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Trusts Holding Partnership Assets: DNI and FAI Calculations, Fiduciary and Reporting

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Trusts Holding Partnership Assets: DNI and FAI Calculations, Fiduciary and Reporting

Fiduciary Accounting Income Calculations For
Trust Income From Partnerships

DNI/Tax Calculations of Trust Income From Partnership Holdings

Presented By Paul Jones

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Fiduciary Accounting Income

- All trusts generally contain provisions dealing with the distribution of income and principal (or corpus).
  - *Example*: The Trustee shall distribute as much or all of the income to Sonny-Boy as the Trustee considers desirable to provide for Sonny-Boy's support, health and education, and shall periodically add all undistributed income to principal. Upon Sonny-Boy's death, the Trustee shall distribute all accrued and undistributed income and all principal then comprising the trust to Debra Daughter.

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Fiduciary Accounting Income

- The trustee must determine:
  - whether specific receipts of the trust are income and, thus, available for distribution to Sonny-Boy, or principal and, thus, held for ultimate distribution to Debra Daughter.
  - whether specific expenses are charged against income or principal.
- The classification of receipts and expenditures as income or principal has a direct impact on determining the income distributable to the income beneficiary and the amount of the principal available for present or future distribution. Thus, ignoring tax consequences, these decisions are vitally important to Sonny-Boy and Debra Daughter.

Fiduciary Accounting Income

Fiduciary accounting income (FAI) is defined under §643(b) as:

- The amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocated to principal under the terms of the governing instrument and applicable local law shall not be considered income.
- In 2004, the IRS amended the Reg. §1.643(b)-1 definition of FAI to provide that amounts allocated between income and principal pursuant to applicable local law will be respected if the local law provides for a reasonable apportionment of the year's total return, including ordinary and tax-exempt income, capital gains, and appreciation, between the income and remainder beneficiaries

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Form 1041

	Schedule B	Income Distribution Deduction		
1	Adjusted total income. See instructions		1	
2	Adjusted tax-exempt interest		2	
3	Total net gain from Schedule D (Form 1041), line 19, column (1). See instructions		3	
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)		4	
5	Capital gains for the tax year included on Schedule A, line 1. See instructions		5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number		6	
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-		7	
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8		
9	Income required to be distributed currently		9	
10	Other amounts paid, credited, or otherwise required to be distributed		10	
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions		11	
12	Enter the amount of tax-exempt income included on line 11		12	
13	Tentative income distribution deduction. Subtract line 12 from line 11		13	
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-		14	
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18		15	

Fiduciary Accounting Income

There is no universal body of law or generally accepted accounting principles to determine trust accounting income. Instead, the fiduciary must look to state law and to the governing instrument. All states have enacted statutes that provide rules for determining fiduciary accounting principal and income and these rules will apply in all situations where the governing instrument is silent.

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Fiduciary Accounting Income

- Uniform Principal and Income Act (2000)
  - Adopted in 46 states and D.C.
- Uniform Principal and Income Amendments (2008)
  - Adopted in 36 states and D.C.
- Uniform Fiduciary Income and Principal (2018)
  - No states adopted (approved in July 2018)
- See: http://www.uniformlaws.org

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Fiduciary Accounting Income

"Principal" is generally used in state statutes defining principal and income. "Corpus" is generally used in the Internal Revenue Code. But in some documents, corpus is defined as principal plus accumulated income.

Principal is the "property held in trust for distribution to a remainder beneficiary when the trust terminates." See UPIA §102(10).

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Fiduciary Accounting Income

"Income" means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset…

See UPIA §102(4)

UPIA general allocation rules

Traditional trust accounting income includes interest, dividends, and rents. See UPIA §3(a) (Unif. Law Comm'n 1997)

Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions.

See UPIA § 401.

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UPIA general allocation rules

- A trustee generally allocates to income money received from an partnership. See UPIA §401(b)
- A trustee allocates the following receipts from an partnership to principal (See UPIA §401(c)):
  - (1) property other than money;
  - (2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
  - (3) money received in total or partial* liquidation of the entity; and
  - (4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

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UPIA Full/Partial Liquidations

Distributions from partnerships that either

(i) at or near the time of a distribution, the partnership indicates that it is a distribution in partial liquidation or

(ii) exceed 20% of the partnership's gross assets

will be <u>principal</u> whether or not intended by the entity to be a partial liquidation.

See UPIA §401(d)

Specific Rules: Receipts

Specific rules apply for characterizing the following receipts:

- distributions from trusts or estates (UPIA §402)
- business activities conducted by the trustee (UPIA §403)
- rental property (UPIA §405)
- obligations to pay money (UPIA §406)
- insurance policies (UPIA§407)
- deferred compensation arrangements (UPIA §409)
- liquidating assets (UPIA §410)
- certain natural resources (UPIA §411)
- timber (UPIA §412)
- derivatives and options (UPIA §414), and
- asset-backed securities (UPIA §415)

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UPIA General Disbursement Rules

The trustee generally makes the following disbursements from <u>income</u>:

(1) one-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee;

(2) one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;

(3) all of the other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest; and

(4) recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.

UPIA §501

UPIA General Disbursement Rules

The trustee generally makes the following disbursements from principal:

(1) the remaining one-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, and one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;

(2) all of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale;

(3) payments on the principal of a trust debt;

(4) expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property;

(5) premiums paid on certain policies of insurance of which the trust is the owner and beneficiary;

(6) estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and

(7) disbursements related to certain environmental matters.

UPIA §502(a), (b), & (c)

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Specific Rules: Disbursements

Specific rules apply for characterizing the following disbursements:

- Depreciation (UPIA §503)
- Reimbursements to Principal (UPIA § 504)

UPIA: Taxes

A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.

A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid:

(1) from income to the extent that receipts from the entity are allocated only to income;

(2) from principal to the extent that receipts from the entity are allocated only to principal;

(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and

(4) from principal to the extent that the tax exceeds the total receipts from the entity.

After applying the above, the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.

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UPIA: Taxes

A Trustee may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

UPIA §506(a)

UPIA: Taxes

If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

UPIA: Taxes

Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on $1 million of taxable income is $350,000. Under UPIA §505(c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income.

Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

UPIA: Taxes

Example (2) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on $1 million of taxable income is $350,000. Under UPIA §505(c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Background For DNI Discussion

- Determinations to be made:
  - Grantor or Nongrantor?
    - Grantor – Disregarded Entity
    - Nongrantor – File Form 1041
  - Nongrantor – Simple or Complex?
      - Classification made year-by-year
    - A trust is a simple trust for a tax year if it satisfies three statutory requirements. A trust that does not qualify as a simple trust is a complex trust.
      - the terms of the trust must require that all of its FAI be distributed currently;
      - the terms of the trust must not provide for any amounts to be paid, permanently set aside, or used for the tax year for the charitable purposes specified in §642(c); and
      - the trust must not actually distribute any amounts during the year other than its FAI required to be distributed currently.

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Distributable Net Income (DNI)

DNI is central to the scheme of taxation for trusts (and estates) and their beneficiaries. DNI is a tax concept that (1) measures the greatest amount that may be deducted by an estate or trust because of distributions to beneficiaries and that may be reported by such beneficiaries as income, and (2) characterizes the income distributed for purposes of computing the distribution deduction and determining the items taxable to the beneficiaries. It is modified taxable income and often approximates gross accounting income less tax deductions.

For many domestic trusts (and estates), the DNI will be equal to the following:

(1) the taxable income determined without the distribution deduction or the personal exemption;

(2) less the net capital gains; and

(3) plus tax-exempt income reduced by expenses (and any charitable deduction) allocated to such income.

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Distributable Net Income (DNI)

DNI and FAI most often are not the same in a given year because the rules for determining FAI and DNI are different and such rules are different because their functions are different.

FAI is concerned with equitable concepts of determining the amount of income and principal between income beneficiaries and remaindermen.

DNI is concerned with determining the appropriate amount of tax to be borne by the trust or estate and its beneficiaries.

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Distributable Net Income (DNI)

- For income tax purposes, DNI “flows out” to the beneficiary (and beneficiary, rather than the trust, pays tax on that net income)
- If distributions to beneficiary(ies) are more than DNI, beneficiary pays tax on all DNI
- If distributions to beneficiary(ies) are less than DNI, the beneficiary will pay tax on part of DNI and trust/estate will pay tax on part of DNI

Distributable Net Income (DNI)

The most common difference between DNI and FAI results from the fact that trustee’s fees under most state laws are chargeable one-half to income and one-half to principal, but are generally deductible in full for federal income tax purposes to the extent they are not associated with tax-exempt interest. Therefore, to the extent trustee's fees are deducted, but charged to principal, DNI normally will be less than FAI.

Similarly, to the extent items of income are taxable, but allocated to principal and not included in FAI, these items could make DNI larger than FAI in these situations. Therefore, both FAI and DNI must be calculated separately under applicable rules.

These results are then used in IRC §651 and §652 or §661 and §662.

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Distributable Net Income (DNI)

To compute DNI, an initial determination of "tentative taxable income" (TTI) is made. TTI is the net taxable income of an estate or trust computed before the distribution deduction considered. After this initial computation is made, the various modifications required by §643 are applied to compute DNI.

Certain deductions that are allowed in computing taxable income, such as the personal exemption, are not taken into account in computing DNI. In addition, certain items of gross income that are taken into account in computing taxable income are not taken into account when computing DNI (such as certain capital gains), and certain items that are excluded from gross income, and thus from taxable income, are included in DNI (such as tax-exempt interest). DNI is computed on an annual basis for each tax year of an estate or trust (or separate share).

Distributable Net Income (DNI)

Section 643 defines DNI to mean taxable income computed with certain modifications. These are the modifications:

(1) No distribution deduction is taken.

(2) No personal exemption is taken.

(3) Capital gains are not included, unless allocated to FAI or paid, credited, or required to be distributed to a beneficiary or paid or set aside for charitable purposes.

(4) Capital losses are not taken into account, except to the extent they reduce the amount of capital gains actually paid or credited to beneficiaries.

(5) The exclusion under §1202 is not taken into account.

(6) For simple trusts, which by definition do not distribute any amounts other than FAI, extraordinary dividends or taxable stock dividends are not included, unless allocated to FAI.

(7) Tax-exempt interest is included, net of disallowed deductions attributable to such interest.

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Tax Reform Act Changes: Taxable Income

- Change to Deduction Rules
  - No miscellaneous itemized deductions
  - $10,000 cap on all state and local income and property taxes except:
    - foreign taxes claimed in lieu of foreign tax credit
    - personal property and real property taxes incurred in a trade or business
    - personal property and real property taxes incurred for activity described in Code§212
  - 20% Deduction for Business Income of Pass-Through Entity

Reconciling Partnership Complications

Distributions of cash from the partnership, rather than the items of income passed-through on Schedule K-1, are used to determine FAI. See UPIA §401(b). As we have discussed, not all cash distributed from a partnership is allocated to income. For example, provides that money received in exchange for part or all of a trust's interest in the entity, and money received in total or partial liquidation are allocated to principal.

Partnerships frequently will distribute cash to the partners for estimated income tax payments on their distributive shares of the partnership's income. If these are included in income, they should be distributed to the beneficiaries under the UPIA, leaving the trust with no cash to pay its tax. If the trustee determines that the distribution was solely made to pay taxes, then is an appropriate time to allocate it to principal.

Cash distributions other than those made for the sale or liquidation of a partnership interest or for taxes should be used to calculate FAI. Distributions to the beneficiaries will carry out some of the trust's income and make it taxable to the beneficiaries. Any remaining items of taxable income, including allocated Schedule K-1 items, are taxable to the trust.

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DNI: Share of Partnership Income

Separate Share Rule: If one trust is created for several beneficiaries, the trust document may subdivide the trust into separate shares, one for each beneficiary. If separate shares are created, DNI is subdivided per share, so that the amount of gross income resulting from distributions to a beneficiary of a share is determined by the DNI allocated to such shares.

If there is gross income included in DNI that is not received in cash, like a share of partnership income, such gross income is to be allocated among the separate shares in the same proportion as FAI from the same source would be allocated.

Section 199A – Trusts and Estates

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Agenda

- Overview
- Deduction
- Qualified Business Income (QBI)
- Qualified Property
- Taxable Income Limitations
- Non-Grantor Trusts and Estates
- Anti-Abuse Rules
- Grantor Trusts
- Charitable Remainder Trusts (CRT)
- Electing Small Business Trusts (ESBT)

Section 199A QBI Deduction - Overview

- Generally, 20% of net “qualified business income” subject to several limitations
- Deduction on passthrough income available to estates and trusts
- To compute deduction, W-2 wages and unadjusted basis of qualified property must be allocated between fiduciary and beneficiaries

Section 199A – The Deduction

- For tax years beginning after December 31, 2017 and before January 1, 2026, taxpayers who have domestic QBI from RPE, or sole proprietorship are entitled to a deduction equal to:

  - (1) the lesser of the combined qualified business income amount of the taxpayer or 20% of taxable income (reduced by net capital gain),

  - plus (2) the lesser of 20% of qualified cooperative dividends or taxable income (reduced by net capital gain).

- QBI is defined as the net amount of income, gains, deduction and loss with respect to a qualified trade or business within the U.S.

Section 199A – Qualified Business Income

- QBI does not include investment income (e.g., capital gains or losses, dividends and interest)
- QBI does not include reasonable compensation paid to S corporation shareholders or guaranteed payments paid to partners
- The overall limitation for the deduction is that the deduction cannot exceed 20% of the excess of taxable income over net capital gain
- If QBI is less than zero, it is treated as a loss from a qualified business in the following year

Section 199A – §199A Deduction Limit

- Deduction is limited to the greater of:
  - 50% of W-2 wages (includes bonuses, elective deferrals and deferred compensation), or
  - 25% of W-2 wages plus 2.5% of “qualified property”

Section 199A – §199A Deduction Limit

- W-2 wage does not include amount that are not property allocated to QBI
- W-2 wages are allocated to shareholders and partners in the same proportion as the original deduction for such wages

Section 199A – Qualified Property

- Qualified property – the unadjusted basis of tangible property subject to depreciation immediately after acquisition.
- The property must be held by and available for use in the qualified trade or business at the close of the year
- The property is included in the calculation each year until its depreciation period has ended
- A special 10 year minimum depreciation period is deemed to exist solely for this purpose even if the MACRS period ends earlier than 10 years

Section 199A – Qualified Property

- What is the basis of property acquired from a decedent for purposes of this calculation.
  - The definition of UBIA in Prop. Reg. §199A-2(c)(3) is the basis on the date placed in service.
  - Will the UBIA of property acquired from a decedent be the date placed in service by the decedent or will it be determined under §1014?

Section 199A – Qualified Property

- UBIA does reflect any adjustments to basis made under §734(b) and §743.

Section 199A – Taxable Income Limitations

- Not all taxpayers are subject to the wage limitations and the SSTB limitation
- Taxpayers with taxable income below $157,500 ($315,000/MFJ) are not subject to the wage and SSTB limitations. They get the full 20% deduction.
- Once taxable income exceeds the $157,500 ($315,000/MFJ) threshold, the exemption from the wage and SSTB limitations phases out.
- The wage and SSTB limitations apply once the taxpayer's taxable income exceeds $207,500 ($415,000/MFJ)

Section 199A – Taxable Income Limitations

- The §199A deduction reduces taxable income
- It does not reduce adjusted gross income
- The §199A deduction is available whether or not the taxpayer itemizes deductions
- Trusts and estates are eligible for the §199A deduction

Section 199A QBI Deduction – Non-Grantor Trusts and Estates

- If trust or estate accumulates income, the trust or estate is taxed on the retained income

- If trust or estate makes distributions to beneficiaries, the trust will get a distribution deduction (limited to distributable net income, or DNI) and the beneficiary will report the amount distributed (limited to DNI)

Section 199A QBI Deduction – Non-Grantor Trusts and Estates

- QBI, W-2 wages and UBIA of qualified property, qualified REIT dividends and PTP income allocated between entity and beneficiary based on entity and beneficiary's share of DNI. Prop. Reg. §1.199A-5(e)(2)(i); Prop. Reg. 1.199A-6(d).

- DNI, for Section 199A purposes, is calculated without Section 199A deduction.

- Threshold amount is determined before taking distribution deduction into account.

- Prop. Reg. has a complicated 2 page detailed example calculating the deduction for a trust.

Section 199A QBI Deduction – Non-Grantor Trusts and Estates - Example

- Complex trust has allocable share of partnership income of $210,000 (QBI) and interest income of $40,000. Thus, the DNI of the trust is $250,000.

- The allocable share of W-2 wages from the partnership is $80,000 and the trust's allocable share of the UBIA of the partnership is $200,000.

- The trust distributes $100,000 (40% of its DNI) to the beneficiaries. Thus, $84,000 (40% of the $210,000 of QBI) of the partnership income, $32,000 (40% of $80,000 W-2 wages) of W-2 wages and $80,000 (40% of $200,000 UBIA) of UBIA is allocated to the beneficiaries. Assume the trust has no deductions other than the distribution deduction.

Section 199A QBI Deduction – Non-Grantor Trusts and Estates - Example

- The remaining 60% of each item (QBI of $126,000, $48,000 of W-2 wages and $120,000 of UBIA) is retained by the trust.

Allocation of Items Between Beneficiary and Trust

	Total	Bene's Share – 40%	Trust's Share – 60%
QBI	$210,000	$84,000	$126,000
W-2	$80,000	$32,000	$48,000
UBIA	$200,000	$80,000	$120,000

Section 199A QBI Deduction – Non-Grantor Trusts and Estates - Example

- The QBI deduction is equal to the *lesser* of:
  - **First part of the test**: 20% of QBI
  - **Second part of the test**: *Greater* of: (1) 50% of W-2 wages for the trade or business or (2) 25% of W-2 wages for the trade or business + 2.5% of UBIA of qualified property for the trade or business

Section 199A QBI Deduction – Non-Grantor Trusts and Estates - Example

- **First part of the test:** The trust's §199A deduction, subject to the wage-basis limitation computed below, is **$25,200** (20% of the $126,000 QBI retained by the trust.

- Since the taxable income threshold ($157,500) is taken into consideration before the income distribution deduction, the trust's QBI is subject to the wage-basis limitation

Section 199A QBI Deduction – Non-Grantor Trusts and Estates - Example

- **Second part of the test:** The amount determined under the wage-basis limitation is the greater of:
  - 50% of allocable W-2 wages (50% x $48,000, or $24,000), or
  - 25% of allocable W-2 wages + 2.5% of allocable UBIA of qualified property (25% x $48,000, or $12,000) + 2.5% x $120,000, or $3,000) for a total of $15,000.
  - The greater of $24,000 or $15,000 under this portion of the calculation is **$24,000**.

Section 199A QBI Deduction – Non-Grantor Trusts and Estates - Example

- The QBI deduction **$24,000** which is the lesser of:
  - First part of the test: $25,200
  - Second part of the test: $24,000

Section 199A QBI Deduction – Anti-Abuse Rules

- Proposed regulations adopt an anti-abuse rule for trusts with respect to Section 199A

- "Trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A. See also §1.643(f)-1 of the regulations." Prop. Reg. 1.199A-6(d)(3)(v).

- Designed to prevent taxpayers from forming multiple trusts with taxable income below the threshold amount

Section 199A QBI Deduction – Anti-Abuse Rules

- Two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and if a principal purpose of establishing such trusts is the avoidance of Federal income tax.

- The anti-abuse rules in the §199A Prop. Regs. applies to taxable years after December 22, 2017.

Section 199A QBI Deduction – Grantor Trusts

- Grantor (or deemed owner under §678) computes the Section 199A deduction as if the person directly conducted the activities of the trust as to the portion owned by the grantor or deemed owner.

- Thus, the grantor or deemed owner would include all attributable items directly in the grantor or deemed owner's return in determining his or her QBI, W-2 wages, UBIA limitation, etc.

- Apparently, the anti-abuse rules do not apply to grantor trusts

Section 199A QBI Deduction - CRTs

- CRT is required to pay a 100% excise on unrelated business taxable income (UBTI)
  - UBTI is gross income from an unrelated trade or business regularly carried on, reduced by deductions allowed by Chapter 1 of the IRC directly connected with carrying on that trade or business. See Reg. 1.512(a)-1(a).
  - "Directly connected" means the expense "must have a proximate and primary relationship" to that particular business.
- Can the Section 199A deduction reduce the UBTI of a CRT?
  - The Section 199A deduction is found in Chapter 1 of the IRC
  - Issue: does the 199A deduction satisfy the requirement that it has a "proximate and primary relationship" to that particular business?

Section 199A QBI Deduction - ESBT

- Is an ESBT entitled to reduce its S corporation taxable income by the Section 199A deduction?

- Could reduce ESBT tax rate from 37% to 29.6% (37% less [37% x 20%] or put more simply 80% of 37%)

- Section 641(c)(2) lists the deductions available to ESBTs and that list does not include the Section 199A deduction
  - Section 641(c)(2)(C) specifically states, "No deduction or credit shall be allowed for any amount not described in this paragraph, …"
  - However, one of the few items allowed under Section 641(c)(2)(C) include "[t]he items required to be taken into account under Section 1366." Section 1366 describes the pass-through of items to S corporation shareholders which seems to include the Section 199A deduction.

Section 199A QBI Deduction - ESBT

- Despite the ambiguity in the statute regarding the availability of the Section 199A deduction for ESBT, the proposed regulations provide that ESBTs are entitled to the Section 199A deduction. Prop. Reg. 1.199A-6(d)(3)(iv).

- The Prop. Regs. provide rules for how the S portion, the non-S portion and the grantor portion of the ESBT take into account the QBI and other items into account.

- The regulations do not, however, clarify whether S portion and the non-S portion of the trust each are entitled to a $157,500 threshold.
  - This would be an issue where the trust owns an interest in a S corporation with a business and also owns other businesses in partnership

Thank You!

S CORPORATION ISSUES AND ENTITY PLANNING OPPORTUNITIES

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S Corporation Issues – Big Picture

- Is trust a valid S corporation shareholder?
- Look into the basis of S corporation's shares and assets
- Look into the tax and book accounting for the trust

Valid S Corporation Shareholders

- Ineligible shareholder can instantly terminate S corporation election
  - Relief may be available, but may also be expensive
- Who is an eligible S corporation shareholder?
  - No more 100 shareholders
  - Individuals other than nonresident aliens
    - Attribution among family members to treat as 1 shareholder
  - An estate
  - A trust described in IRC 1361(c)(2) – generally look through to treat individual as deemed owner of stock
  - Another S corporation who holds 100% of the stock of a qualified subchapter S subsidiary
    - Cannot have preferred/common stock in S corporation, but make sure 100% applies to both voting and nonvoting shares if multiple classes are created by voting right

Trusts as S Corporation Shareholders

- Grantor trusts under Subchapter J where all assets are treated as owned by an individual
  - Grantor is owner – no restriction
  - One beneficiary as owner – must be a qualified subchapter S trust (QSST)
- Electing small business trust (ESBT)
- Trusts in transition after death of individual owner of stock – 2 year limited eligibility
  - Grantor trust where deemed owner has died
  - Testamentary or pourover trust to which stock is transferred by will
  - At end of 2 years, must become grantor trust, QSST, or ESBT
- Voting trust

Qualified Subchapter S Trust (QSST)

- Authorized by IRC 1361(d)
- Generally, must have one individual beneficiary who is a U.S. citizen or resident and who receives all accounting income of trust annually
  - Known as the "current income beneficiary"
- Status granted by election if trust is an eligible QSST
  - Election must be signed by current income beneficiary
  - If made simultaneously with corporation's S election, use Form 2553, Part III
  - One election needed for each S corporation
  - If election made for existing S corporation, must use freeform election containing information from Part III of Form 2553

Qualified Subchapter S Trust (QSST)

- Other requirements:
  - Corpus can only be distributed to current income beneficiary during current income beneficiary's life, whether during term of trust or at trust's termination
  - Current income beneficiary's income interest must end at earlier of:
    - Death of current income beneficiary; or
    - Termination of trust.
  - All "income" distributed to current income beneficiary
    - How is "income" defined?

Qualified Subchapter S Trust (QSST)

- Two types of trust income:
  - Accounting income determined under trust instrument and/or state law (often revised uniform principal and income act) which is not allocated to principal
  - Taxable income determined under Code
- Problem with QSST is that taxable income is different from accounting income
  - Taxable income includes pass-through share of S corporation income
  - Accounting income generally only includes “money” received from entity which is not allocable to principal (see UPIA section 401)

Qualified Subchapter S Trust (QSST)

- Income distributions to current income beneficiary
  - Determined on year-by-year basis (trust must use calendar year)
  - All income must be distributed no later than 65 days after close of taxable year
  - Husband and wife treated as current income beneficiary if they file jointly, but must both sign QSST election
  - Under regs, “income” limited to distributions from the S corporation to the trust, and not trust’s distributive share of S corporation income
  - Identification of current income beneficiary, and income, depend on terms of trust instrument and applicable local law

Qualified Subchapter S Trust (QSST)

- Special rules on income distributions
  - Trust is treated as grantor trust with respect to current income beneficiary
    - As a result, beneficiary is taxed on all taxable income of QSST, whether or not actually distributed
    - Same result as if current income beneficiary were individual shareholder – shareholder is taxed on distributive share
  - Cash may not follow phantom income
    - Should tax distributions be required?
    - Trustee and directors/officers of S corporation may be different – could there be conflicts on S corporation distributions?
  - Regs may allow allocation of distributions from S corporation to principal if permitted under local law and trust instrument
    - Current income beneficiary would still be taxed on amount allocated to principal
    - Principal would still have to be exclusively distributed to current income beneficiary during term of QSST

Qualified Subchapter S Trust (QSST)

- Special eligibility concerns
  - Separate share treatment
    - Allocate S corp stock to QSST share and non-S corp assets to non-QSST share
    - Each share should have separate EIN if shares will have different distribution standards
  - If grantor (instead of beneficiary) treated as owner of stock under grantor trust rules, then no QSST election allowed, but trust still qualifies if it is 100% grantor trust
    - Inter vivos QTIP
    - Trust discharging grantor's legal obligation to support current income beneficiary
  - Powers of appointment – testamentary OK, lifetime not OK if anybody other than current income beneficiary is permissible appointee
    - Lifetime general power of appointment which is a valid 678(a) power over 100% of trust makes it a grantor trust with respect to current income beneficiary

Qualified Subchapter S Trust (QSST)

- Termination of election – occurs when:
  - Any additional beneficiary gains right to receive current income or corpus of QSST
    - Termination is instantaneous
  - QSST fails to distribute all income annually
    - Termination effective first day of following taxable year if 65-day election not made
  - Late election – due within 16 days and 2 months of first transfer of S corporation stock to QSST
    - Note – trust that is grantor trust with respect to any individual must make election within this time period if grantor trust status ends
- If termination occurs or election is late, relief may be granted under IRC 1362(f) and Treas. Reg. 301.9100-1 through -3
- At death of current income beneficiary, make sure remainder interest beneficiary is also current income beneficiary

Electing Small Business Trust (ESBT)

- Permitted beneficiaries:
  - Individuals
  - Estate
  - Charities (other than governmental organizations)
  - Governmental organizations, only as contingent remainder beneficiary
  - Generally excludes potential current beneficiaries who would not be eligible S corporation shareholders
- No beneficiary’s interest in trust can be acquired by purchase
- Election required
- Tax-exempt trusts, including CRAT or CRUT, are expressly disqualified

Electing Small Business Trust (ESBT)

- Election
  - Same deadline as QSST (16 days and 2 months after deemed transfer of S corporation stock)
  - Only one election required per trust, even for multiple S corps
    - But, if s corps file in different service centers, must file one election for each service center
  - Signed by trustee
  - Consists of election statement – same info as QSST election, plus
    - Name, address, and TIN of all "potential current beneficiaries"
    - Name, address, and TIN of all S corporations in which ESBT holds stock

Electing Small Business Trust (ESBT)

- Taxation of ESBT
  - Governed by IRC 641(c) (do not look in Subchapter S and regs for taxation guidelines)
  - S corporation portion of trust is taxed as follows:
    - Distributive share of S corporation income taxed at highest trust tax rate (currently 37%), except for capital gains/qualified dividends (which are subject to highest applicable capital gains rates
    - No exemption amount for AMT
    - No loss deduction allowed except for losses from sale of S corporation stock
      - Capital loss cannot exceed net capital gains
    - No charitable deduction

Electing Small Business Trust (ESBT)

- Potential current beneficiaries
  - Treated as shareholders of S corporation for purposes of qualification
  - S corporation qualification
    - All potential current beneficiaries count towards 100 shareholder limitation
  - Includes any beneficiary who can receive distributions of income or principal during tax year
  - Does not include beneficiaries with future interests but no present right during tax year to receive income or principal
  - Includes grantor of trust
    - Contrast with QSST rules – grantor trust can make ESBT election but not QSST election

Electing Small Business Trust (ESBT)

- Potential current beneficiaries - special issues
  - Distributee trusts – only count when first funded
    - Must independently qualify as S corporation shareholder when funded
  - Powers of appointment
    - Only includes permissible appointees of power of appointment (general or nongeneral) when exercised
    - Does not include fiduciary powers of appointment
  - Disregards persons meeting definition of "potential current beneficiary" during 1-year period preceding disposition of all S corporation stock

Electing Small Business Trust (ESBT)

- Termination
  - When trust ceases to qualify as ESBT
  - When any potential current beneficiary is added who is an ineligible S corporation shareholder
  - When ESBT disposes of all S corporation stock
  - Special rules for disposition of S corporation stock in exchange for installment obligation:
    - Election ends at earlier of:
      - Receipt of last installment; OR
      - Disposition of installment obligation

S Corporations and Trusts – Special Concerns

- Grantor trust planning – including beneficiaries
- ESBT election may be more attractive with 199A deduction
  - However, beware potential current beneficiary effect on 100 shareholder requirement
- QSST may be a less palatable option for problem beneficiaries
  - Guaranteeing an income stream creates creditor protection and divorce protection issues, depending on applicable law
- Late election planning – may provide relief
- Decanting/modification – beware effect on trust's election

Entity Planning Opportunities

- General goals for non-taxable estates
  - Maximize step-up in basis
  - Shift outside basis step-up to assets inside entity
  - Force inclusion of contributed assets in donor's estate
- General goals for taxable estates
  - Maximize discounts/freeze value of retained interest
  - Gifting opportunities - use annual exclusions
  - Shift income to other family members, especially in lower brackets
- Non-tax goals
  - Limited liability protection
  - Centralized management of assets

Entity Planning Opportunities

- Partnerships (LLC's as well)
  - Husband and wife
    - Elect out of subchapter K (not for LLC)
    - Community property treatment
  - Donor
    - Can retained control bring assets back into estate for step-up? See *Powell v. Commissioner*
  - 754 election where authorized at death of partner under IRC 743
  - Basis-shifting – see work of Paul Lee with Northern Trust
  - Beware hot assets (inventory, A/R, depreciation recapture)
  - Beware step-down issues

Entity Planning Opportunities

- C corporations
  - Preserve NOL as estate asset?
  - Use lower corporate tax rate
  - Structured redemptions
  - Convert to S corp? Lower BIG tax period (5 years) is a boon; can use 199A deduction
  - Structured spinoffs as part of estate/trust administration or succession planning
  - Preferred stock recapitalization freeze still an option – 2704 regs dead for now

Entity Planning Opportunities

- S corporation
  - Legacy C corps – beware BIG tax and C corp E&P
  - No 754 election – must liquidate to shift outside basis to inside basis
  - Beware shareholder qualification
  - 199A deduction a good option
  - Beware other elections that could affect basis and sales of assets:
    - 338(h)(10) election
    - 336(e) election