

# **Advanced Section 199A with Trusts and Estates**

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(Distinguished)

# Agenda

- Background
  - Deduction
  - Qualified Business Income (QBI)
  - Qualified Property
  - Taxable Income Limitations
- Application to Estates and Trusts
  - Non-Grantor Trusts and Estates
  - Grantor Trusts
  - Charitable Remainder Trusts
  - Charitable Lead Trusts
  - Electing Small Business Trusts
  - Anti-Abuse Rules
  - Multiple Trust Rule
  - Reporting Requirements



# Basics

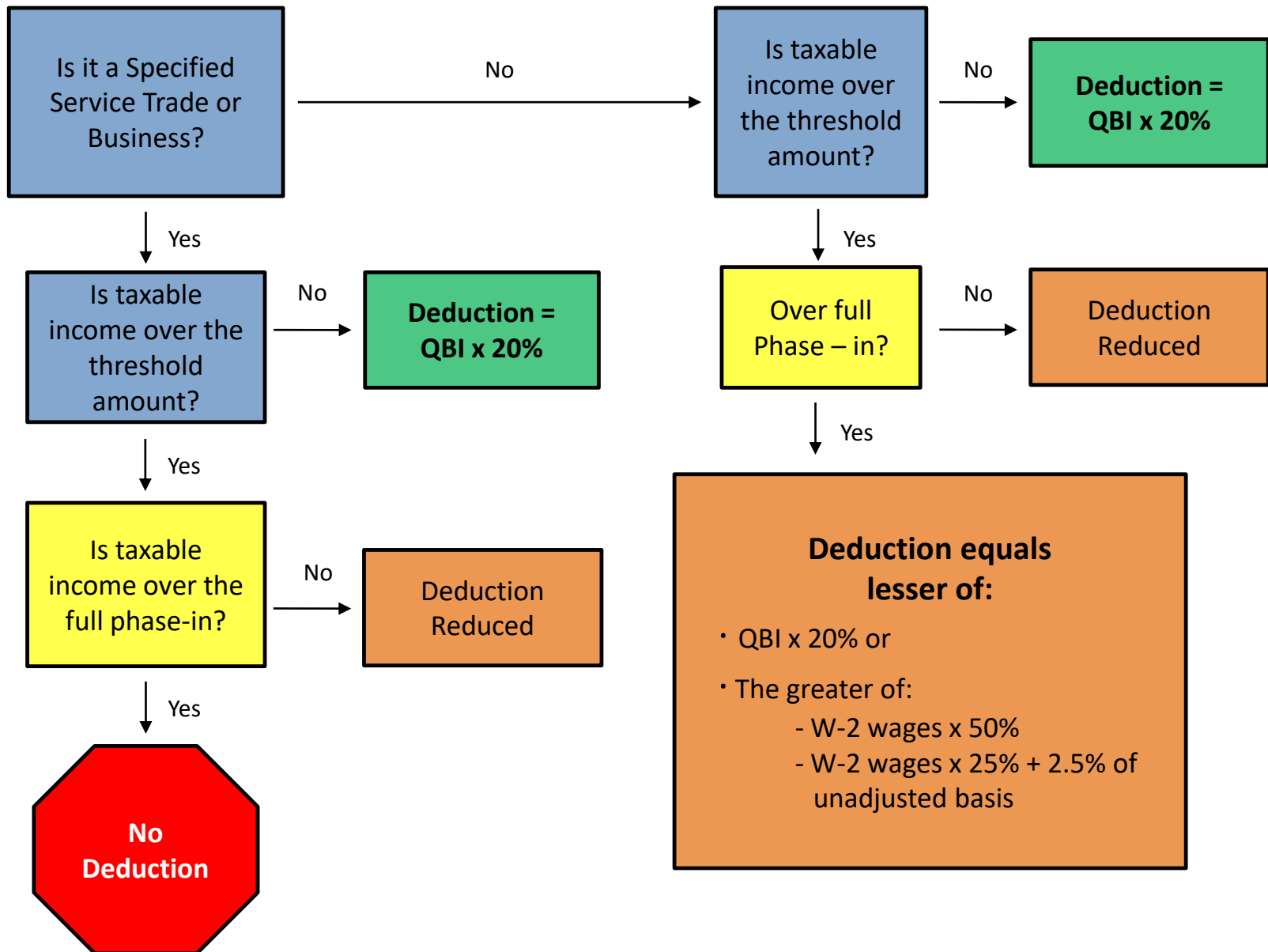
- Deduction equal to 20% of domestic “qualified business income” (QBI) from a pass-through entity
- Basically, provides an effective top marginal rate of 29.6% [37% x (1 – 20%)]
- Applies to trusts & estates



§ 199A, §11011

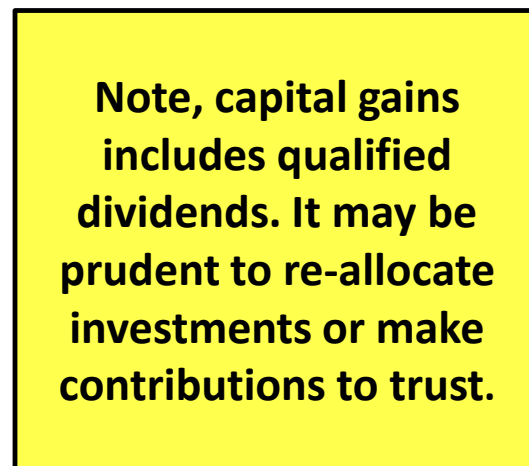
# Eligible Taxpayers

- Owners of any pass-through business:
  - Sole proprietorships (Schedule C)
  - Sole owners (or TIC owners) of rental real estate (Schedule E)
  - S-Corporation owners (Form 1120S)
  - Partnership owners (Form 1065)



# Overall Income Limitation

- The deduction also cannot exceed the lesser of
  - The “Combined QBI Amount,” or
  - $20\% \times (\text{total taxable income} - \text{capital gain})$
- Combined QBI amount = deduction for each qualified trade or business **PLUS** 20% of REIT dividends and PTP income



# Eligible Taxpayers

TYPES OF TAXPAYERS	2020 THRESHOLD AMOUNT
Married Filing Jointly	\$ 326,600
Married Filing Separately	\$ 163,300
<b>All other Taxpayers (including Trusts &amp; Estates)</b>	<b>\$ 163,300</b>

# Pass-thru Deduction

- Specified Service Business – defined in § 1202(e)(3)(A):

“any trade or business involving the performance of services in the fields of health, law, 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”
- The final version includes new statutory language to exclude **architects and engineers** from the Specified Service Business definition



# Limitation Formula Definitions

## *Simplified*

- **W-2 Wages**
  - Equal to wage expense [§199A(f)(1)]
  - Does not include guaranteed payments or payments to independent contractors
- **Qualified Property**
  - Tangible property being depreciated (e.g. does not include land)
  - Depreciation period is the latter of the regular depreciation period or 10-years
- **Unadjusted Basis**
  - Equal to basis immediately after acquisition
  - Not adjusted for depreciation
  - Not adjusted for 754 elections

# Termination

## **(i) Termination.**

This section shall not apply to taxable years beginning after December 31, 2025.

A photograph of a sunset over a dark horizon. The sun is a bright yellow-orange circle partially obscured by a thin layer of clouds. The sky is a gradient of dark orange to black. The text "SUNSET PROVISION" is overlaid in white, bold, sans-serif font in the center of the image.

**SUNSET PROVISION**

# Qualified Business Income

## *Trade or Business Issue*

- The deduction is available to a qualified trade or business
- The term “trade or business” is not defined by statute or regulations, but rather by a facts and circumstances test
- Generally, the following is required:
  - Profit motive
  - Continuous and regular activity
  - Activity has begun
  - Sale of goods or services
- Primary QBI issues:
  - Hobbies
  - **Triple net leases or vacant land**
  - Intermittent or unusual activities

# Qualified Business Income

## *Trade or Business Issue*

- In *Curphey*, the Tax Court analyzed whether the taxpayer's activities were a "trade or business" within the meaning of Section 162 and reiterated that it has repeatedly held "that the rental of even a single piece of real property for the production of income constitutes a trade or business."
- However, the preamble to final regulations for IRC § 1411 clearly states that Treasury and the Service "do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law."

# Partnerships & S-Corps

## *Allocable Share Simplified*

- Partner/shareholder must use their allocable share for all calculations
- Example:
  - Mike and Karen contribute rental real estate to a FLP and gift units to trusts for their grandchildren
  - QBI, W-2 Wages, and Qualified Property is allocated to the couple and the trusts according to ownership



# Trust Planning Example

## *Family Involved in Rental Real Estate*

Richard and Delores, a married couple, purchased 500 apartment units between 1975 and 1990. These are managed by others and they pay no wages. The Qualified Business Income from this activity is about \$1,900,000 and their total taxable income is about \$2,200,000. The original basis of the improvements is fully depreciated so they have a minimal amount of qualified property; about \$750,000. Based on these facts, below is a summary of their QBI deduction in 2018:

QBI Deduction = Lesser of:

(a) 20% of net business income:  $\$1,900,000 \times 20\% = \mathbf{\$380,000}$

(b) 20% of taxable income:  $\$2,200,000 \times 20\% = \mathbf{\$440,000}$

(c) greater of: (i) 50% of W-2 wages ( $\$0 \times 50\% = \$0$ ) or (ii) 25% of W-2 wages plus 2.5% of unadjusted cost basis of assets:  $[\$0 \times 25\%] + [\$750,000 \times 2.5\%] = \mathbf{\$18,750}$

# Trust Planning Example

## *Family Involved in Rental Real Estate*

Richard and Delores, gift interests in the entities which own the properties evenly to 15 trusts set up for each of their four children and 11 grandchildren. The Qualified Business Income and taxable income for each of these trusts is approximately \$126,667. This is less than the threshold amount of \$163,300 and therefore the limitation does not apply. Based on these facts, below is a summary of their QBI deduction for each trust:

QBI Deduction = Lesser of:

(a) 20% of net business income:  $\$126,667 \times 20\% = \mathbf{\$25,333}$

(b) 20% of taxable income:  $\$126,667 \times 20\% = \mathbf{\$25,333}$

Non-Grantor Trust  
Required

# Key Planning Ideas

## Reduce Taxable Income below the threshold amount

- Tax-free bonds
- Life insurance & annuities
- Real estate investments
- Oil & gas investments
- Recognize losses
- Avoid recognizing gains
- Charitable contributions
- Pension plan contributions
- Increase payroll
- Accelerate business expenses
- Cost segregation studies
- Captive insurance companies
- Broaden ownership group to those with lower taxable income
- Gifts to taxpayers with lower taxable income (e.g. children & trusts)



# Key Planning Ideas

- Increase QBI for those below the threshold amount**
  - Defer business expenses (e.g. insurance premium or property tax payment plans)
  - Defer acquisitions of new property eligible for 179 or bonus treatment
  - Reduce wages paid
  - Drop S-election to avoid owner's wage
  - Reduce leverage



# Key Planning Ideas

## Pass the “Wage” or “Capital” Test

### Increase qualified property

- Acquire or improve property before year-end
- Carefully consider whether items are capitalized or expensed
- Understand what property will “roll-off” at year-end

### Increase Wages

- Employee bonuses
- S-election

### REVIEW AND COMPUTE THE EFFECTIVENESS OF BOTH AGGREGATION ELECTIONS



# Trust Foundational Concepts

## Types of Trusts

- Simple trusts
  - Required to distribute accounting income annually
  - Beneficiaries will always claim the 199A deduction
  - Cannot make principal distributions
  - Cannot make distributions to charity
- Complex trusts
  - May accumulate income
  - May distribute income or principal to beneficiaries
  - The trust is entitled to claim the 199A deduction for accumulated income and the beneficiaries for distributed income
  - May make distributions to charity

# Trust Foundational Concepts

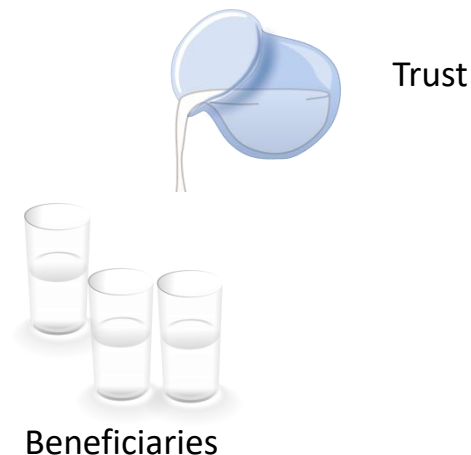
## Types of Trusts

- Grantor trusts
  - Trust and grantor treated as one taxpayer
  - Income taxed to grantor
- Charitable trusts
  - Split-interest trusts consisting of an income beneficiary and a remainder beneficiary
    - Charitable Lead Trust (CLT) – charity is the income beneficiary
    - Charitable Remainder Trust (CRT) – charity is the remainder beneficiary
  - Last for a term of years or life

# Trust Foundational Concepts

## Distributable Net Income (DNI)

- Determines the amount of the trust's or estate's income distribution deduction.
- Determines how much the beneficiaries must report as income on their tax returns.
- Determines the character (e.g. interest, dividends, etc.) of the taxable income in beneficiaries' hands.



# Complete v. Incomplete Gift Trust Planning

## Completed Gift Trusts

- Traditional estate (tax) planning
- Property generally not included in the grantor's estate
- Not dependent on special provisions in the state trust code

## Incomplete Gift Trusts

- Income tax and asset protection planning
- Property generally included in the grantor's estate (and receives a basis adjustment at death)
- Requires the trust to be formed under the law of a limited set of states

**Both create an additional taxpayer for Section 199A.**

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

- Allocating DNI between the trust or estate and its beneficiaries must take into account whether any of the following apply:
  - The general rule that the allocation of DNI between a trust or estate and its beneficiaries is based the pro-rata allocation of DNI based on distributions
  - The separate share rule – the trust will be treated as a single trust to determine if taxable income exceeds the threshold amount
  - The section 663(b) election i.e., the 65 day rule election
  - The section 643(e) election

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

- Following the allocation of these items, the trust uses its own taxable income to determine its section 199A deduction and the beneficiary use their own taxable income to determine their own section 199A deduction.
- The threshold amount for a non-grantor trust or an estate for purposes of determining whether and to what extent the W-2 wages and UBIA limitation and the SSTB limitation applies is \$160,700 for 2019 (\$163,300 for 2020). Reg. 1.199A-6(d)(3)(iv).



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

- Threshold amount is determined after taking distribution deduction into account. Reg. 1.199A6(d)(3)(iv).
- Separate shares of a trust are aggregated to determine if the threshold amount has been exceeded. In other words, each separate share of a trust is not entitled to its own \$160,700 threshold for 2019 (\$163,300 for 2020).

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

- Planning opportunity – distributions from a trust or estate will determine who gets the benefit of the section 199A deduction. For example, the trustee may decide to make a distribution in a particular year if the trust beneficiary to whom a distribution is made is in a better position to use the section 199A deduction than the trust.
- Caution – breach of fiduciary duty claim by a beneficiary. For example, such a distribution could also push the beneficiary beyond the threshold amount, or disqualify their SSTB from a section 199A deduction. Alternatively, perhaps the trustee lost or was entitled to a lower section 199A deduction because he did not make a distribution to a beneficiary.

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

- Planning opportunity – distributions, including distributions for which a Section 663(b) election is made), may leave the trust with taxable income below the threshold amount.

# Section 199A QBI Deduction

## Non-Grantor Trusts and Estates – Example

- For 2020 a complex trust has allocable share of partnership income of \$300,000 (QBI) and dividend and interest income of \$100,000. Thus, the DNI of the trust is \$400,000.
- 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 (25% of its DNI) to the beneficiaries. Thus, \$75,000 (25% of the \$300,000 of QBI) of the partnership income, \$20,000 (25% of \$80,000 W-2 wages) of W-2 wages and \$50,000 (25% of \$200,000 UBIA) of UBIA is allocated to the beneficiaries. Assume the trust has no deductions other than the distribution deduction.
- The remaining 75% of each item (QBI of \$150,000, \$60,000 of W-2 wages and \$150,000 of UBIA) is retained by the trust.

# Section 199A QBI Deduction

## Non-Grantor Trusts and Estates – Example

	Total	Bene's Share – 25%	Trust's Share – 75%
QBI	\$300,000	\$75,000	\$225,000
W-2	\$80,000	\$20,000	\$60,000
UBIA	\$200,000	\$50,000	\$150,000

# 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 **\$45,000** (20% of the \$225,000 QBI retained by the trust).
- The trust's taxable income is \$300,000 (\$75,000 interest and dividends + \$225,000 QBI) after taking the income distribution deduction into account.
- Since the trust's taxable income exceeds the applicable threshold of \$163,300, the trust's section 199A deduction 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 \$60,000, or \$30,000), or
  - 25% of allocable W-2 wages + 2.5% of allocable UBIA of qualified property (25% x \$60,000, or \$15,000) + 2.5% x \$150,000, or \$3,750) for a total of \$18,750.
  - The greater of \$30,000 or \$18,750 under this portion of the calculation is **\$30,000**.



# Section 199A QBI Deduction

## Non-Grantor Trusts and Estates – Example

- The QBI deduction **\$30,000** which is the lesser of:
  - First part of the test: \$45,000
  - Second part of the test: \$30,000

# 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. Reg. 1.199A-6(d)(2).
- 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

- According to the proposed regulations, a CRT is not entitled to and does not calculate a section 199A deduction and the threshold amount does not apply to the trust

# Section 199A QBI Deduction CRTs

- Any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient's own threshold amount for purposes of section 199A, taking into account any annuity or unitrust amounts received from the trust
- Therefore, a taxable recipient of a unitrust or annuity amount from a CRT must take into account QBI, qualified REIT dividends and qualified PTP income for purposes of determining the recipient's section 199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists or such section 199A items under Reg. 1.664-1(d)

# Section 199A QBI Deduction CRTs

- QBI, qualified REIT dividends and qualified PTP income of a CRT will be allocated to the classes of income within the category of income described in Reg. 1.664-1(d)(i)(a)(1) based on the rate of tax that normally would apply to that type of income, not taking into account the characterization of that income as QBI, qualified REIT dividends or qualified PTP income for purposes of section 199A
- The amount of any W-2 wages or UBIA of qualified property of the CRT in a taxable year will be allocated to the unitrust or annuity recipients based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year.
  - Example: If 10% of the QBI of a CRT is distributed to the recipient and 90% of the QBI is retained by the trust, 10% of the W-2 wages and UBIA of qualified property is allocated and reported to the recipient and 90% of the W-2 wages and UBIA of qualified property is treated as retained by the trust.

# Section 199A QBI Deduction CRTs – Tier System

## Ordinary Income

Other ordinary income (ordinary income tax rates)

Qualified dividends - 20% rate

## Capital Gains

Short-term capital gains (ordinary income tax rates)

28% gain on “collectibles” and §1202 gains

25% §1250 unrecaptured gain

All other long-term gain

Qualified 5 year gain (post 12/31/00 and pre-5/6/03, revived after 12/31/08))

## Tax Exempt Income

## Return of Corpus

**CATEGORY**

# Section 199A QBI Deduction CRTs – Tier System

## Ordinary Income

- Other ordinary income (ordinary income tax rates)
- Qualified dividends - 20% rate

## Capital Gains

- Short-term capital gains (ordinary income tax rates)
- 28% gain on “collectibles” and §1202 gains
- 25% §1250 unrecaptured gain
- All other long-term gain
- Qualified 5 year gain (post 12/31/00 and pre-5/6/03, revived after 12/31/08))

## Tax Exempt Income

## Return of Corpus

**CLASS**

# Section 199A QBI Deduction CRTs

- A charitable lead trust is taxed as either a grantor trust or a non-grantor trust
- If the CLT is a grantor CLT, the CLT computes the Section 199A deduction as if the grantor directly conducted the activities of the trust as to the portion owned by the grantor or deemed owner. Reg. 1.199A-6(d)(2).
  - 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.
- If the CLT is a non-grantor CLT, the CLT would apply the rules for non-grantor trusts to determine any applicable section 199A deduction for the trust and its taxable beneficiaries.



# Section 199A QBI Deduction

## ESBTs

- 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

## ESBTs

- Despite the ambiguity in the statute regarding the availability of the Section 199A deduction for ESBT, the final regulations provide that ESBTs are entitled to the Section 199A deduction. Prop. Reg. 1.199A-6(d)(3)(vi).
- The final 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 S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT.
  - The grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or deemed owner of the trust
  - The non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT

# Section 199A QBI Deduction

## ESBTs

- The final regs state that the S portion and the non-S portion of an ESBT are treated as a single trust in determining whether the taxable income of an ESBT exceeds the threshold amount. In other words, the S portion and non-S portion are not each entitled to a separate \$163,300 threshold. Reg. 1.199A-6(d)(vi).

# Section 199A QBI Deduction Anti-Abuse Rules

- Final regulations adopt an anti-abuse rule for trusts with respect to Section 199A
- “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 Section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount. Reg. 1.199A-6(d)(3)(vii).
- If the rule is violated, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the Section 199A deduction.
- Designed to prevent taxpayers from forming multiple trusts with taxable income below the threshold amount.

# Section 199A QBI Deduction Anti-Abuse Rules

- This anti-abuse rule could apply to situations not covered by section 643(f) i.e., to the creation of a single trust, or to multiple trusts that have different primary beneficiaries (which would not be covered by section 643(f)).
- The anti-abuse rule should not apply to a trust that was established before the enactment of section 199A since such a trust could not have been established to obtain a deduction under section 199A since section 199A didn't exist at that time.
- The anti-abuse rules in the §199A Regs. apply to taxable years after December 22, 2017.

# Section 199A QBI Deduction

## Multiple Trust Rule

- 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. Reg. 1.643(f)-1.
- Under this rule, spouses are treated as one person. In other words, if a spouse creates one trust and the other spouse creates a second trust, the grantors will be treated as the same for purposes of applying this anti-abuse test, even if the trusts are created and funded independently by the two spouses.
- The multiple trust regulation applies to taxable years ending after August 16, 2018 (the date the proposed regulation was published in the Federal Register).

The End