BESSEMER TRUST

Section 199A—Qualified Business Income Deduction Including Highlights of Proposed Regulations

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A. Overview

The top corporate tax rate is 21% under the 2017 Tax Act, effective beginning in 2018. This reduced top income tax rate applies to any entities that are subject to income taxation under Subchapter C. A complicated provision in new §199A provides tax-favored treatment of business income from passthrough entities (sole proprietorships, partnerships, limited liability companies, or S corporations) that are not subject to taxation under Subchapter C and that will be taxed at the individual tax rates of the owners, which could be as high as 37%. The deduction under §199A reduces the wide discrepancy (21% vs. 37%) in the top rates at which business income would be taxed, depending on whether the business is taxed as a C corporation or as a proprietorship or passthrough entity. Very generally (but with various limitations and exceptions), the §199A deduction is a deduction for the individual owner's tax calculation equal to 20% of the individual's qualified business income; the 20% deduction results in an effective top rate of (1 – 0.20) x 37%, or 29.6%. This deduction is subject to various limitations, the most important of which apply to taxpayers with taxable income over a certain threshold amount and are (1) based on the wages paid by the business or wages plus the basis of its property, or (2) in certain specified service businesses (designed to prevent converting what would otherwise be normal service income into business income). The deduction is allowed to individuals, trusts and estates.

B. Temporary, Through 2025

The provision is in the Subtitle A of the 2017 Tax Act addressing individual tax reform, and like most of the individual tax provisions in the Act, applies only through 2025.

C. Proposed Regulations

The IRS on August 8, 2018 issued 184 pages of proposed regulations (including a 104 page preamble) to §199A and the multiple trust rule under §643. In addition, Notice 2018-64 was issued in conjunction with the proposed regulations and addresses alternative methods for calculating W-2 wages as used in the computations under §199A. The issuance of complicated detailed proposed regulations to this complex Code section within only about eight months of the passage of the Act is amazingly fast.

The separate sections of the proposed regulations cover the following general topics-

§1.199A-1 Definitions and operational rules-General rules for computation of deduction, trade or business, loss carryover rules

§1.199A-2 W-2 wages and unadjusted basis immediately after acquisition

§1.199A-3 Guidance regarding various terms including qualified business income, allocation among multiple trades or businesses

§1.199A-4 Aggregation

§1.199A-5 Specified service trades or businesses and performing services as employee

§1.199A- 6 Guidance regarding computational and reporting rules for "relevant passthrough entities" and regarding trusts and estates (including an anti-abuse rule)

§1.643(f)-1 Multiple trusts.

D. Abbreviations

The proposed regulations employ a number of abbreviations, which no doubt will become part of tax lingo, and are used in this summary. The abbreviations include the following:

- **QBI** Qualified business income
- **RPE** Relevant passthrough entity
- **SSTB** Specified service trade or business
- **UBIA** Unadjusted basis immediately after acquisition (of "Qualified Property")
- **PTP** Publicly traded partnership
- **REIT** Real estate investment trust

E. General Computation Formula for Deduction.

1. **Threshold Amount.** The threshold amount is taxable income, determined without considering the §199A deduction itself, of $157,500 for taxpayers other than joint return filers and $315,000 for married couples filing joint returns, indexed for inflation for tax years beginning after 2018. Prop. Reg. §1.199A-1(b)(11). The $157,500 threshold is taxable income, which would be calculated after considering the individual's allowable deductions or the $24,000 standard deduction, if a larger amount (and all adjustments allowed in arriving at adjusted gross income, which would include 50% of self-employment tax). Low income taxpayers (with taxable income below the threshold amount) are not subject to the "W-2 and UBIA limitation" or the specified service trade or business limitation (both of which are described below). Those limitations are phased in for the next $50,000 /$100,000 (i.e., other than joint return/joint return taxpayers) of taxable income.

2. **Individuals with Taxable Income Not Exceeding Threshold Amount.**

   Deduction = Lesser of:

   (1) 20% of QBI {including QBI of SSTBs} + 20% of (qualified REIT dividends + qualified PTP income); or

   (2) 20% x (taxable income – net capital gain). Prop. Reg. §1.199A-1(c).

   The last element means that the deduction cannot exceed taxable income reduced by the taxpayer's net capital gain for the year. In effect, the 20% deduction cannot exceed 20% of the taxpayer's ordinary income. That same overall limit on the deduction applies for individuals with taxable incomes exceeding the threshold amount (described immediately below).

3. **Individuals with Taxable Income Exceeding Threshold Amount.**

   Deduction = Lesser of:

   (1) QBI component + 20% of (qualified REIT dividends + qualified PTP income); or

   (2) 20% x (taxable income – net capital gain). Prop. Reg. §1.199A-1(d).

   QBI component = sum of the following for each separate trade or business--

   Lesser of:

   (1) 20% of QBI for that trade or business, or

   (2) What is referred to in this outline as the "W-2 wages or UBIA limitation" (or sometimes as the "W-2 wages or capital limitation"), which is the greater of the individual's allocable share of

   (i) 50% of W-2 wages for that trade or business, or

   (ii) 25% of W-2 wages for that trade or business + 2.5% of UBIA of qualified property for that trade or business,

   Subject to a special rule for SSTBs, which is that QBI, W-2 wages, and UBIA of qualified property of a SSTB are not taken into account, and

   Subject to a phase-in rule if taxable income is in the "phase-in range." Prop. Reg. §1.199A-1(d).

   Phase-In Range. For taxpayers with up to $50,000 ($100,000 for joint returns) over the threshold amount, the W-2 wages or UBIA limitation is applied proportionately by the amount that the excess bears to $50,000 (or $100,000, as appropriate). Prop. Reg. §1.199A-1(d)(iv)(B).

   The REIT dividends and PTP income provisions in the first element of the basic deduction formula in effect means that the wage limitation and limitation of SSTB income does not apply to those types of income.

F. Qualified Business Income

QBI "means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of §1.199A-3(b) [which also requires that the income be effectively connected with a U.S. trade or business]." Prop. Reg. §1.199A-1(b)(4). (Observe that credits attributable to trades or businesses are not considered.)

1. **Trade or Business.** Section 199A(d)(1) describes a "qualified trade or business" as any trade or business other than an SSTB or the trade or business of performing services as an employee. (The exception for an SSTB does not apply to taxpayers with taxable income under the threshold amount. §199A(d)(3)(A)(i).)

The proposed regulations adopt the definition of a trade or business under §162. Substantial case law and rulings have developed regarding whether the management of real estate rental property constitutes a trade or business; operating under a triple net lease may not qualify as a trade or business (although the proposed regulations refer to an example of an individual leasing land to suburban airports for parking lots with no suggestion that it may not be a trade or business, Prop. Reg. §1.199A-1(d)(4)Ex.1).

The proposed regulations add a helpful special rule for purposes of §199A—the rental of property to a related trade or business is treated as a separate trade or business if the two separate businesses are commonly owned, meaning the same persons directly or indirectly own 50% or more of each business (applying attribution rules attributing ownership from an individual's spouse, children, grandchildren, and parents). Prop. Reg. §1.199A-1(b)(13), referring to §1.199A-4(b)(1)(i) & §1.199A-4(b)(3)(family attribution). The exception is very helpful because business owners often segregate rental property from operating businesses. (If desired, the taxpayer could aggregate the two businesses under the aggregation rules of §1.199A-4 if the requirements of that section are satisfied.)

2. **Trade or Business of Performing Services as an Employee.** A business of serving as an employee is not eligible for the §199A deduction. §199A(d)(1)(B). The proposed regulations include several special rules to discourage current employees from becoming independent contractors in an attempt to qualify for the deduction. First, the employer's Federal employment tax classification of the employee as a non-employee is immaterial. Prop. Reg. §1.199A-5(d)(2). Second, if an employee becomes an independent contractor while providing substantially the same services as before, a presumption arises that the person is an employee for purposes of §199A. The presumption may be rebutted by showing that the individual is performing services in a capacity other than as an employee. Prop. Reg. §1.199A-5(d)(3) (including three rather detailed examples). This presumption provision purportedly applies to taxable years ending after December 22, 2017 (after the regulations are finalized). Prop. Reg. §1.199A-5(e)(2)(i). Observe that no contrary presumption exists providing that an independent contractor is presumed to remain an independent contractor, leaving open the possibility of an independent contractor converting to employee status if more W-2 wages are needed for owners to be able to use the §199A deduction.

3. **Specific Items Included and Excluded from QBI.** QBI is generally the net amount of income, gain, deduction, and loss from an active trade or business within the United States, including §751 gain, but not including certain types of investment income (short or long term capital gains or losses including gains or losses under §1231 treated as capital gains or losses, dividends or interest unless the interest is allocable to a trade or business but interest attributable to the investment of working capital is not included), annuity income not received in connection with the business, net gain from foreign currency transactions and commodities transactions, and income from notional contracts. In addition, QBI does not include reasonable compensation paid to the taxpayer, any guaranteed payment under §707(c), or payment to a partner for services under §707(a). Prop. Reg. §1.199A-3(b).

4. **No Imputed Reasonable Compensation From Partnerships.** Reasonable compensation concepts are applied to S corporations to prevent avoidance of self-employment tax abuses, but no tax rules require partnerships to pay their active owners a guaranteed payment (treated as compensation). The proposed regulations do not require a partnership to pay reasonable compensation for purposes of §199A. Preamble to §1.199A proposed regulations at 39-40.

5. **Losses; Multiple Businesses.** If a taxpayer has multiple businesses, the QBI must be determined for each separate business. If any business has a negative QBI, that loss is netted against the QBI from businesses with positive QBI. The loss is allocated across businesses with positive QBI proportionately based on the amount of QBI in each such business with positive QBI, and that allocation is made before the individual applies the limitations based on W-2 wages and UBIA of qualified property. The net QBI of each business, after considering apportioned losses is then compared with the W-2 wages and UBIA limitation for each business. The W-2 wages and UBIA from a business with a negative QBI are not taken into account for other businesses and are not carried over to subsequent years for that business. Prop. Reg. §1.199A-1(d)(2)(iii)(A).

   If the net QBI for all businesses in a year is a negative number, the negative amount is treated as QBI from a separate business, and is carried over to subsequent years to offset the positive QBI of businesses in subsequent years. Prop. Reg. §1.199A-1(d)(2)(iii)(A).

   Net operating losses are generally not considered attributable to a trade or business and are not taken into account in computing QBI because the items giving rise to the loss were allowed in computing taxable income in the year incurred. If some losses that were disallowed by §461(l) in determining income give rise to an NOL, the disallowed deductions will not be included in the QBI computation in the year incurred, and the NOL attributable to that business will constitute QBI in later years. Prop. Reg. §1.199A-3(b)(1)(v).

G. W-2 Wages

The taxpayer's pro rata share of the total W-2 wages paid by the business (including wages paid to the taxpayer) is considered in determining the W-2 wages or UBIA limitation.

1. **General Rules.** W-2 wages includes wages as defined in §3401(a) subject to wage withholding, and also include elective deferrals (under §402(g)(3)), and deferred compensation (under §457), and Roth contributions. Prop. Reg. §1.199A-2(b)(2)(i). Amounts are considered only if they are properly included on a Form W-2 and W-3 filed with the Social Security Administration by the 60th day after the due date (generally January 31 of the following calendar year), including extensions, for such returns. §199A(b)(4)(C). If a corrected return is filed after that 60th day date, any increase in reported wages is ignored but any decrease must be taken into account in determining the business's W-2 wages. Prop. Reg. §1.199A-2(b)(2)(iii).

Procedures are included for determining W-2 wages for short years (arising from the acquisition or disposition of a business interest by the taxpayer). Prop. Reg. §1.199A-2(b)(2)(iv)(C).

Three alternative methods are provided for calculating W-2 wages in Notice 2018-64, issued in conjunction with the proposed regulations. These are (i) the unmodified box method (lesser of Boxes 1 and 5 for all employees' W-2 forms, the simplest approach, but that may not be as large a number as the other approaches), (ii) the modified Box 1 method (Box 1 less some amounts that are not wages for withholding purposes and totals in Box 12, Code D, E, F, G, and S relating to elective deferrals), and (iii) the tracking wages method (all wages subject to withholding and totals in Box 12, Code D, E, F, G, and S relating to elective deferrals). The effect is that W-2 wages include most pension plan contributions (including elective deferrals), health insurance costs, and various other items of compensation.

2. **Management Company Exception.** The proposed regulations add a regulatory rule providing relief for situations in which the employees for various separate businesses are employed by a central management company. For example, real estate investors often form separate LLCs to own separate real estate investments, and each separate business pays a management fee to a central management company that hires employees to provide management services for all of the separate businesses. Prop. Reg. §1.199A-2(b)(2)(ii). Without this rule, the businesses would have no W-2 wages to apply for determining the W-2 wages and UBIA limitation applicable to those businesses. The proposed regulation is very succinct, simply providing that a taxpayer can take into consideration any W-2 wages paid by another person "provided the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE." *Id*.

3. **Allocation of Wages among Businesses and to QBI.** If an employee is used in multiple businesses, the W-2 wages are allocated among those businesses in the same manner that expenses are allocated among the businesses under §1.199A-3(b)(5). The wages allocated to each business is then further allocated to determine the wages properly allocated to QBI for each business. Prop. Reg. §1.199A-2(b)(3)-(4). (An RPE must identify and report associated wages to its partners or shareholders. Prop. Reg. §1.199A-6(b).)

H. UBIA Limitation (Sometimes Referred to as the "Capital Limitation")

1. **Code Description.** The wages limitation was relaxed in the Conference Agreement by adding that the wage limitation is the greater of (a) 50% of W-2 wages, or (b) the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of qualified property (generally meaning all tangible property subject to depreciation) for the useful life of such property. This separate "real estate exception" based largely on the basis of property in the business could be very beneficial to real estate companies.

2. **Qualified Property.** Qualified property is tangible depreciable property held at the close of the tax year that is used at any time during the year for the production of QBI and for which the depreciable period has not ended before the close of the individual's or RPE's taxable year. Prop. Reg. §1.199A-2(c)(1)(i). Raw land and inventory are not depreciable, so do not count.

   An addition or improvement to property is treated as separate qualified property placed into service on the date of the addition or improvement. (This is important for purposes of determining how long the basis of the property can be counted as UBIA.) Prop. Reg. §1.199A-2(c)(1)(ii).

   Businesses cannot simply acquire property briefly at the end of the year to "beef up" the UBIA amount. Property that is acquired within 60 days of year-end and disposed of within 120 days without being used in the business at least 45 days is not qualified property. Prop. Reg. §1.199A-2(1)(iv).

3. **Depreciable Period.** The depreciable period starts when the property is placed in service and ends on the later of (i) 10 years later, or (ii) the end of last full year of the applicable recovery period under §168(c). Prop. Reg. §1.199A-2(c)(2). The business will need to keep track of this period as well as the period of actual depreciation.

4. **Unadjusted Basis Immediately After Acquisition.** Using the "unadjusted" basis means that depreciation, bonus depreciation, §179 depreciation etc. have no impact on this number.

   For like-kind exchanges, the date of service of the relinquished property applies, but the adjusted basis at the time of the exchange becomes the new unadjusted basis, in effect applying the worst rule for both issues from the taxpayer's perspective (but exceptions to that general rule apply). Prop. Reg. §1.199A-2(c)(2)(iii). The non-recognition provisions in §1031 are mandatory, but a taxpayer may specifically structure a transaction so that it does not qualify as a like-kind exchange under §1031.

   Basis adjustments under §§734(b) and 743(b) of property held in an RPE with a §754 election in effect are not counted (such basis adjustments "are not treated as qualified property"). Prop. Reg. §1.199A-2(c)(1)(iii).

I. Aggregation

1. **Significance.** The proposed regulations adopt an approach of allowing taxpayers (not the passthrough entity) to aggregate separate businesses that meet certain tests, which results in combining the QBI, W-2 wages and qualified property of the aggregated separate businesses. This can be very helpful, for example, if some businesses have little wages or qualified property (for the UBIA limitation) and other businesses have a relative abundance of W-2 wages or qualified property. This is somewhat similar to the concept of "grouping" under the passive activity loss rules, but the rules are different, and a particular taxpayer may choose to aggregate businesses for purposes of §199A in a different manner than the same taxpayer groups businesses for passive activity loss purposes. Aggregation is at the option of the taxpayer, and all of the owners of a business do not have to make the same aggregation decision.

2. **Requirements.** Businesses may be aggregated if–

   (i) The same person or group of persons, directly or indirectly, owns 50% or more of each business being aggregated (i.e., 50% or more of the shares of an S corporation or 50% of more of the capital or profits of a partnership);

   (ii) The ownership exists for a majority of the taxable year;

   (iii) All of the items attributable to each business are reported on returns having the same taxable year, not considering short taxable years;

   (iv) None of the businesses is an SSTB; and

   (v) The businesses satisfy at least two of the following three factors (based on all the facts and circumstances):

   (A) The businesses provide products and services that are the same or are customarily offered together;

   (B) The businesses share facilities or significant centralized business elements (such as personal, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); and

   (C) The businesses "are operated in coordination with, or reliance upon, one or more businesses in the aggregated group (for example, supply chain interdependencies)." Prop. Reg. §1-199A-4(b)(1).

3. **Common Ownership Test.** Common ownership is determined after applying an attribution rule attributing ownership by an individual's spouse, children, grandchildren, or parents. Prop. Reg. §1.199A-4(b)(3). There is no attribution from non-grantor trusts to a beneficiary (as there is under the common ownership rule for purposes of the anti-cracking and packing rule for SSTBs).

   The taxpayer does not have to own more than 50% of each aggregated business, as long as *someone* owns 50% or more of the aggregated businesses.

4. **Consistency.** Once the taxpayer elects to aggregate businesses, the taxpayer must consistently report the aggregated businesses in all subsequent years. A newly created or newly acquired business may be added to the aggregated group assuming the requirements are satisfied; or if facts have changed so that a prior aggregation no longer satisfies the requirements, the aggregation will no longer apply and the individual may determine a new permissible aggregation (if any). Prop. Reg. §1.199A-4(c)(1).

   This consistency requirement means that taxpayers must very carefully decide what businesses to aggregate. Conditions may change in the future making the aggregation undesirable (for example, if one of the aggregated companies has a loss that has the effect of offsetting the QBI of other businesses, in effect "wasting" use of some or all of the W-2 and UBIA of those other businesses).

5. **Disclosure.** The taxpayer must disclose the aggregation on each year's return by attaching a statement containing information required in the regulations, and the IRS may disaggregate the businesses if the taxpayer fails to attach the required disclosure statement. Prop. Reg. §1.199A-4(c)(2).

6. **Examples.** The proposed regulations contain 14 detailed examples illustrating the aggregation rules.

J. Specified Service Trades or Businesses (SSTBs)

1. **General Rule.** The deduction does not apply for specified service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading services, dealing in securities, partnership interests, or commodities, or any business where the principal asset is the reputation or skill of one or more of its employees (by reference to §1202(e)(3)(A), except for engineering or architecture). §199A(d)(2). This provision decreases the incentive of specified service businesses to pay low compensation income for the service-provider employees and claim that most of the income from the business is qualified business income entitled to the 20% deduction.

   The listed service fields are generally based on service fields in §1202 (for qualified small business stock), and almost no case law or rulings exists as to the meaning of those terms. The proposed regulations generally apply those terms broadly, but give specific examples of types of businesses that are or are not included. The proposed regulations do not apply a bright-line licensing rule.

2. **Reputation or Skill of Employee as Principal Asset.** The proposed regulations interpret this term narrowly, as applying only to businesses receiving income from: (1) endorsing products or services, (2) using an individual's image, likeness, name, signature, voice, trademark, or other symbols associated with the individual, or (3) appearing at an event or on radio, television or other media format. Prop. Reg. §1.199A-5(b)(2)(xiv). This position avoids a concern that almost any business closely associated with a particular individual (such as "Tony's" restaurant) could be treated as an SSTB.

3. **De Minimis Rule for Mixed Businesses.** If a business has income from the specified service fields and also has other income, the business will not be treated as an SSTB if less than 10% of its gross receipts are from the specified service field (or 5% if it has gross receipts over $25 million). Prop. Reg. §1.199A-5(c)(1).

4. **Cracking and Packing.** Soon after the passage of §199A, commentators discussed possible "cracking and packing" transactions in which business would be structured to "crack" apart as much ancillary activity income as possible (for example, for administrative functions) from the service business, or to "pack" other qualifying businesses into the service business to transform the business into one that is not primarily in the designated service field. *See* Avi-Yonah, Batchelder, Fleming, Gamage, Glogower, Hemel, Kamin, Kane, Kysar, Miller, Shanske, Shaviro, & Viswanathan, *The Games They Will Play: An Update on the Conference Committee Tax Bill* (December 22, 2017) (excellent discussion of specific strategies including "cracking" and "packing" strategies for specified service companies). The proposed regulations limit this type of activity; planning alternatives remain but will require more maneuvering.

   50% and 80% Tests. The proposed regulations add that an SSTB includes any business (i) with 50% or more common ownership (directly or indirectly, with attribution), and (ii) that provides 80% or more of its property or services to an SSTB. Prop. Reg. §1.199A-

5(c)(2)(i). For example, if the marketing, billing, and payroll administrative functions are structured in a separate entity to provide such activities for the service business in return for a fee, if 50% common ownership exists between the administrative entity and the service entity, and if the administrative entity provides at least 80% of its services to the service entity, the administrative entity will be treated as part of the service entity, and the entire entity will be an SSTB.

Common ownership is determined for purposes of this "anti-cracking and packing" rule after applying the attribution rules of §267(b) or §707(b). Prop. Reg. §1.199A-5(c)(2)(iii). Generally, this includes attribution among trusts and their grantors and beneficiaries, and includes family attribution among siblings, spouses, ancestors and descendants. (The attribution rule applied for purposes of the aggregation rule discussed above is much narrower, including just family attribution from an individual's spouse, children, grandchildren, and parents.)

Meeting Only 50% Test. If a business (that is not otherwise an SSTB) does not provide 80% of its product or services to an SSTB but 50% common ownership exists between the business and an SSTB, the business is not treated as an SSTB in its entirety, but the portion of the business that provides property or services to the 50% commonly-owned SSTB is treated as part of the SSTB. Prop. Reg. §1.199A-5(c)(2)(ii).

Business Incidental to SSTB. If a business that would not otherwise be an SSTB (i) has 50% common ownership (applying attribution under §267(b) and §707(b)) with an SSTB, (ii) shares expenses with the SSTB, and (iii) accounts for 5% or less of the combined gross receipts of the business and SSTB, the business is treated as incidental to and part of the SSTB for purposes of §199A. Prop. Reg. §1.199A-5(c)(3) (including an example of a dermatologist that provides medical services through an LLC disregarded entity that also sells skin care products representing no more than 5% of the combined gross receipts of the LLC).

Anti-Abuse Provisions Effective Currently. The cracking and packing and incidental business rules described above purportedly apply to taxable years ending after December 22, 2017 (after the regulations are finalized). Prop. Reg. §1.199A-5(e)(2)(i). The preamble discusses that §7802(b)(2) provides that regulations issued within 18 months of the date of the enactment of the statutory provision to which they relate are not prohibited from applying to taxable periods prior to the issuance of the final regulations, and §7805(b)(3) provides that any regulation may take effect or apply retroactively to prevent abuse. (The various anti-abuse rules in the §199A proposed regulations that are effective immediately are listed on page 80 of the preamble to the regulations.)

Planning Alternatives. The primary planning alternatives for segregating some of the income of a service business to qualify as QBI will involve avoiding the 50% common ownership test. For example, three law firms might enter into a venture to have marketing, billing, and payroll services provided by a separate administrative company owned by the owners of the three firms, with each group owning far less than 50% of the administrative entity. The firms might have the separate entity hire all of the administrative employees and enter into an employee leasing arrangement. Such structures may be rather unwieldy.

K. Trusts

The deduction is available to non-corporate taxpayers, including trusts and estates. (The Senate version would not have made the deduction available to trusts and estates.) References to trusts below also apply to estates.

1. **Threshold Amount**. For trusts, the threshold amount (for purposes of determining whether and to what extent the W-2 wages and UBIA limitation and the SSTB limitation applies) is $157,500. §199A(e)(2)(A); Prop. Reg. §1.199A-6(d)(3)(iii). Surprisingly, the proposed regulations take the position that in determining whether the trust's taxable income exceeds the threshold amount, the taxable income before taking into consideration the distribution deduction is used. Prop. Reg. §1.199A-6(d)(3)(iii).

2. **Allocation Among Trust and Beneficiaries.** A trust computes its §199A deduction based on the QBI, W-2 wages, UBIA qualified REIT dividends and qualified PTP income that are allocated to the trust, and beneficiaries take into account their allocated share of such items in computing their deductions under §199A. Prop. Reg. §1.199A-6(d)(1).

   The QBI (including any negative amounts at the at the trust level), W-2 wages, UBIA of qualified property, qualified REIT dividend and qualified PTP income are allocated among the trust and the beneficiaries based on the relative proportion of the trust's DNI that is retained or distributed to each. For that purpose, the DNI is determined taking into account the separate share rule of §663(c) but is determined without regard to §199A. If a trust has no DNI for the year, all of those items are allocated entirely to the trust. Prop. Reg. §1.199A-6(d)(3)(ii).

3. **Calculation at Trust Level.** The proposed regulations provide detail about how the trust calculates its QBI, including how to allocate qualified items of deduction for determining QBI. Prop. Reg. §1.199A-6(d)(3)(i). A very detailed two-page example of the rather complicated calculation process is provided. Prop. Reg. §1.199A-6(d)(3)(vi).

4. **Grantor Trusts.** To the extent that the grantor (under §§671-677 & 679) or another person (under §678) is treated as the owning all of part of the trust, such person computes its §199A deduction as if the person directly conducted the activities of the trust as to the portion owned by the grantor or other person. Therefore, the grantor (or other deemed owner for a §678 trust) would include all attributable items directly in the grantor's or deemed owner's return in determining his or her QBI, W-2 wages, UBIA limitation, etc. This treatment suggests that the anti-abuse rules (described below) do not apply to grantor trusts. *See* Gassman Shenkman, Ketron, Denicolo & Crotty, *Proposed Regulations for 199A – The Good, The Bad, the Taxpayer-Unfriendly*, LEIMBERG INFORMATION SERVICES INC. TAX PL. NEWSLETTER #152 (Aug. 13, 2018) ("This means that a grantor could establish a trust considered as owned by a named beneficiary pursuant to Section 678, and the individual beneficiary will be considered to be the owner of the Section 199A interest without application of the anti-abuse rules that would apply to a non-grantor ("complex") trust").

5. **ESBTs.** The statute and legislative history do not specifically address the availability of the §199A deduction for electing small business trusts (ESBTs). Uncertainty existed regarding the availability of the §199A deduction for ESBTs because §641(c) describes the manner in which the taxable income and the tax is determined for ESBTs, and §641(c)(2)(C) states that only certain items of income, loss, deduction, or credit may be considered in determining the tax for ESBTs. The few allowed items include "[t]he items required to be taken into account under section 1366," and §1366 describes the passthrough of items to S corporation shareholders, which would include the passthrough of business income that would be reported on the Schedule K-1 from the S corporation. Therefore, an argument can be made that ESBTs are entitled to the deduction under the statutory provisions, but the answer is far from clear.

   Without even referring to this statutory ambiguity, the proposed regulations provide that ESBTs are entitled to the §199A deduction. Prop. Reg. §1.199A-6(d)(v). The regulations do not clarify whether the S component and the non-S component of the trust (for example if the trust owns an S corporation with a business and owns other businesses in partnerships) each would have a $157,500 threshold amount.

6. **Section 199A Anti-Abuse Rule for Trusts.** The statute authorizes the IRS and Treasury to adopt regulations implementing certain aspects of §199A, but none of those provisions specifically refers to the treatment of trusts. Nevertheless, the proposed regulations adopt an anti-abuse rule for trusts specifically with respect to §199A (and, as discussed below, also adopt a separate general multiple trust rule under proposed regulations to §643).

   The proposed regulations include the following short (but very important) anti-abuse rule for trusts (which, as discussed above, likely applies only to non-grantor trusts). "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) (emphasis added).

   Section 199A does not specifically authorize regulations regarding the treatment of trusts under §199A, and the proposed regulation refers to the new proposed regulation under §643(f) (discussed below), suggesting that the IRS is acting under the authority of §643 to adopt regulations treating two or more trusts as one trust if (1) the trusts have substantially the same grantors and primary beneficiaries and (2) a principal purpose of the trusts is the avoidance of income tax.

   The anti-abuse rule saying a trust will not be respected if a significant purpose is to receive a §199A deduction could apply to situations not covered by §643(f). For example, it could apply to the creation of a single trust, or it could apply to multiple trusts that clearly have different primary beneficiaries and therefore would not be covered by §643(f). An individual with income above the threshold amount may own interests in businesses that do not have sufficient W-2 wages or UBIA of qualified property to qualify for any §199A deduction to the individual; alternatively, the individual may own interests in SSTBs for which no §199A deduction would be available to the individuals with taxable income over the threshold amount. The individual may want to give interests in the business to a trust for the individual's child, but the individual is motivated to "pull the trigger" and make the transfer now in large part so that the trust could be structured to have taxable income under $157,500 and therefore not be subject to W-2 and UBIA limitation or the limitation on SSTBs. "A significant" purpose is of the trust receiving a §199A deduction, so the proposed regulation might apply, despite the fact that §643(f) clearly does not apply. The maximum tax savings from the §199A deduction alone would not exceed approximately $157,500 (the threshold amount for the trust is $157,500) times a 20% §199A deduction times a 37% rate, or $11,655. (In round figures, the savings for the trust would be about $150,000 x 20% x 40%, or $12,000.)

The individual may have a number of children and grandchildren. If the individual transfers interests in the businesses to 5 separate trusts, each having a different primary beneficiary, the savings could be 5 times $11,655, or $58,275.

The regulation does not indicate what it means by saying that the trust "will not be respected." Is the trust ignored or are multiple trusts aggregated or are the beneficiaries or the grantor substituted as the taxpayer in lieu of the trust? *See* Gassman Shenkman, Ketron, Denicolo & Crotty, *Proposed Regulations for 199A – The Good, The Bad, the Taxpayer-Unfriendly*, LEIMBERG INFORMATION SERVICES INC. TAX PL. NEWSLETTER #152 (Aug. 13, 2018).

The trust anti-abuse rule for §199A described above to avoid exceeding the threshold amount purportedly applies to taxable years ending after December 22, 2017 (after the regulations are finalized). Prop. Reg. §1.199A-6(e)(2)(i).

7. **Proposed Regulations Regarding Multiple Trusts Under §643(f).** As discussed above, §643(f) authorizes the IRS to adopt regulations treating two or more trusts as one trust if certain conditions are satisfied. However, §643(f) applies "under regulations prescribed by the Secretary" and no such regulations have ever been issued. In *SIH Partners v. Commissioner*, 150 T.C. No. 3 (January 18, 2018), the Tax Court addressed the validity of regulations that were adopted in response to §956(d) referring to a tax effect for controlled foreign corporations that would apply "under regulations prescribed by the Secretary" and §956(e) providing that "[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section …." In that case the taxpayer "contends, and respondent does not dispute" that §956(d) "is not self-executing" and that the amount of income inclusions at issue "can be determined only by reference to regulations…." Without regulations, does §643(f) have any substantive effect?

   Proposed regulations under §643(f) issued in conjunction with the proposed regulations to §199A provide an anti-abuse rule regarding multiple trusts, but those regulations are not effective until they are adopted as final regulations. Prop. Reg. §1.643(f)-1(d). The proposed regulations reiterate the general rule of §643(f) that two or more trusts will be aggregated and treated as a single trust (i) if they have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (ii) if a principal purpose for establishing the trusts or for contributing additional property to the trusts is the avoidance of Federal income tax. Prop. Reg. §1.643(f)-1(a).

Paragraph (b) of the proposed regulation addresses the principal purpose requirement and provides that "[a] principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts." Prop. Reg. §1.643(f)-1(b).

The regulations include two examples. One is of a rather unusual situation in which an individual transfers a pizzeria and gas stations to three trusts for the grantor's sisters and brothers after reading an article suggesting that transferring business interests to multiple identical trusts for family members can avoid the wage limitation of §199A. The trusts are not identical, but a lot of similarities exist regarding the beneficiaries of the trusts. The facts state that the trusts would not have been funded but for the enactment of §199A. The example concluded that the three trusts should be aggregated and treated as a single trust. Prop. Reg. §1.643(f)-1(c)Ex.1.

The second example is a more typical situation in which two trusts are created for two children. The first trust is for one child with a mandatory income interest and the other trust is for the other child with a discretionary distribution standard for education, support, and maintenance, and also allowing payment of the first child's medical expenses. The second child is the remainder beneficiary of both trusts. The example concludes that significant non-tax differences exist between the substantive terms of the trusts, so tax avoidance will not be presumed as a principal purpose for the creation of the trusts. Even though the two children are beneficiaries of both trusts to some degree, sufficient differences existed to avoid the presumption. If the trusts clearly have different beneficiaries, the case should be even easier to find that the presumption under the regulation does not apply. Prop. Reg. §1.643(f)-1(c)Ex.2.

The second example raises questions about the meaning of trusts having the "same primary beneficiaries." The presumption provided in the regulation helps satisfy the second leg of §643(f)—that a principal purpose of the multiple trusts is to avoid Federal income tax. The example might have been resolved readily if the trusts did not meet the first leg of §643(f) because they did not have the same primary beneficiaries. The trusts seem to provide primarily for different beneficiaries–though some overlaps exists of the beneficial interests in the two trusts. The last sentence of the example saying that "absent other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust" suggests that aggregation could occur under the regulation, meaning that the trusts must be deemed to have the same "primary beneficiaries" even though the trusts seem to provide primarily for different beneficiaries. The example seems to take the position that relatively little crossover of beneficiary interests will be enough to say that the trusts have the same "primary beneficiaries," but no regulations purport to delineate what is required for trusts to have the same "primary beneficiaries."

The Joint Committee on Taxation General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 states that trusts will not be treated as having different primary beneficiaries under the new multiple trust rule "merely because the trusts have different contingent beneficiaries" and includes an example that is fairly similar to Example 2 in the Proposed Regulations but reaches the conclusion that the multiple trusts should not be aggregated. In the example in the Joint Committee Report, son is the mandatory income beneficiary of trust 1. Daughter is the discretionary beneficiary of income of trust 2 for education support, and maintenance and son is also a discretionary beneficiary of trust 2 of income or corpus for his medical expenses. Daughter is the remainder beneficiary of both trusts. While the Joint Committee Report concludes that the separate trusts would not be aggregated, it reaches that conclusion not because the trusts have different primary beneficiaries but because "there are substantial independent purposes, and tax avoidance is not a principal purpose for the existence of separate trusts." (Another example in the Joint Committee Report created four trusts for four children, with a "round robin" selection of only three of the children as discretionary beneficiaries of a particular trust, and each of the children were discretionary beneficiaries of three of the four trusts. One child is strategically eliminated from each of the trusts to create the appearance of differences, but the trustee has the discretion to distribute income among any of the three beneficiaries of each particular trust, and each child is a discretionary beneficiary of three of the trusts. This is somewhat of a reciprocal trust arrangement, and the practical effect is almost the same as if a single trust had been created for the four children. Without a concept of addressing that type of reciprocal arrangement, the "different primary beneficiary" test would become somewhat meaningless.)

The ambiguity created by the second example in the §643(f) proposed regulation and the similar example in the legislative history suggests that a more detailed description is needed of who is the "primary beneficiary" of a trust for purposes of §643(f).

The §643(f) multiple trust regulation purportedly applies to taxable years ending after the date that the proposed regulations was published in the Federal Register (August 16, 2018). Prop. Reg. §1.643(f)-1(d). If the regulation is finalized in 2018, it will be in effect for calendar year 2018 and tax years thereafter. The preamble (unsupported by language in the regulation itself) offers relief for pre-existing trusts, stating that the regulation applies only to "any arrangement involving multiple trusts entered into or modified on or after [August 16, 2018]." However, for potential multiple trust arrangements "entered into or modified before [August 16, 2018], the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f)," and the preamble states that before final regulations are published, the Treasury and the Service contend that proposed regulation section 1.643(f)-1 reflects Congressional intent concerning multiple trusts "that are appropriately subject to treatment under section 643(f)." The net effect might be interpreted to apply the reasoning of the proposed regulation to multiple trusts existing before August 16, 2018.

L. Fiscal Year Entities

Planners have wondered how income from a fiscal year entity, with a fiscal year ending in 2018, would be treated for QBI purposes. Section 199A applies to taxable years beginning after 2017 and before 2026. The proposed regulations take the very taxpayer-friendly position that "[f]or purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items" from a fiscal year entity with a fiscal year ending after 2017, "such items are treated as having been incurred during the individual's taxable year in which or within which such RPE taxable year ends." Prop. Reg. §1.199A-6(e)(2)(ii).

The phrase "receives any of these items" is ambiguous, but presumably that refers to income and expenses reported to the owner on the Schedule K-1 from the entity for the fiscal year ending after 2017. This means that income actually earned by an entity in 2017 but during the fiscal year ending in 2018 will qualify as QBI in 2018 for which the owner may receive a 20% deduction. This good news will lead to some practical problems in implementation, particularly for fiscal years ending in 2018.

> This means that an individual could receive a 2017 Schedule K-1 from a passthrough entity whose fiscal year ends on January 31, 2018 and the individual can include the entire 12 months income from the passthrough entity as QBI on his or her 2018 Form 1040, despite that 11 months of the income was earned before January 1, 2018.
>
> The IRS's decision was probably based on a desire for simplicity and administrability. However, the proposed regulations failed to address how the individual would determine its share of QBI, W-2 wages, or UBIA of qualified property from the passthrough entity's Schedule K-1 when the entity is not required to report those items to its partners and shareholders until years beginning on or after the date the final regulations are published in the Federal Register. Until further guidance is issued, partners and shareholders of fiscal year passthrough entities may just have to use any reasonable method to determine their share of these QBI items." Carol Cantrell, *Mastering the New Qualified Business Income (QBI) Rules and Avoiding Penalties*, TEXAS SOC'Y OF CPAS 2018 ADV. EST. PL CONF. at 21-22 (August 2018).

M. Reporting Requirements for Passthrough Entities

Partnerships and S corporations involved in any trade or business will have to make additional computations and provide additional information to their owners. The §199A deduction is not available to the RPE, but applies to the owners of the RPE on their individual returns. "The RPE must determine and report the information necessary for its direct and indirect owners to determine their own section 199A deduction." Preamble, at 74. The RPE must make various computations. It must (i) determine if it is engaged in one or more trades or businesses and whether any of those are SSTBs, (ii) determine the QBI of each business engaged in directly, (iii) determine the W-2 wages and UBIA of qualified property for each business engaged in directly, and (iv) determine whether it has any REIT dividends or PTP income directly or through another RPE or PTP. Prop. Reg. §1.199A-6(b)(2).

After making those determinations, the RPE must report on the Schedule K-1 issued to its owners the QBI, W-2 wages, and UBIA of qualified property attributable to each separate trade or business and whether any of the businesses are SSTBs. The RPE must report on a statement attached to Schedule K-1 those items reported to it by another RPE in which the RPE owns an interest. Prop. Reg. §1.199A-6(b)(3).

If the RPE fails to "identify or report" that information on the Schedule K-1, the owner's share of any QBI, W-2 wages and UBIA of qualified property will be presumed to be zero. Prop. Reg. §1.199A-6(b)(3)(iii).

Accordingly, each partnership or S corporation engaged in a trade or business has a serious responsibility to determine and report information to owners so that they have the information to claim the §199A deduction with respect to the entity's trade or business activities.

N. Impact of §199A on Tax Calculation and Other Taxes

1. **No Reduction of AGI; Deduction Available to Non-Itemizers**. The deduction reduces taxable income, but not AGI (so the deduction does not affect limitations throughout the Code based on AGI). The deduction is available to both itemizers and non-itemizers. (In other words, the deduction is available in addition to the standard deduction.)

   On the draft Form 1040 for 2018, the qualified business income deduction appears at the bottom of page 1 of Form 1040 after the lines for adjusted gross income and the standard deduction. It is neither an "above the line" deduction in arriving at adjusted gross income nor an itemized deduction.

2. **Effect of Deduction for Partners or S Corporation Shareholders.** The §199A deduction is applied to the owner's individual income tax, not at the partnership or corporation level. It has no effect on the adjusted basis of partner's interest, the adjusted basis of an S corporation shareholder's stock, or an S corporation's accumulated adjustments account. Prop. Reg. §1.199A-1(e)(2).

3. **Self-Employment Tax.** The §199A deduction does not reduce self-employment income under §1402. §199A(f)(3); Prop. Reg. §1.199A-1(e)(2).

4. **Net Investment Income.** The §199A deduction does not reduce net investment income under §1411. §199A(f)(3); Prop. Reg. §1.199A-1(e)(2).

5. **Alternative Minimum Tax.** The QBI deduction is the same for both regular tax and AMT purposes. Prop. Reg. §1.199A-1(e)(4).

O. Penalties

The 2017 Tax Act amended §6662 to provide that the 20% penalty for substantial understatement of income tax will apply if the understatement exceeds the greater of $5,000 or 5% (rather than 10%) of the tax required to shown on the return if the individual claims a §199A deduction. §6662(d)(1)(C). Therefore, if an individual claims merely $1 of deduction under §199A, the standard for applying the understatement penalty is 5% rather than 10%, regardless of whether the understatement is attributable to QBI. As always, the penalty does not apply if the taxpayer has "substantial authority," Reg. §1.6662-4(d)(3)(i), or if the taxpayer has a "reasonable basis" for the position. §6662(d)(2)(B).

P. Resources

Some excellent resources regarding the new proposed regulations include the following. Carol Cantrell, *Mastering the New Qualified Business Income (QBI) Rules and Avoiding Penalties*, TEXAS SOC'Y OF CPAS 2018 ADV. EST. PL CONF. at 21-22 (August 2018); Gassman Shenkman, Ketron, Denicolo & Crotty, *Proposed Regulations for 199A – The Good, The Bad, the Taxpayer-Unfriendly*, LEIMBERG INFORMATION SERVICES INC. TAX PL. NEWSLETTER #152 (Aug. 13, 2018); Tony Nitti, *IRS Provides Guidance On 20% Pass-Through Deduction, But Questions Remain*, FORBES (August 9, 2018).