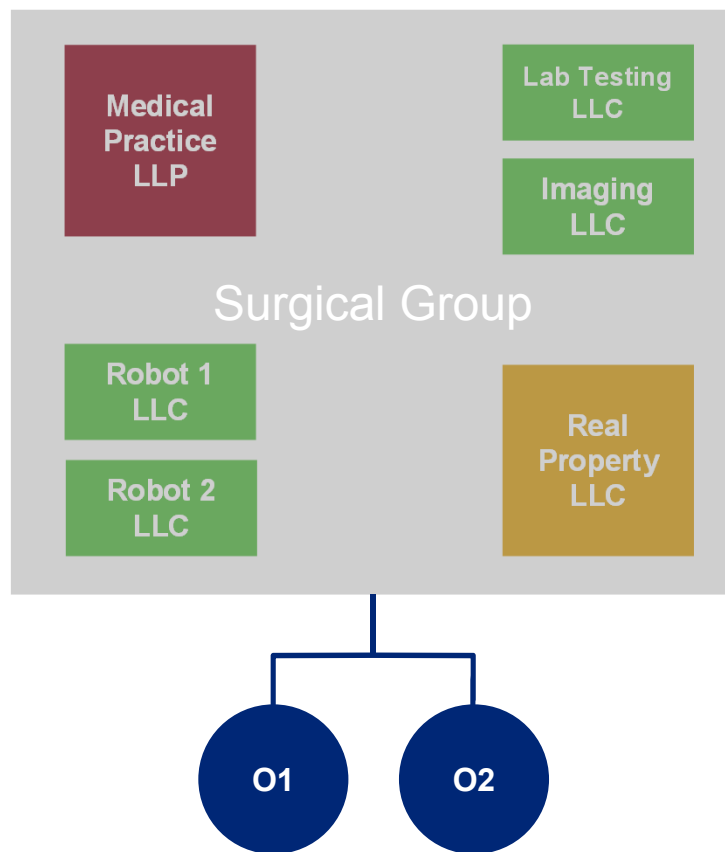
- » Owners often engage in some level of vertical integration
- » Breaking down the business can reveal 199A opportunities
- » Case Study: the specialist surgical group
 - Two surgeons are partners
 - Roughly a dozen employees
 - Expensive assets: land, buildings, surgical robots



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- » Case Study: the specialist surgical group
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 - Roughly a dozen employees
 - Expensive assets: land, buildings, surgical robots
- » Opportunity: liability and tax planning

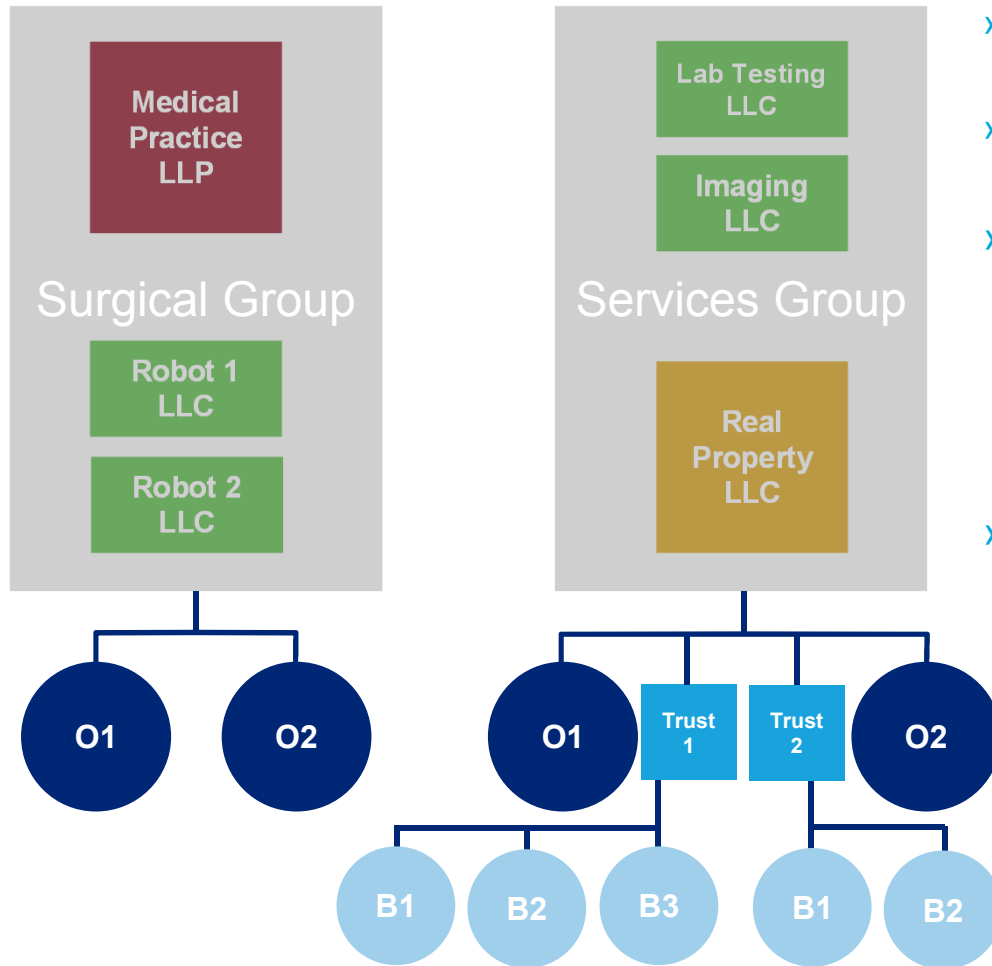




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- » Case Study: the specialist surgical group
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 - Expensive assets: land, buildings, surgical robots
- » 199A Result
 - Medical practice: SSTB
 - Imaging Business, Lab Testing Business, & Surgical Robots, Real Property Leasing Company: SSTBs (?)
 - Consider:
 - anti-crack & pack regs (199A-5(c)(2))
 - aggregation by taxpayers
 - administrative burden

199A Trust & Estate Planning | Estate Planning for Business Owners



WHAT IS THE BUSINESS?

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 - Imaging Business, Lab Testing Business, & Surgical Robots, Real Property Leasing Company: SSTBs (?)
 - Consider: anti-crack & pack regs (199A-5(c)(2)), aggregation by taxpayers, administrative burden
 - What about trusts as co-owners?

199A for Estates

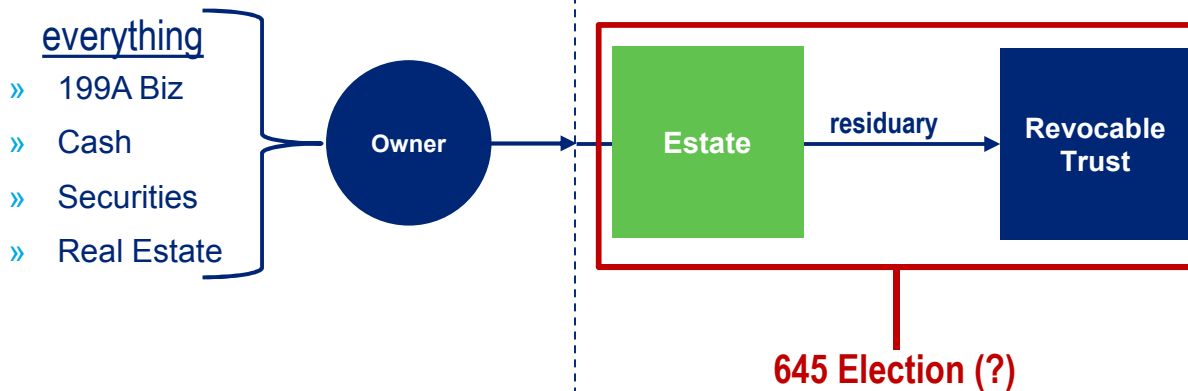
- » Hybrid flow-through/entity application
- » Has a threshold amount for 199A purposes

199A for Trusts

- » *Grantor Trusts*: flow-through to grantor
- » *Non-Grantor Simple Trusts*: flow-through to income beneficiary
- » *Non-Grantor Complex Trust*: hybrid flow-through/entity application
- » *Charitable Remainder Trusts*: it's complicated

199A Trust & Estate Planning | Estate Administration

Pre-Death Post-Death



CONSIDERATIONS

- » Estate & Trusts treated as taxpayers
 - Accelerated brackets
- » Funding
- » Interim Distributions
- » Fiduciary Considerations
- » 645 Election
 - Fiscal year election
 - S-corp holding time limits
 - Multiple returns

» **Trust Terms**

- Discretionary Distributions, especially income
- Impact of DNI
- Pot-Trusts, Sub-Trusts, and Separate Shares
- Grantor Trusts
- QTIPs

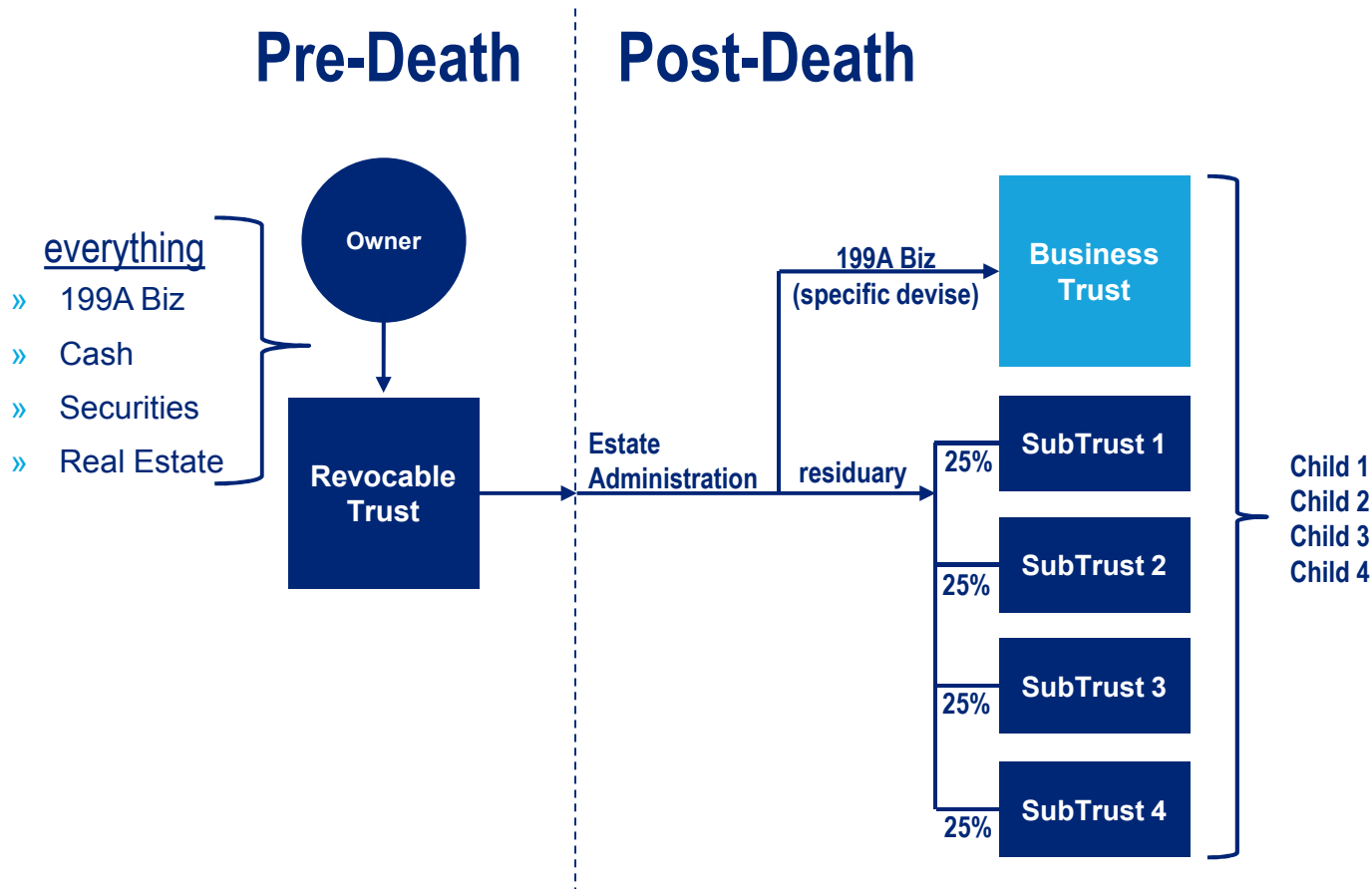
» **Transaction Structuring**

- Sales vs. Gifts
- Grantor Trust Status
- Promissory Notes

» **Anti-Abuse Rule / Multiple Trust Rule**

- See Stacey's Section on Multiple Trust Rule
- For now: anytime you see multiple trusts sharing ownership of a QTIP, consider the impact of their consolidation for threshold purposes

199A Trust & Estate Planning | Trust Structures



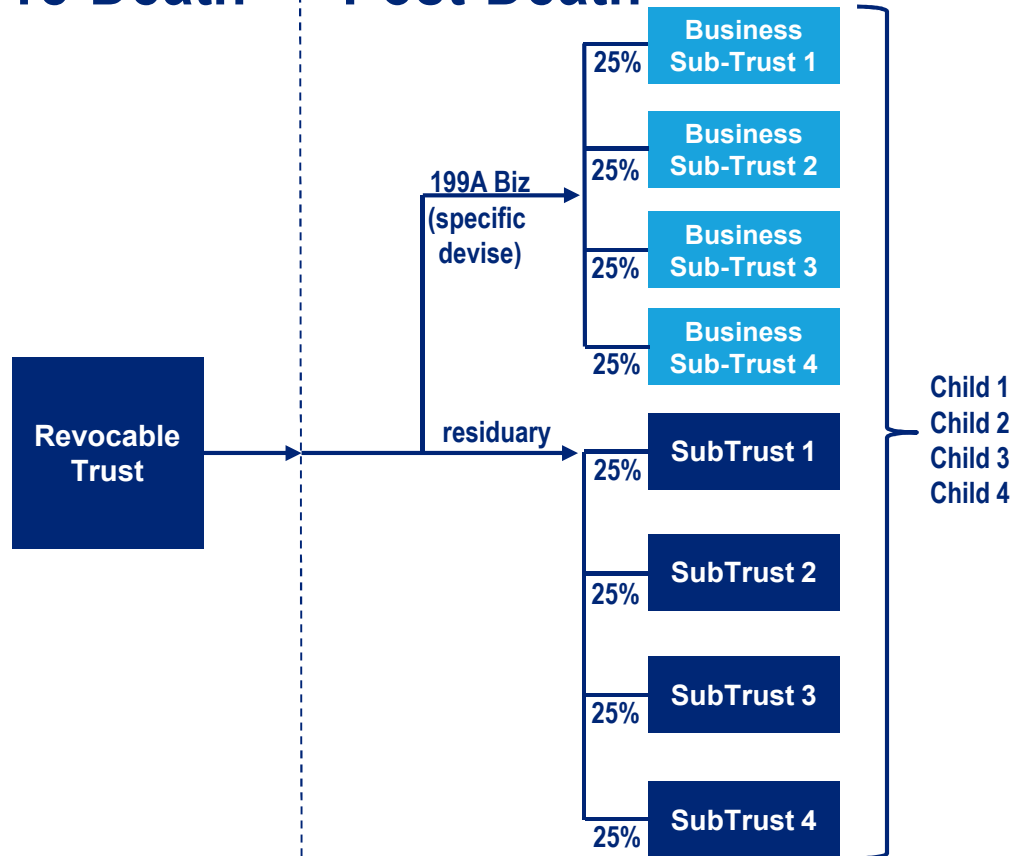
BUSINESS POT TRUST

- » Why?
 - Unified ownership & management
 - Special Asset
 - Beneficiary Privacy/Autonomy
- » Typical Terms
 - Retain business interest
 - Directed Trustee
 - Discretionary income/principal
- » 199A Result
 - 1 Trust, 4 benes
 - Tax vs. fiduciary duties

199A Trust & Estate Planning | Trust Structures

Pre-Death

Post-Death



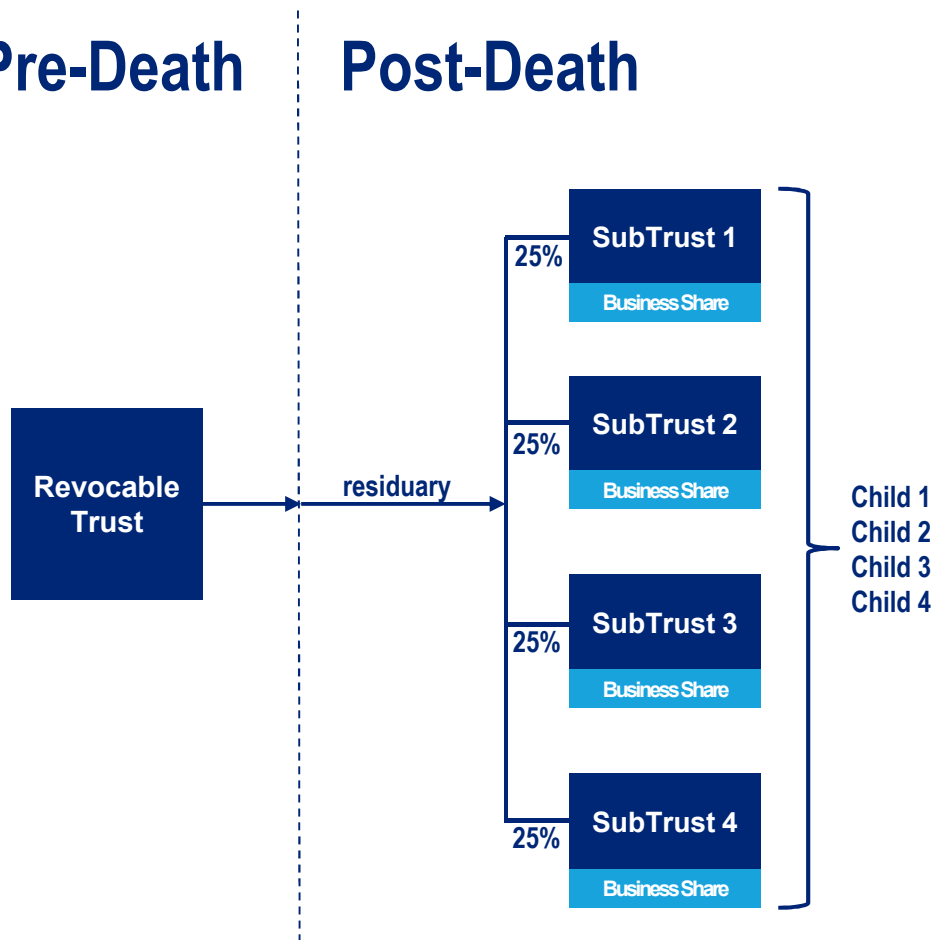
BUSINESS SUB-TRUSTS

- » Why?
 - Unified ownership & management
 - Differentiation of trust terms
- » Optimal Terms
 - Same Trustee/Trust Director
 - Discretionary income
- » 199A Result
 - 8 Trusts, 4 benes
 - Separate 199A
 - Modulate income distributions

199A Trust & Estate Planning | Trust Structures

Pre-Death

Post-Death



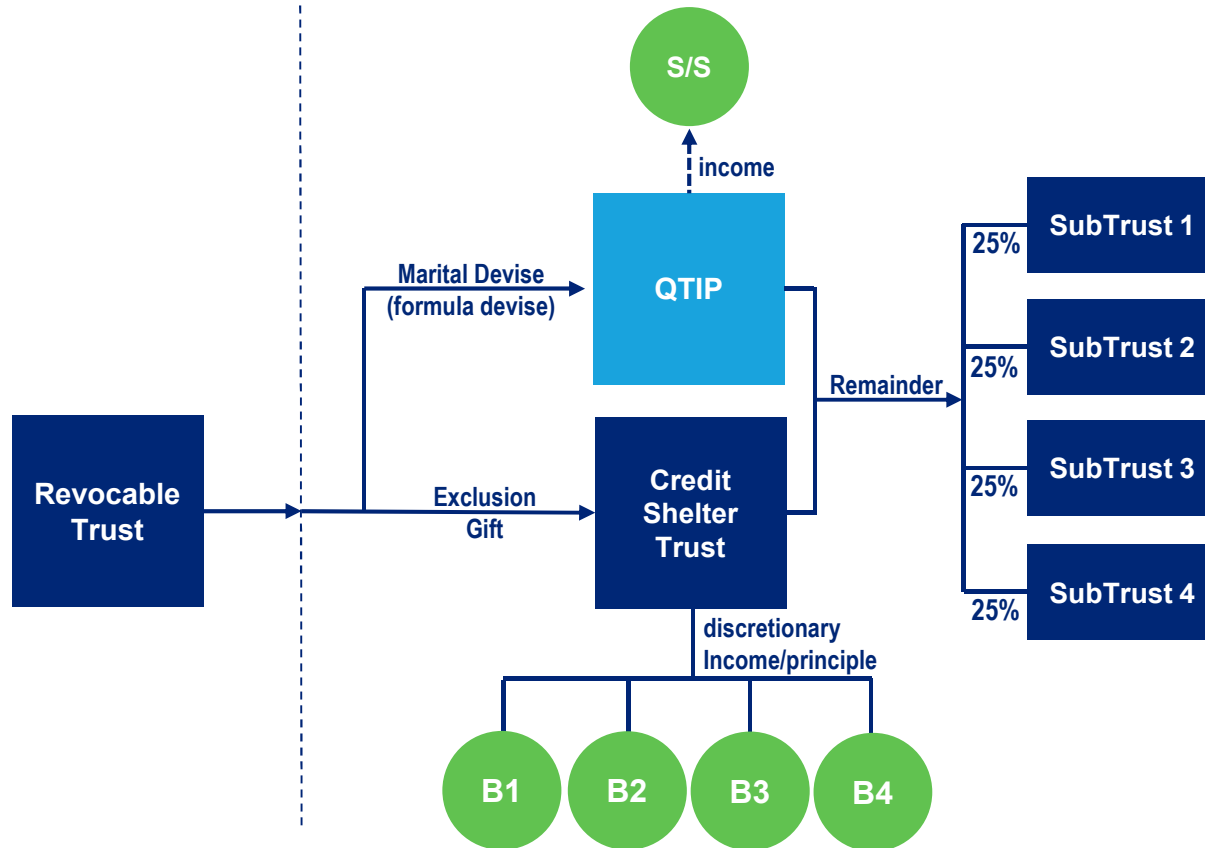
BUSINESS CARVE-OUT

- » Why?
 - Simplified administration
- » Typical Terms
 - Retain business interest
 - Discretionary income/principal
 - Voting Agreement among Trustees?
- » 199A Result
 - 4 Trust, 4 benes
 - Combined investment & 199A income

199A Trust & Estate Planning | Trust Structures

Pre-Death

Post-Death



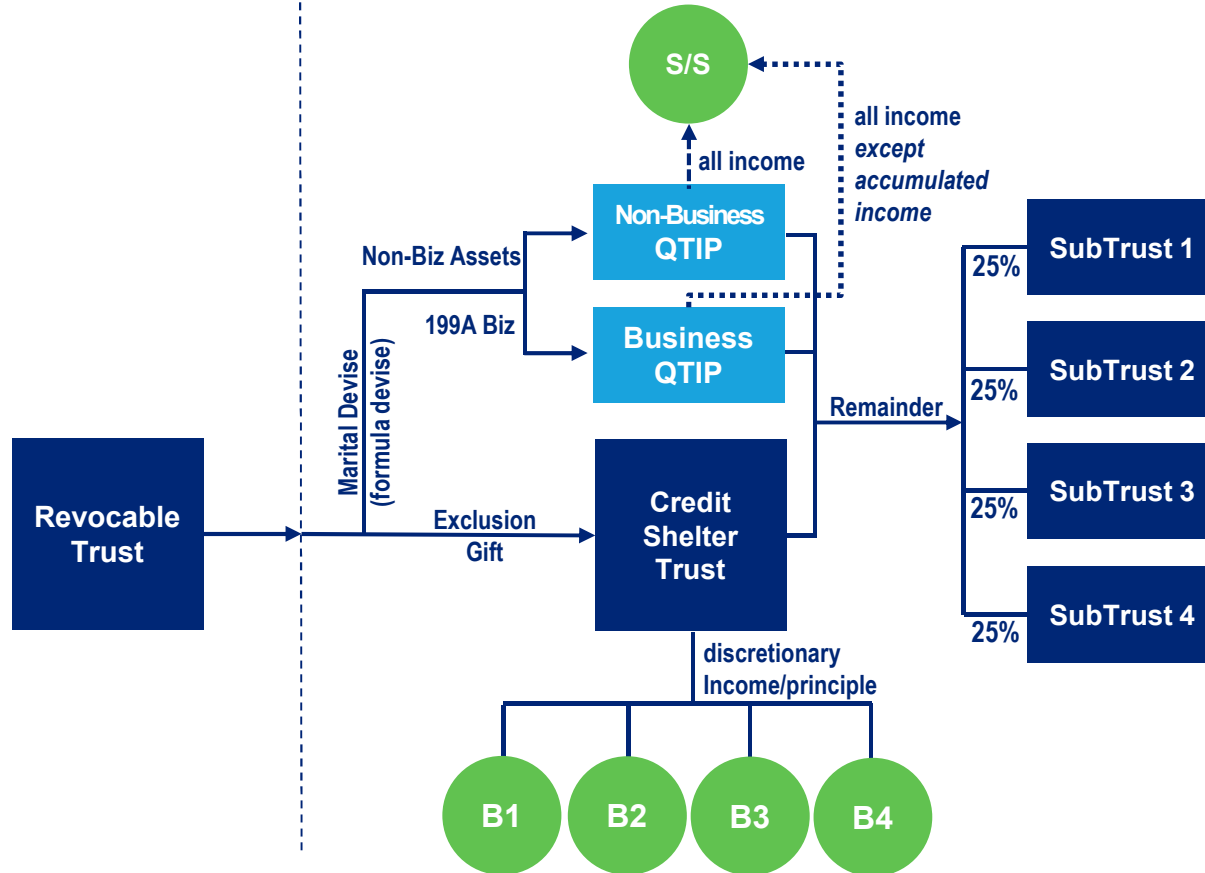
THE QTIP

- » Why?
 - Tax Deferral
 - Contractual/Statutory Spousal Obligations
- » Typical Terms
 - All Income
 - Discretionary principal
- » 199A Result
 - 2 Trusts, 5 beneficiaries
 - Where does business go?

199A Trust & Estate Planning | Trust Structures

Pre-Death

Post-Death



THE DUAL QTIP

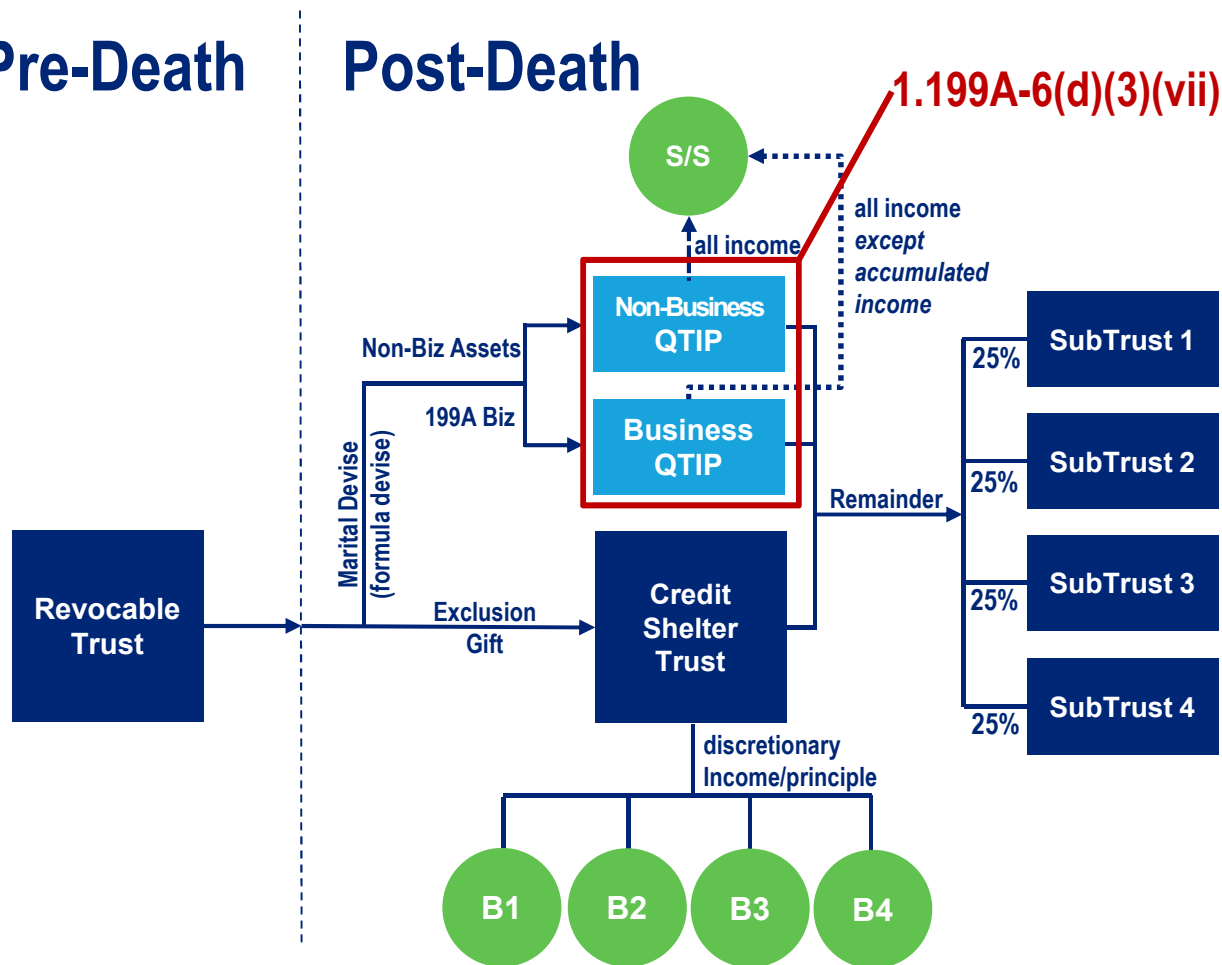
- » Why?
 - Tax Deferral
 - Accumulate income*
- » Typical Terms
 - All Income / All Income with spousal deferral power
- » Use of 6166?
- » 199A Result
 - 2 Trusts (still), 5 benes
 - Modulate income distributions *and* permit principal distributions

* See CFR 20.2056(b)-5(f)(7) (permissible to accumulate income *if* the power belongs to spouse in his/her individual capacity)

199A Trust & Estate Planning | Trust Structures

Pre-Death

Post-Death

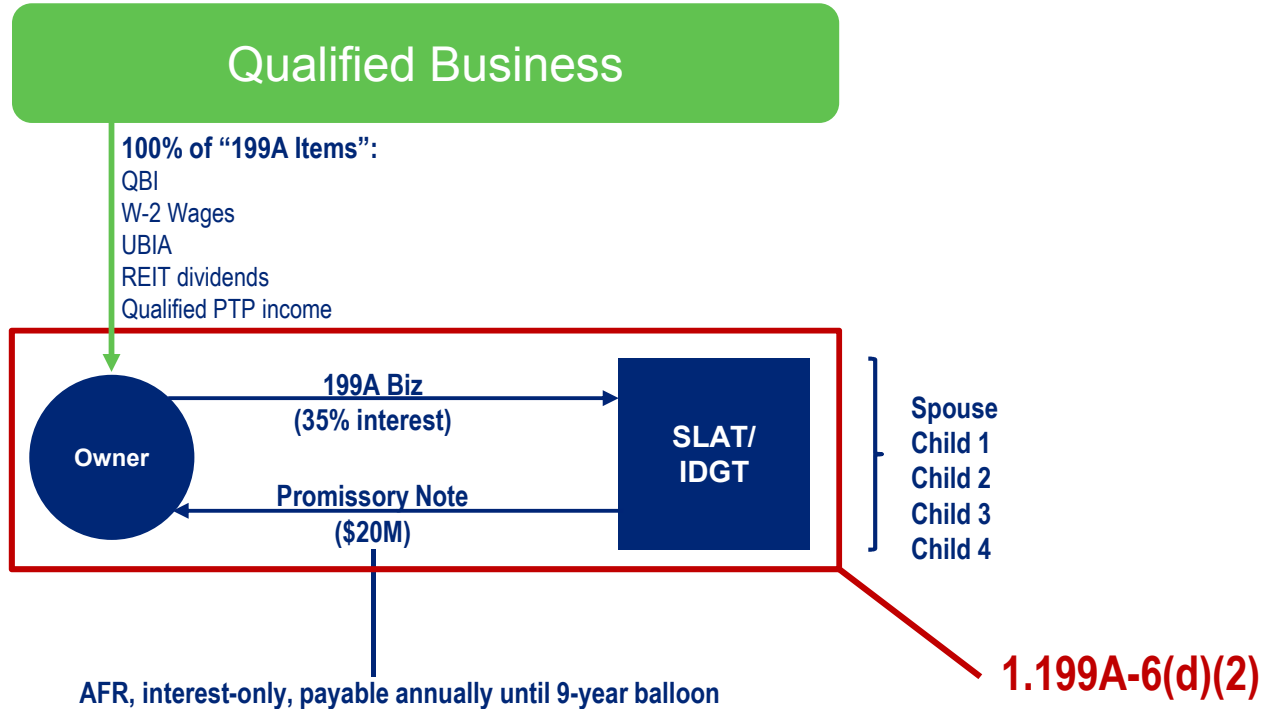


THE DUAL QTIP

- » Why?
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 - All Income / All Income with spousal deferral power
- » Use of 6166?
- » 199A Result
 - 2 Trusts (still), 5 benes
 - Modulate income distributions *and* permit principal distributions
 - Anti-Abuse Rules?
 - PLR 200209008

* See CFR 20.2056(b)-5(f)(7) (permissible to accumulate income *if* the power belongs to spouse in his/her individual capacity)

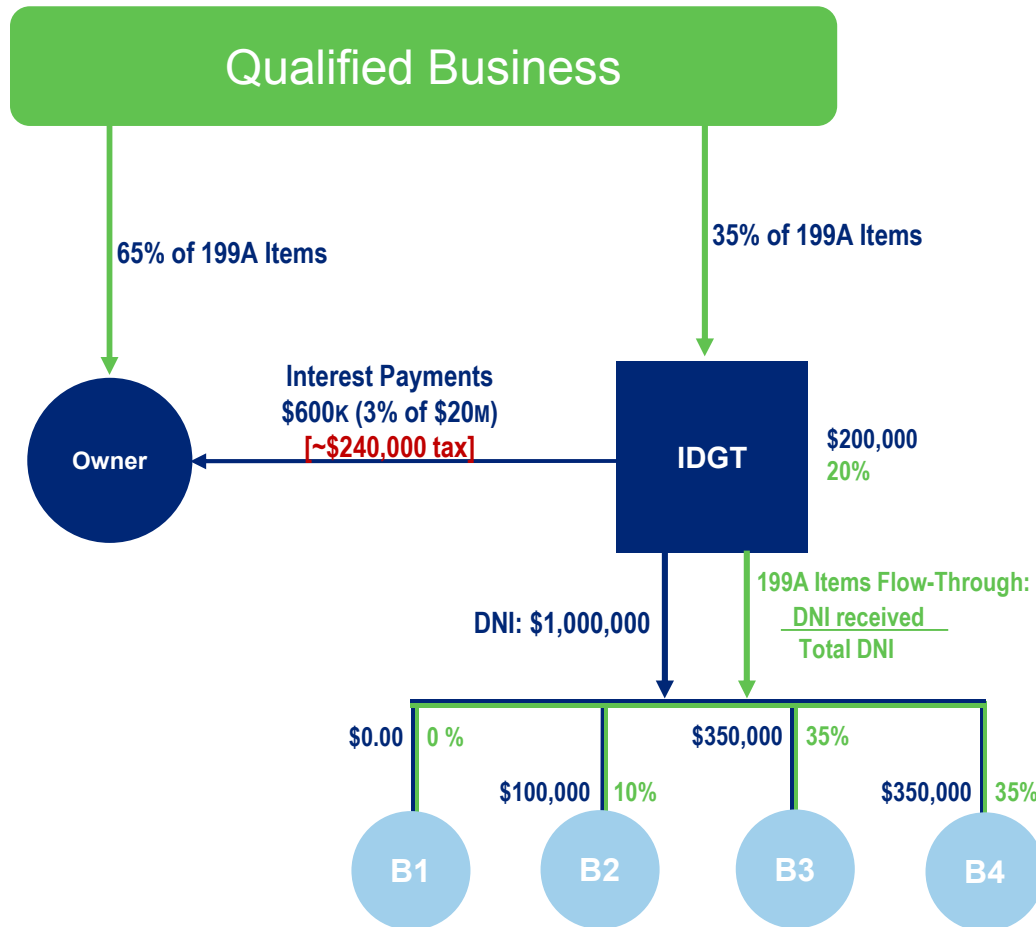
199A Trust & Estate Planning | Trust Structures



SALE TO IDGT

- » Grantor Trust Status
 - Avoids capital gains
 - Avoids recognition of income on interest
- » 199A Result
 - 1 Trust, 5 benes
 - Grantor keeps 199A deduction

199A Trust & Estate Planning | Trust Structures



SALE TO IDGT / SWITCH OFF GRANTOR TRUST STATUS

- » Grantor Trust Status Switch
 - Year 1: grantor trust
 - Year 2: turn off grantor-trust status (no more SLAT)
- » 199A Result
 - 1 Trust, 4 benes
 - Trust has 199A deduction; flow-through to beneficiaries to the extent of DNI distributions
 - Grantor recognizes income on interest payments
 - When could this make sense?
 - What if beneficiaries could aggregate and use the 199A items (e.g. W-2 wages) for other 199A QBI?
 - What if this were a gift not a sale?

Multiple Trusts Rule

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Eligibility for 199A Deductions

- Trusts and estates are entitled to deduction
- **Threshold amount of taxable income of trust or estate equals that of a single filer**
- Deduction can be taken by:
 - Grantor of grantor trust (grantor treated as directly conducting activities of the trust **with respect to portion of trust treated as owned by the grantor**);
 - Non-grantor trust or estate; or,
 - Beneficiary(ies) (non-grantor trust or estate treated as **relevant pass-through entity** (“RPE”))

QBI Calculation at Entity Level

Treasury Regulation Section 1.199A-6(d)(3)(i)

- QBI of a non-grantor trust or estate is computed by:
 - Allocating qualified items of deductions described in Section 199A(c)(3) in accordance with the classification of those deductions under Treas. Reg. Section 1.652(b)-3(a)
 - Allocating deductions not directly attributable within the meaning of Treas. Reg. Section 1.652(b)-3(b) in a manner consistent with the rules under such section
 - **Note:** Depletion and depreciation deductions under IRC Section 642(e) and amortization deductions under IRC Section 642(f) that **are properly included** in the computation of QBI of the trust or estate **notwithstanding any other provision of the Code**

Allocation Between Trust or Estate & Beneficiaries

Treasury Regulation Section 1.199A-6(d)(3)(ii)

- QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of the trust or estate (“QBI and other items”) are allocated based on distributable net income (DNI), as defined under IRC Section 643(a), for the tax year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate
- Calculation of DNI:
 - Determined **with** regard to the **separate share rule** of IRC Section 663(c)
 - Determined **without** regard to Section 199A
- If **trust or estate is treated as RPE**, then allocation made among the trust and beneficiaries on the portion of DNI received by each beneficiary

Allocation Between Trust or Estate & Beneficiaries

Treasury Regulation Section 1.199A-6(d)(3)(ii)

- If the trust or estate has no DNI for the tax year, then the QBI and other items allocated 100% to the trust or estate
 - For purposes of determining whether the trust or estate has taxable income in excess of the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under IRC Section 651 or 661
- *See comprehensive example of the allocation of DNI and calculation of the 199A deduction with respect to trusts, estates and beneficiaries under Treasury Regulation Section 1.199A-6(d)(3)(viii)*

Special Rules

Electing Small Business Trusts (“ESBT”)

- ESBT divided into three portions: S portion, grantor portion, and non-S portion
- S portion
 - 199A deduction attributed to the assets in the S portion of the ESBT
 - Must take into account the QBI and other items from any S corporation owned by the ESBT
- Grantor portion
 - Must take into account the QBI and other items from any assets treated as owned by the grantor or another person under the grantor trust rules (IRC Section 671 – 679)
- Non-S portion
 - Must take into account any QBI and other items from any other entities or assets owned by the ESBT
- In determining the taxable income of the trust (for purposes of analyzing whether the threshold amount is exceeded), the S portion and non-S portion are treated as one trust

Anti-Abuse Rule: Directly Related to Section 199A

Treasury Regulation Section 1.199A-6(d)(3)(vii)

- The IRC Section 199A threshold applies to trusts
- IRC Section 199A(h) provides that anti-abuse regulations shall be prescribed
- Anti-abuse rule provides that a trust “**formed or funded** with a **principal purpose** of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under IRC Section 199A **will not be respected as a separate trust entity for purposes of determining the threshold amount**” under IRC Section 199A
- Applies if ***even one*** trust is involved
- Effective for tax years ending after December 22, 2017

Anti-Abuse Rule: Applicable to Subchapter J

Multiple Trust Rule under IRC Section 643(f) and Treasury Regulation Section 1.643(f)-1

- Trusts **formed or funded** with a **principal purpose** of avoiding, **or of using more than one**, threshold amount for purposes of calculating the deduction under Section 199A will not be respected as a separate entity
- Trust Aggregation Rule - Aggregation of Two or More Trusts (treated as single trust) if:
 - The trusts have **substantially the same** grantor(s) and primary beneficiary(ies); **AND**
 - **A principal purpose** of **establishing** the trusts or **contributing** additional cash or other property to the trusts is the avoidance of Federal income tax
 - **NOTE: Spouses treated as one person**
- IRC section 643(f) – Effective with respect to
 - trusts created after March 1, 1984
 - trusts created before March 1, 1984, but only with respect to that portion attributable to contributions of principal after March 1, 1984
- New Regulations effective for tax years ending after August 16, 2018

Multiple Trusts Treated as One Trust

Resulting Ambiguity

- Ambiguity with respect to definition of: “primary beneficiary”; “principal purpose”; and “arrangement involving multiple trusts”
- Ambiguity of when “grantors” and “beneficiaries” will be “substantially” the same
- Impact of the separate share rule
- Impact on arrangements involving multiple trusts entered into before March 1, 1984
- Impact on arrangements involving multiple trusts entered into or **modified** after March 1, 1984
- Impact on arrangements involving multiple trusts entered into or **modified** between March 1, 1984 and August 16, 2018
- Impact on grantor trusts that become non-grantor trusts on or after August 16, 2018
- When will a modification trigger the multiple trust rule?
- What would be deemed an additional contribution?

Multiple Trusts Treated as One Trust

Current Guidance

- **Note:** IRS will not rule on whether two or more trusts shall be treated as one trust for purposes of Subchapter J. [See Rev. Proc. 2019-3](#)
- Determination of whether an arrangement involving multiple trusts is subject to treatment under IRC section 643(f) may be made on the basis of:
 - IRC section 643(f) and interpretive law
 - Legislative history of IRC Section 643(f) – notably, the [committee reports](#) to the Tax Deficit Reduction Act of 1984
- Look to grantor’s motives in creating the trusts and trust provisions
- Presences of nominal beneficiaries or different contingent beneficiaries will not prevent rule from applying

Examples of Whether Multiple Trust Rule Applies

Committee reports to the Tax Deficit Reduction Act of 1984

- *Example 1:*

- Grantor (G) has two brothers and two sisters. G creates four trusts, each providing the trustee with discretion to distribute current or accumulated income to any one or more of the trust beneficiaries. Each trust has three beneficiaries — three of the G's four siblings. Each sibling is a beneficiary of three of the four trusts. If the grantor established the four trusts for the principal purpose of avoiding the federal income tax, the four trusts will be treated as one for federal income tax purposes.

- *Example 2:*

- Grantor (G) has two children, a son (S) and a daughter (D). G creates one trust, with all income payable currently to S and with the remainder payable to D upon S's death. G creates a second trust, with discretionary income and principal for S's medical expenses and discretionary income for D's education, support and maintenance, and with the remainder payable to D upon S's death. These trusts should be treated as separate trusts for federal income tax purposes and not aggregated into one even though the trusts have the same remainder beneficiary.

Factors in Creating Multiple Trusts

- Tax reasons and non-tax reasons for the creation of new trust or additional contribution to existing trust
 - Estate, gift, GST and income tax, etc.
 - Creditor protection
 - Litigation exposure given rights of current and remainder beneficiaries
- Benefits of arrangement (not limited to income tax savings) vs. administrative costs and professional fees